January 2012
IMF Country Report No. 12/14

Kenya: 2011 Article IV Consultation, Second Review Under the Three-Year Arrangement Under the Extended Credit Facility and Requests for Modification of Performance Criteria and Augmentation of Access—Staff Report; Public Information Notice and Press Release on the Executive Board Discussion; 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 a combined discussion of the 2011 Article IV consultation with Kenya, Second Review Under the Three-Year Arrangement Under the Extended Credit Facility and Requests for Modification of Performance Criteria and Augmentation of Access, the following documents have been released and are included in this package:

- The staff report for the combined 2011 Article IV Consultation, Second Review Under the Three-Year Arrangement Under the Extended Credit Facility and Requests for Modification of Performance Criteria and Augmentation of Access, prepared by a staff team of the IMF, following discussions that ended on October 31, 2011, with the officials of Kenya on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 23, 2011. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN) and Press Release, summarizing the views of the Executive Board as expressed during its December 9, 2011, discussion of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively.

- A statement by the Executive Director for Kenya.

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

Letter of Intent sent to the IMF by the authorities of Kenya*
Memorandum of Economic and Financial Policies by the authorities of Kenya*
Poverty Reduction Strategy Paper--Progress Report
Technical Memorandum of Understanding*

*Also included in Staff Report

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

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INTERNATIONAL MONETARY FUND

KENYA

Staff Report for the 2011 Article IV Consultation, Second Review Under the Three-Year Arrangement Under the Extended Credit Facility and Requests for Modification of Performance Criteria and Augmentation of Access

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

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

November 23, 2011

Background: After recovering in 2010, the Kenyan economy has faced a number of challenges in 2011, including the severe drought in the Horn of Africa and high international commodity prices that have affected both the urban and the rural poor. However, growth momentum has been preserved. But the combination of external shocks and strong domestic demand, fueled by rapidly expanding credit to the private sector, has led to sharp inflationary pressures, a widening of the current account deficit, and the depreciation of the shilling.

Program: The Executive Board approved a three-year ECF for Kenya on January 31, 2011 for SDR 325.68 million (120 percent of quota). Policies in the first half of 2011 remained in line with the program. All June program targets were met. However, net domestic assets (NDA) and net international reserves (NIR) deviated from their September indicative targets because the authorities delayed their monetary policy response to inflation, expecting a reversal in international and domestic food prices that did not materialize. The authorities are now adopting decisive measures to address macroeconomic imbalances. On the strength of these policies, the authorities are requesting augmentation of access equal to 60 percent of quota under the Extended Credit Facility (ECF) arrangement for total access equivalent to 180 percent of quota.

Discussions: The team comprised Messrs. Fanizza (head), Morales, Milkov, and Ms. Raei (all AFR) and Mr. Liu (SPR). Ms. Meeyam (MCM) provided support from Headquarters. Discussions were held in Nairobi October 13–31, 2011. Mr. Gudmundsson (Resident Representative) participated in the discussions, and Ms. Rose Ngugi from the Executive Director's office joined the mission. The mission met Prime Minister Odinga, Deputy Prime Minister and Minister of Finance Kenyatta, Central Bank Governor Ndung'u, the Parliament Finance and Budget Committees, other senior officials, representatives of the private sector including financial institutions, and the donor community.

Staff views: The staff recommends completion of the review, modification of all performance criteria and indicative targets for the next 12 months to fit the revised balance of payments outlook, and approval of augmentation of access equal to 60 percent of quota with frontloading equal to 18 percent of quota for the first disbursement and four disbursements equivalent to 10.5 percent of quota. Kenya continues to maintain an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.

Publication: The authorities have consented to publication of the staff report and Letter of Intent and its attachments.

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ACRONYMS

CBK	Central Bank of Kenya
CBR	Central Bank rate
CPI	Consumer Price Index
CPIA	Country Policy and Institutional Assessment
ECF	Extended Credit Facility
IFMIS	Integrated Financial Management and Information System
KNBS	Kenya National Bureau of Statistics
KRA	Kenya Revenue Authority
Ksh	Kenyan Shilling
MTDS	Medium-Term Debt Management Strategy
MTP	Medium-Term Plan
NDA	Net Domestic Assets
NIR	Net International Reserves
NPV	Net Present Value
ODC	Other Depository Corporation
PC	Performance Criteria
PFM	Public Financial Management
PPG	Public and Publicly Guaranteed
PPP	Public Private Partnership
SDR	Special Drawing Rights
SSA	Sub-Saharan Africa
TMU	Technical Memorandum of Understanding
VAT	Value-Added Tax
WB	World Bank

Executive Summary

Kenya's economy has continued to expand, but high inflation and exchange rate pressures are threatening the growth outlook. Economic activity has remained strong, with GDP growth above 5 percent in FY 2010/11 and little sign of a slowdown so far. The drought in the Horn of Africa, higher international prices and strong domestic demand have boosted inflation—18.9 percent in October—and swelled the external current account deficit. Because monetary authorities hesitated to respond to these developments, inflationary expectations heightened, leading to a rapid depreciation of the shilling that if not addressed could destabilize macroeconomic conditions and bring growth to a halt. The authorities have already started to adjust their policies to stem inflationary expectations and stabilize the exchange rate to preserve the basis for continued growth.

Program implementation during the first half of 2011 was in line with the objectives. All quantitative performance criteria and indicative targets for June 2011 have been met. In particular, the fiscal position at end-June was significantly better than expected, thanks to strong revenue performance and strict expenditure control. Structural reforms have also moved forward and the benchmark on the submission of the value-added tax (VAT) law is set to be met before the end of January 2012. After June 2011, monetary policy response to inflation shocks was delayed in the expectation of a reversal in international and domestic food price increases that did not materialize. Since September 2011, the central bank has increased its policy rate significantly and maintained a tightening bias to discourage excessive credit growth, which had previously fueled inflation and widened the external current account deficit.

The authorities have requested augmentation of access under the Extended Credit Facility (ECF) arrangement to deal with the impact of the drought and higher-than-anticipated international prices, and they have adopted additional measures to address macroeconomic imbalances. Fiscal policy in 2011/12 will be geared toward rationalizing non-priority expenditure to contribute to the stabilization effort, while expanding targeted policies to shield the poor from the impact of higher prices. This will help contain the primary fiscal deficit and reduce the public debt-to-GDP ratio to below 43 percent by end 2013/14. The central bank will maintain a tightening bias to bring inflation down within the authorities' target range (5 ± 2 percent) by end-2012. The floating exchange rate regime will be maintained, and the central bank will resume the buildup of its international reserve buffer once the exchange rate stabilizes.

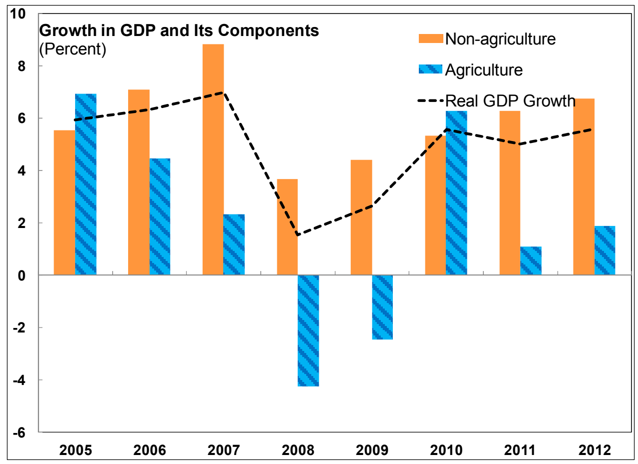
Fundamental reforms under the program are under way. The Public Finance Management (PFM) Law is ready for submission to the Commission on the Implementation of the Constitution. The new VAT law will contribute significantly to increasing revenue mobilization and minimize administrative costs. Financial sector reform will aim at strengthening cross border supervision and enhancing risk management. Capital markets reform will allow small and medium-size enterprises (SMEs) to expand their access to new sources of financing, and pension schemes will be redefined under a comprehensive pension reform that will transform the National Social Security Fund (NSSF) into a social insurance pension scheme.

Risks to the program implementation arise from a further deterioration of the global outlook and possible heightened political tensions. The latter are associated with the upcoming 2012 elections and the International Criminal Court hearings on the 2007 post-election violence. In addition, security concerns linked to the ongoing military operations at the Somali border could have an adverse impact on both tourism inflows and the budgetary position.

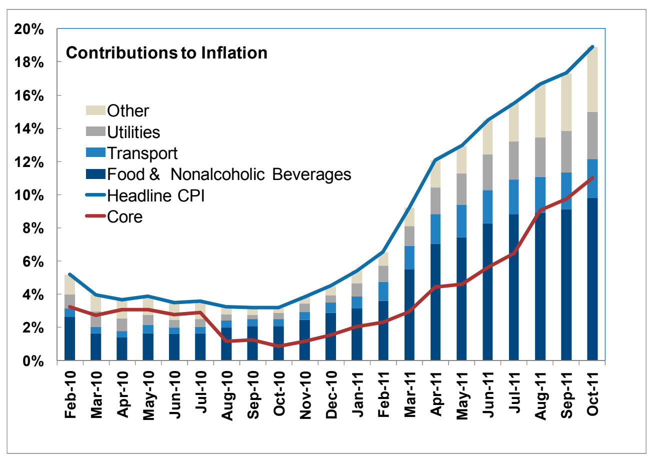
I. MACROECONOMIC DEVELOPMENTS AND PROGRAM IMPLEMENTATION

1. **Kenya's economy has continued to expand, but inflation and exchange rate pressures have increased sharply as a result of external and domestic factors.** The drought in the Horn of Africa has magnified the impact of the surge in global food and oil prices. Balance of payments needs have grown as a result of persistently higher international prices and the cost of supporting the population affected by the famine. Delays in the monetary policy response to rising inflationary expectations, coupled with a widening external current account deficit, have placed strong pressures on the exchange rate.

- **GDP growth has shown little sign of slowing down so far and is estimated at 5.3 percent in 2010/11**. Private investment remains dynamic and has supported growth above 5 percent across all non-agricultural sectors. Agriculture is recovering from the downturn in the first quarter of 2011.

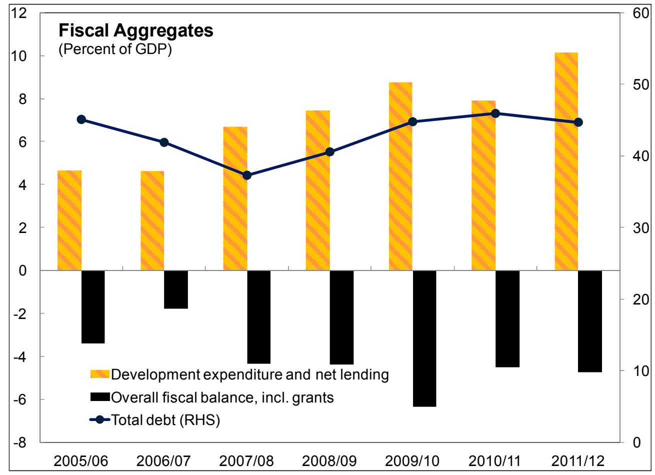


- **Inflation reached 18.9 percent in October (11.3 percent for core inflation), well above the Central Bank of Kenya (CBK) target range (5 ± 2 percent).**[1] Food and fuel inflation have remained higher than anticipated, and exchange rate depreciation has led to higher inflation expectations and an acceleration of core inflation.

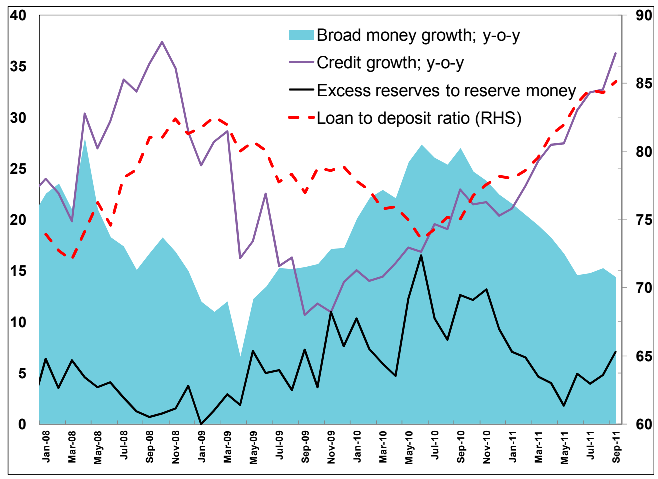


[1] Core inflation is defined as inflation excluding food and energy from the consumer basket.

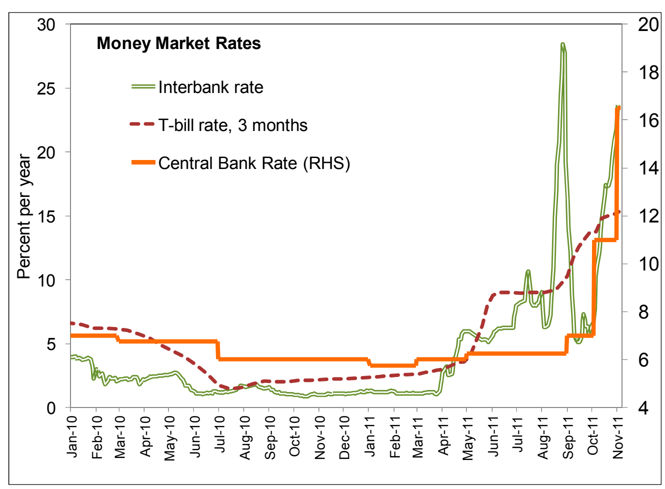
- **Fiscal policy has moved toward consolidation.** The primary deficit declined from 3.8 percent of GDP in FY 2009/10 to 1.5 percent of GDP in FY 2010/11 because of delays in domestically-financed investment, restraint in current spending, and strong tax revenue performance. The FY 2010/11 primary balance was significantly above the program floor.



- **Private sector credit growth accelerated to 36 percent in September, about twice the rate of the year before.** From the first quarter of 2011, credit growth has exceeded deposit growth as the latter has slowed down in the face of higher inflation. Monetary policy remained in line with the program targets until end-June 2011, but it became looser than programmed with the CBK's net domestic assets (NDA) above the September indicative targets under the program.[2]

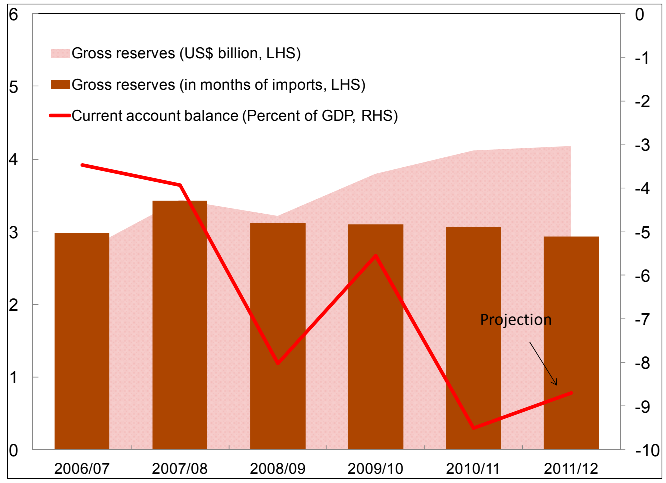


- **The CBK has raised its central bank rate (CBR), its policy rate, by 9 ½ percentage points since October to reverse inflationary pressures**, pushing commercial banks to adjust their lending interest rates. Interbank interest rates hovered around 17 percent in October from below 2 percent in January 2011. Treasury bill rates have risen sharply, although they are still slightly below interbank rates.

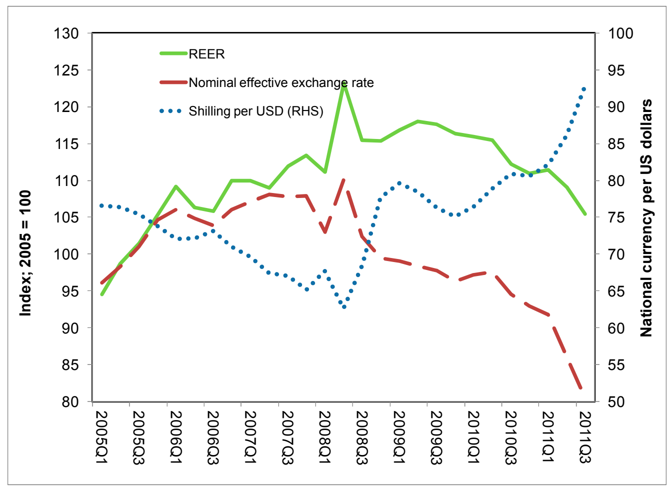


[2] September 2011 NDA stood at negative Ksh 26 billion compared to the ceiling target of negative Ksh 45 billion. September 2011 NIR stood at USD 3,436 million, compared to the floor target of USD 3,600 million. The fiscal indicative targets for September 2011 were all met.

- **High international prices, strong domestic demand, and higher drought-related energy and food imports swelled the external current account deficit** to an estimated 9.5 percent of GDP in 2010/11 from 5.5 percent the previous year. The CBK observed the June net international reserves (NIR) target under the program. However, NIR started to decline since June because the CBK suspended foreign exchange purchases in light of persistent exchange rate pressures.



- **The nominal effective shilling exchange rate depreciated by 15 percent this year through September 2011 reflecting balance of payments pressures and high inflation.** Except for small-size foreign exchange sales in recent weeks, the central bank has allowed the exchange rate to adjust to absorb the external shocks.



2. **The implementation of the structural reforms under the program has progressed.** The value-added tax (VAT) bill is almost ready to send to parliament (structural benchmark for the second review), and submission to the Commission on the Implementation of the Constitution of a public finance management (PFM) bill that harmonizes different views within the government is expected by end-2011. The government is in the process of incorporating relevant suggestions from the public on the draft VAT bill. The government has also made significant progress in preparing the ground for the implementation of an Integrated Financial Management and Information System (IFMIS), which will facilitate expenditure controls.

3. **Kenya's growth potential remains hampered by the lack of adequate infrastructure and an economic activity that is heavily dependent on climatic vagaries.** The authorities have started to (i) upgrade the country transport infrastructure by investing on new roads and ports; (ii) invest in geothermal energy to reduce the country's dependence on hydro-power generation that has been affected by the increased frequency of droughts; and (iii) expand the coverage of the irrigation systems to reduce the impact of droughts on agriculture.

II. The Issues

4. ***Kenya faces adverse external conditions from the drought in the Horn of Africa, persistently high import prices, and the weak global financial environment. These conditions have magnified the inflation and currency depreciation pressures from the ongoing expansion of domestic demand. The authorities believe that high inflation and exchange rate instability now threaten to bring to a halt the economic expansion. They plan to adjust monetary and fiscal policies to rein in excessive growth of domestic demand, to bring inflation down and preserve the basis for continued growth. Augmentation of access under the ECF arrangement would prevent the need for an abrupt adjustment.***

A. Heightened External Vulnerabilities

5. **Adverse external conditions have placed pressures on Kenya's external position.** The drought in the Horn of Africa has hit Kenya hard (Box 1). The need for emergency food relief for about 10 percent of the country's population and for Somali refugees has raised balance of payments needs. Increases in import prices appear more persistent than previously anticipated, explaining most of the deterioration of the external current account (cumulative 1.8 percent of GDP) over the medium term relative to the projections at the time of the first review. Also, weakened global financial conditions have reduced expected financial inflows.

Box 1. Horn of Africa Drought and Food Crisis: Impact on Kenya

The drought in the Horn of Africa has hit Kenya hard. The overall contribution to GDP of drought-affected areas is just about 5 percent, but the number of Kenyans in need of immediate food aid could reach 3.75 million, concentrated in the country's north and north-eastern districts. The total number of refugees from Somalia in Kenya has reached nearly 600,000 at end-September 2011.

The negative impact of the drought on 2011/12 GDP is estimated at about 0.4 percent. This includes a direct impact of about 0.2 percent of GDP, chiefly from loss of livestock, and an additional slowdown of similar magnitude in agriculture and hydropower generation because of lower than normal rainfall.

The drought exacerbated inflationary pressures by limiting domestic supplies of cereals and increasing the cost of imports. It also put pressure on the balance of payments, because of higher food imports for emergency humanitarian assistance (about 1.7 percent of GDP), and increased fossil fuel imports (0.6 percent of GDP) needed to substitute for lower hydropower generation. In response to the drought, the authorities have reallocated expenditure equal to about 0.3 percent of GDP within the 2011/12 budget to help the most vulnerable households to mitigate the impact of the crisis.

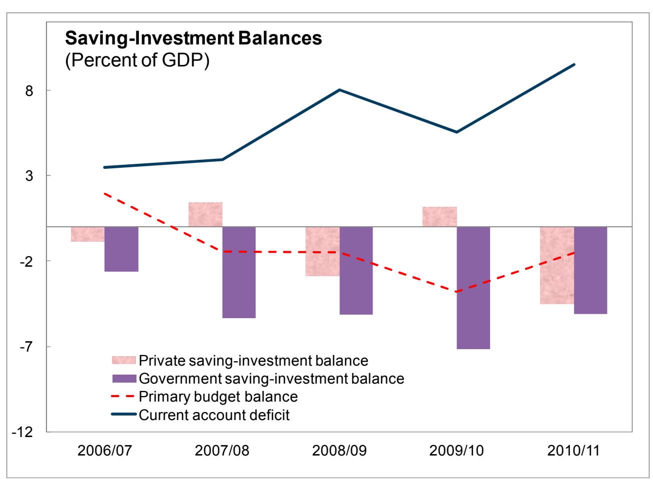
The recurring nature of droughts in Kenya points to the need for long-term solutions. These include investments in irrigation schemes; enhancements of market mechanisms for the production, storage, and distribution of cereals; improvements of road infrastructure for access to drought-prone areas; and investments in renewable energy to reduce the country's dependence on thermal power.

Indicators of the Estimated Near-Term Impact of the Drought

	2011/12	2012/13	Total
Economic activity (percentage points of GDP)			
Direct impact (loss of livestock)	0.2	-	0.2
Indirect impact (agriculture and power generation)	0.2	-	0.2
Balance of payment (US$ millions)			
Emergency humanitarian assistance [1/]	373	187	560
Additional fossil fuel imports	190	-	190
Fiscal policy (percent of GDP)			
Assistance to vulnerable households (budget reallocation)	0.3	-	0.3

1/ The humanitarian assistance need for 2011/12 is based on estimates from OCHA and for 2012/13 are based staff estimates.

B. Monetary Policy and Macro-financial Imbalances



6. **The authorities explained that the decision to delay the response of monetary policy in June-September 2011 reflected the expectation of a reversal in the international and domestic food price increases.** The CBK resisted raising interest rates to address rising inflationary expectations. As demand pressures

mounted, inflation became persistent and reached its historical peak in October.[3] Policy delays have also contributed to the buildup of macroeconomic imbalances. The loose monetary conditions contributed significantly to the substantial deterioration of the private savings-investment balance in FY2010/11.

7. **Low interest rates not only fueled higher inflation pressures (Box 2), but also encouraged financial arbitrage against the shilling and delayed the execution of the government borrowing program:**

- The interest rate on the CBK overnight lending facility has often been below interbank market interest rates, encouraging its use by banks as a regular funding facility, sometimes in volumes that have exceeded total daily interbank transactions.

- Low interbank interest rates at the beginning of 2011 encouraged offshore banks to borrow in Kenya shillings to take long foreign exchange positions. This may have contributed to the rapid exchange rate depreciation.

- The government has raised interest rates on its securities sharply, but not to a level high enough to attract sufficient financing. Moreover, banks' appetite for government securities has declined as a larger share of government securities is held to maturity to avoid further mark-to-market losses. As a result, the government has used all of the available CBK financing under the statutory limits (overdraft facility) in FY 2011/12.

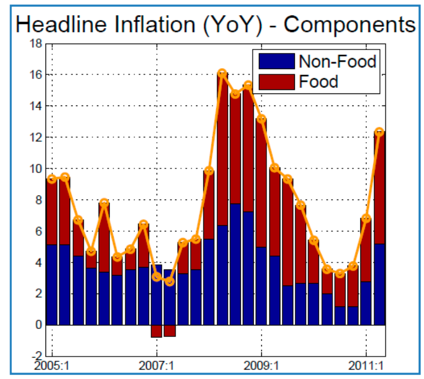
8. **The authorities emphasized that rapid private sector credit growth has been driven by demands reflecting a welcome dynamism in economic activity, but they agreed that easy monetary conditions have more recently played a key role** (Box 3). Demand for investment financing and working capital has steadily increased for banks oriented toward the corporate sector. Personal and real estate loans have increased faster, raising their share in total loans markedly.

9. **The acceleration of credit growth has heightened credit and liquidity risk**. Half of total bank loans are concentrated in personal, real estate and trade loans, sectors more sensitive to a possible deterioration of the quality of the loan portfolio arising from high interest rates or a slowdown in retail economic activity. Liquidity risks and funding costs are rising faster for small banks with limited access to interbank markets and wholesale funds in an environment of higher interest rates and rapid credit growth.

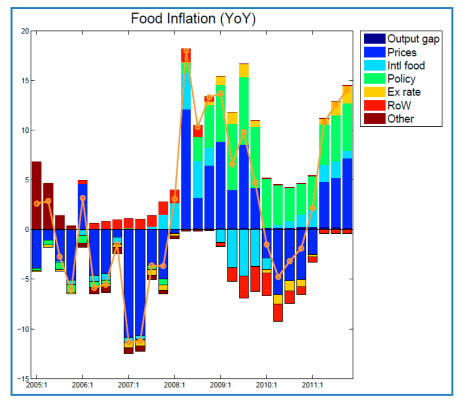
[3] Based on the modified CPI time series described in Appendix I.

Box 2. Monetary Policy and Food Inflation: A Model for Policy Analysis[1/]

Disentangling the effects of food inflation shocks –both domestic and foreign- from other inflationary pressures is of crucial importance for assessing the monetary policy stance in Kenya. We use a small monetary model for this purpose, adapted to the specific features of Kenya. The model incorporates food and non-food price dynamics via two separate Phillips Curves and a Taylor-type monetary policy rule. The model's parameters are not econometrically estimated but calibrated to be consistent with the structure of Kenya's economy.

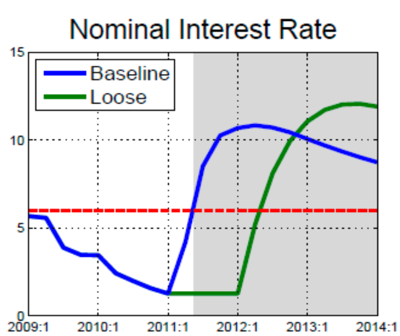


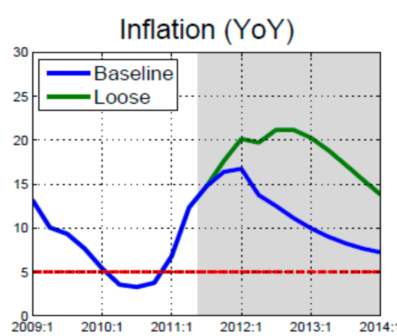
We apply the model to decompose historical data into trends and shocks. The main findings are as follows:[2/]



- Imported food shocks have accounted for some of the inflation dynamics in Kenya, both in 2008 and 2011, but domestic food shocks (harvest shocks) have also played a role.
- Loose monetary policy has played an important role in driving inflation above trend in 2008 and 2011.
- Despite the accommodative monetary stance, inflation rapidly declined towards the end of 2008. This sharp fall was mainly explained by external disinflationary forces (rapid fall in commodity prices owing to global recession) and a sharp slowdown in private domestic demand because of political uncertainty.
- However, in 2011, private domestic demand remains strong and global commodity prices are projected to stay high.

Model simulations suggest that, unlike the 2008 food inflation episode, higher international prices and strong domestic demand require prompt monetary policy tightening, whereas a delayed response would lead to higher inflation and would require a stronger adjustment later on.



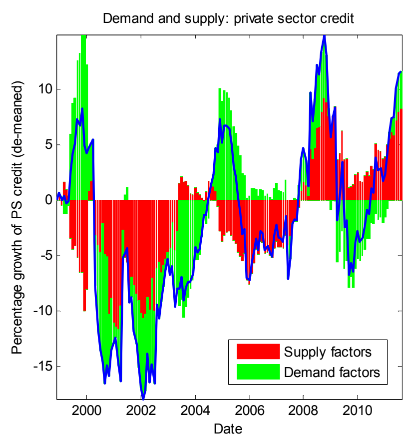


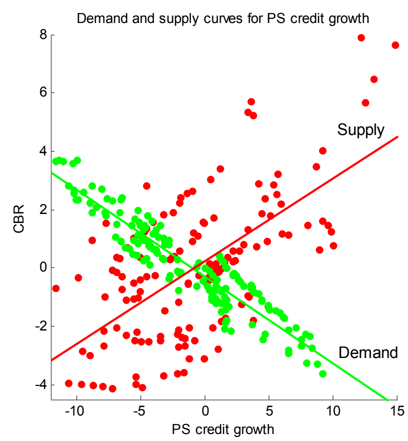
1/ The model is work in progress by IMF staff from the African Department (AFR) and the Research Department (RES), with the collaboration of OG Research.

2/ The second chart illustrates the contributions of different shocks to food inflation. Shocks comprise output gap, exogenous prices (Prices), international food prices (Int. food), policy changes (Policy), exchange rate (ex rate), external demand (RoW) and residual shocks (Other).

Box 3. Is Private Sector Credit Growth Supply or Demand Driven?

Economic recovery explains increasing demand for credit, but more recently supply factors, in the form of low interest rates, seem to play a more important role in explaining credit growth. Private sector (PS) credit growth reached 36 percent (year on year) in end-September 2011 on the back of the strong economic recovery and historically low interest rate environment. Historical shock decomposition analysis [1/] that identifies the contribution of supply and demand factors suggests demand factors explained most of the rise in private sector (PS) credit growth during the 2009–10 economic recovery. However, since mid-2010, supply factors driven by declining interest rates and easy monetary conditions have played the dominant role. Despite the increase in interest rates at the end of the sample, supply factors continue to contribute to above average credit growth. Using the elasticity of the demand for PS credit, we find that a 1 percent increase in the repo rate (an upward vertical shift of the supply curve) reduces PS credit growth by about 3 percentage points for a given level of credit demand.





1The historical decomposition is based on a bi-variate monthly VAR of private sector credit growth and the repo rate. A positive supply shock assumes a decrease in the repo rate (price) and an increase in private sector credit (quantity), whereas a demand shock assumes an increase in both the repo rate and PS credit.

III. Policy Adjustment and the ECF-supported Economic Program

10. ***The authorities' economic program plans additional adjustment in monetary and fiscal policies to strengthen the external position while preserving the basis for strong growth. The policies will focus on reducing domestic absorption by gradually bringing the growth in domestic demand more in line with that of available resources, in order to curb inflation and lower the external current account deficit. However, the authorities believe that, in light of the worsened external position, they would require additional Fund financing to be able to gradually accumulate international reserves to the equivalent of four months of imports by the end of the program period. Moreover, they stressed that enhanced Fund support in the near term will help their efforts to stabilize the exchange rate and rein in inflation while maintaining growth at above 5 percent in 2011/12***:

- **Monetary policy will bear the brunt of the adjustment to rein in domestic demand.** The CBK has raised its policy interest rate substantially and will seek to keep a tight policy to bring inflation down to the upper bound of the inflation target range by end-

2012, helped by a reduction in international food and fuel prices in line with WEO projections.

- **Fiscal policy will continue to focus on medium-term consolidation, and will front load the adjustment to temper domestic demand.** The authorities have adopted a somewhat more ambitious medium-term target to deal with the worsened balance of payments outlook. The objective is now to bring the debt-to-GDP ratio to about 41 percent by FY 2014/15, compared with over 44 percent under the original program. The primary deficit target for FY 2011/12 has been adjusted downward despite additional spending to prepare for the 2012 elections and conduct the operations at the Somali border.

- **Policy adjustment would be complemented by additional financing from international development partners and increased access under the ECF arrangement to help rebuild the international reserves buffer (Table A).** Exogenous shocks and demand pressures increased financing requirements by 4.9 percent of GDP relative to the First Review over FY 2011/12 to FY 2014/15. The external current account deficit is expected to narrow by 3 percentage points of GDP over the program period, despite a projected continuous deterioration of the terms of trade. This improvement will result mainly from the impact of policies on imports of goods and services. The domestic-foreign interest rate differential should attract capital inflows to Kenya once the exchange rate stabilizes.

Table A. Financing Requirements (with respect to the First Review) and Policy Adjustments Under Passive and Active Scenarios

	2011/12	2012/13	2013/14	2014/15
		(percent of GDP)		
Additional financing requirements in passive scenario	1.9	1.5	1.1	0.4
of which: Exogenous shock (international prices and the drought)	1.4	1.1	0.9	0.4
Demand pressures	0.5	0.4	0.2	0.0
Policy adjustments in the active scenario	1.1	0.8	0.8	0.4
Change in private saving-investment balance (Monetary tightening)	0.6	0.6	0.5	0.4
Change in public saving-investment balance (Fiscal adjustment)	0.5	0.2	0.3	0.0
Additional financing requirements in the active scenario	0.8	0.6	0.3	0.0
Development partners	0.5	0.4	0.2	0.0
IMF Augmentation	0.3	0.2	0.1	0.0
Memorandum items:				
External current account in passive scenario	-9.7	-9.0	-7.2	-6.0
External current account in active scenario	-8.6	-8.2	-6.4	-5.5

- **Financial sector policy will concentrate on mitigating credit and liquidity risks potentially arising from an environment of high interest rates.** Following a period of buoyant credit growth, monetary policy tightening may bring about an increase in non-performing loans (NPLs) that may affect the financial soundness of banks with weaker balance sheets.

A. Reining in Inflation

11. **Starting in October 2011, the CBK has tightened monetary policy and streamlined its monetary policy framework.** The CBK has increased its policy rate (CBR) to 16.5 percent in several steps. Under the new monetary policy framework, the CBK will use the CBR to guide interbank market rates to achieve the NDA operational target. In addition, the CBK raised reserve requirements by 0.5 percent to 5.25 percent of liabilities (to become effective on December 15, 2011).

12. **To mitigate pressures on the shilling, the CBK has lowered the limit on banks' net open currency position from 20 percent to 10 percent of assets and set a minimum tenure of seven days for currency swaps.** In addition, it has taken several measures that would limit scope for non-resident banks to take positions against the shilling. These include (i) a one-year minimum period to borrow or lend in shillings from/to non-resident banks; and, (ii) a restriction to use non-resident shilling accounts for purposes not justified by underlying customers' transactions.

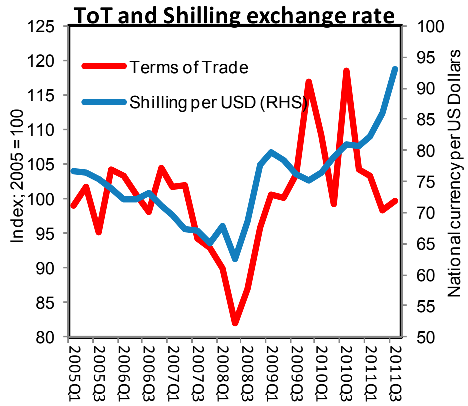
13. **Looking forward, monetary policy would seek to ease inflationary expectations and bring down inflation to the upper bound of the inflation target by end-2012.** Credit growth is expected to decelerate to 20 percent by June 2012. The government intends to borrow from the CBK only on a temporary basis with a zero balance on the overdraft facility by the end of the fiscal year. Accumulation of international reserves will resume gradually. To assess the extent of the needed monetary policy response, the central bank intends to monitor developments in (a) its net domestic assets in relation to the program targets, (b) private credit growth, (c) interbank market rates and volumes and (d) interbank foreign exchange markets. In addition, to gauge inflation expectations, it will extract information from the evolution of yield curve and the market survey it conducts on monthly basis.

14. **The floating exchange rate regime has helped to absorb the impact of exogenous shocks**. The Kenyan shilling depreciated against major currencies in 2011 reflecting deteriorations in the terms of trade and persistently high inflation. The REER depreciated by 6.5 percent from December 2010 to September 2011, in line with the deterioration of the current account balance. The authorities indicated that their internal assessment did not point to significant real exchange rate misalignment. This assessment is in line with staff's external stability and sustainability analysis, which finds no significant evidence of exchange rate misalignment or threat to medium-term external sustainability (Figure 1).

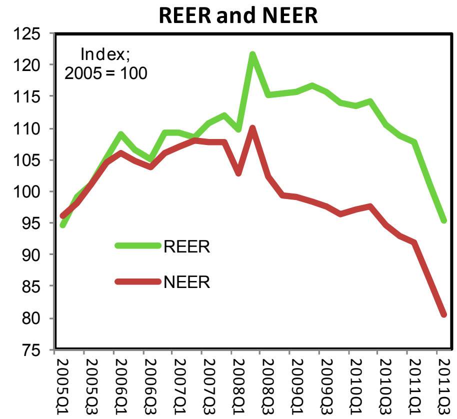
15. **The government indicated its commitment to maintaining free prices and avoiding price controls.** Parliament has approved a law giving the ministry of finance the power to declare some goods essential and cap their prices, but the government indicated that it will refrain from using these powers and continue to rely instead on targeted subsidies and cash transfers to protect the poor.

Figure 1. Kenya: External Stability and Sustainability Analysis

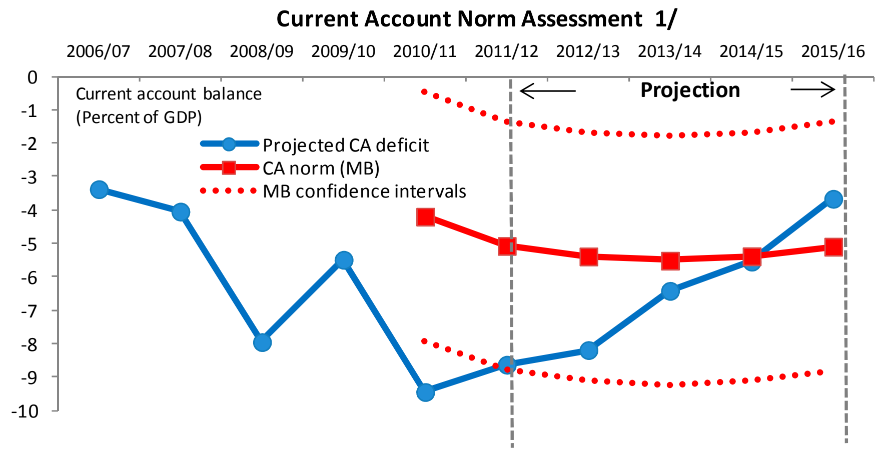
Terms of trade deterioration has placed renewed pressures on the Kenyan shilling exchange rate...



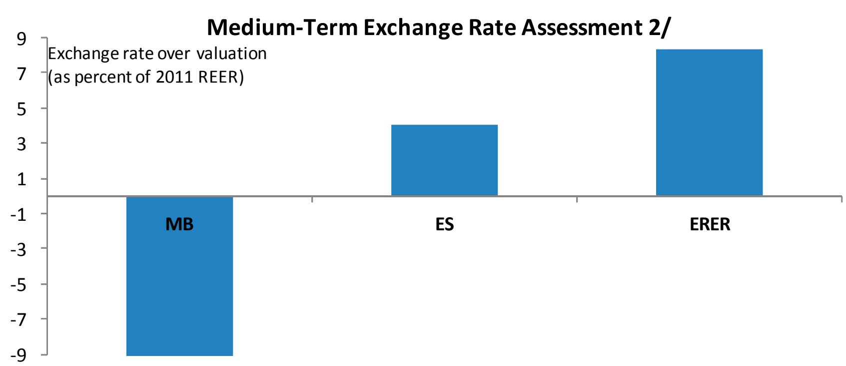
...while the NEER and REER have depreciated consistent with the deterioration of the external current account.



The projected medium-term current account deficit is in line with staff's assessment of the medium-term sustainable current account balance using the macro balance approach.



The assessment of the current real effective exchange rate using three alternative models are within the 10 percent band, which does not constitute significant evidence of exchange rate misalignment.



Sources: Country data and IMF staff estimates.

1/ The macroeconomic balance (MB) and external sustainability (ES) current account norm approach are based on panel regression estimates by Vitek (2010).

2/ Three models include: the macroeconomic balance (MB), the external sustainability (ES), and the equilibrium real exchange rate assessment (ERER) approach, see Vitek (2010). The trade balance elasticities are based on the estimates by Tokarick (2010). The exchange rate assessment is based on the average real effective exchange rate for 2011 up to end-September.

B. Consolidating the Fiscal Position

16. **The authorities aim at a fiscal primary deficit of 2.2 percent of GDP in FY 2011/12, down from 2.7 percent envisaged in the first program review.** This level is consistent with program objectives and frontloaded adjustment, and includes the cost of implementing the constitution, preparing elections, and financing the security operations at the Somali border. To achieve this target, the authorities plan to keep a tight lid on current outlays and, if needed, delay the implementation of low-priority investment projects.

17. **In the medium term, the authorities plan to bring the fiscal primary deficit to 1.4 percent of GDP by FY 2013/14.** This would reflect an increase in revenue from 24.5 percent of GDP in FY 2011/12 to 25 percent of GDP in FY 2013/14. Total expenditure and net lending are projected to decline by 0.1 percent of GDP in the same period, allowing capital spending increase from 10.1 to 10.5 percent of GDP.

18. **To further progress towards their medium-term consolidation objectives, the authorities plan to focus on expenditure control and prompt implementation of the VAT law.** The government would continue to seek savings in non-priority spending, contain growth in the wage bill, and reprioritize investment spending. It would also boost revenue collection through the implementation of the VAT law. Before submitting the bill to parliament for approval, the government is incorporating suggestions to the VAT law, including suggestions from the Fund.[4]

19. **The authorities intend to reinstate in FY 2012/13 the excise tax on diesel fuel that was removed to mitigate the impact of higher fuel prices on the purchasing power of the vulnerable portion of the population.** The elimination of excise taxes on kerosene and its reduction for diesel fuel, the release of maize reserves, and the removal of tariffs on maize and wheat imports have led to an estimated revenue loss of 0.3 percent of GDP in FY2011/12. These measures will be replaced by targeted policies, including expanding Kenya's existing social safety net programs for both urban and rural areas, with a neutral impact on revenue.

20. **Kenya continues to follow its prudent medium-term debt strategy, but changing financial conditions pose challenges.** The sharp increase in the cost of domestic financing has complicated borrowing decisions while exchange rate depreciation has raised the value of external debt significantly. The Debt Management Office (DMO) has maintained its policy of providing guarantees only for energy projects (still in the pipeline). A draft Private-Public Partnership (PPP) Act plans the review of eventual contingency liabilities arising in PPP contracts by the DMO.

21. **The authorities emphasized that their commitment to sound expenditure management would ensure an orderly transition towards fiscal decentralization.** The proposed new PFM law defines the extent and the modalities of the decentralization process that

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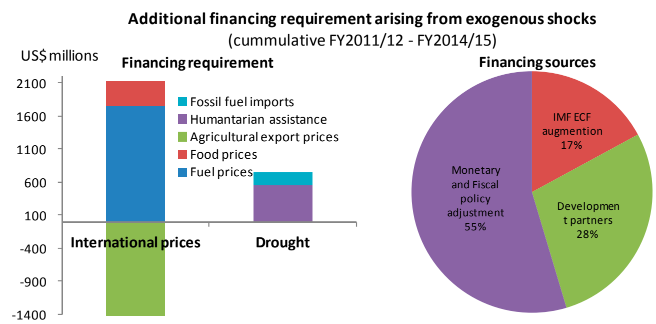
[4] The draft VAT bill reflects inputs from the IMF 's Fiscal Affairs (FAD) and Legal (LEG) Departments.

will allow assessment of the costs of decentralization before its implementation. Technical assistance from the IMF Statistics Department (STA) is helping the authorities to extend the coverage of the fiscal accounts to the general government.

22. **Technical arrears were incurred in repaying the International Development Association (IDA) obligations last September and have since been fully repaid.** The authorities explained that the delay occurred because of the introduction of new procedures to obtain clearance by the controller of the budget according to the new constitution. The process has already been streamlined to avoid further technical arrears episodes.

C. Mitigating External Shocks



23. **Financing requirements arise mainly from higher-than-anticipated fuel prices, only partly offset by an increase in agricultural export prices.** Moreover, the need for humanitarian assistance constitutes the main impact of the drought on financing requirements. Monetary and fiscal policy adjustments are expected to address 55 percent of these gross financing requirements. The remaining financing requirement is expected to be covered by international development partners and increased access under the ECF arrangement:

- International development partners have pledged around $450 million to assist Kenya directly in response to the drought according to recent Office for the Coordination of Humanitarian Affairs (OCHA) reports.[5]
- Increased access under the ECF arrangement by 60 percent of quota (about $250 million) will contribute about 17 percent toward covering Kenya's total financing needs between FY 2011/12 and FY 2014/15.
- Other underlying balance of payments' financing requirements are expected to come mainly from foreign direct investment, capital goods suppliers credit, and portfolio capital inflows attracted by higher interest rates as the central bank tightens monetary policy.
- The central bank plans to resume building up its international reserve buffer. Once external pressures subside, a sizable international reserve buffer (at a minimum of

[5] Main donors include the World Food Program, United Nations High Commissioner for Refugees, UNICEF, and FAO. Among countries, the main contributors are the US, Japan and European countries through the European Commission or bilaterally (chiefly Germany, the UK and Sweden).

4 months of import coverage) would shield Kenya from volatile international prices and private capital flows.[6]

D. Monitoring Financial Risks and Deepening Financial Reform

24. **The financial system remains sound.** Most banks remain highly profitable and capital adequacy ratios are still high, although they declined in September 2011 compared to June. This decline reflects: (i) an acceleration in lending that increased total risk-weighted assets, and (ii) mark-to-market losses that limited the growth of capital. NPLs continued to decline (4.9 percent of loans in September 2011), reflecting the rapid growth of the loan base and improved loan recovery practices by banks. Leading domestic financial institutions continue expanding to neighboring countries, chiefly Uganda, Tanzania, and Sudan (Box 4).

25. **The authorities indicated that banking supervision will increasingly focus on emerging risks in small banks (Figure 2).** The central bank will monitor the use of central bank liquidity facilities to identify structural liquidity imbalances in individual institutions and take early corrective action if needed. Banks facing structural liquidity problems will put in place a recovery plan without resorting to CBK facilities.

26. **The authorities indicated that credit risk will be monitored more closely in light of rapid credit expansion.** In particular, personal loans show higher-than average NPL ratios and may have been hit by higher interest rates. Moreover, to address risks stemming from increasing financial inclusion and strong credit growth, the CBK plans to conduct macro and micro stress tests, and more frequently assess whether loan write offs and provisioning practices are in line with regulations.

27. **The Capital Markets Authority (CMA) has continued improving capital market governance and development.** The CMA has adopted a risk based supervision model and is actively enforcing higher minimum capital requirements for brokers and investment banks. Guidelines on Internal Control and Risk Management have been drafted to provide guiding principles for licensed institutions on minimum requirements for complying with applicable laws. To strengthen the Investor Protection Fund, a draft regulation of Investor Compensation is prepared and is in the market consultation process. The CMA is also working on more flexible requirements for SMEs that want to be listed in the Nairobi Stock Exchange (NSE). The demutualization process is still planned for completion by June 2012, but the process has been put on hold temporarily because of an injunction raised by a broker seeking inclusion in the process.

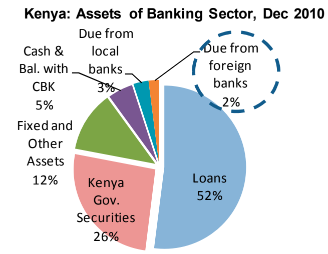
28. **The National Social Security Fund** (NSSF) **is undertaking significant reform.** A new framework for social security policy will redefine pension schemes, including by transforming the NSSF from a provident fund into a social insurance pension scheme. A new management has radically improved the NSSF's governance environment, including by appointing fund managers and custodians, fully complying with requirements set by the Retirement Benefits Authority (RBA), the pension funds regulator.

[6] See Box 1 in Country Report No. 11/48, Request for a three-year arrangement under the Extended Credit Facility.

29. **Kenya has taken steps towards introducing anti-money laundering (AML) and combating the financing of terrorism (CFT) provisions, but the action plan agreed with the Financial Action Task Force (FATF) has been partially implemented.** The AML advisory board to the Financial Intelligence Unit (FIU) has been appointed. A Mutual Evaluation Report reflecting an assessment by the Eastern and Southern Africa Anti-Money Laundering Group has been recently finalized. However, a review conducted by the Financial Action Task Force (FATF) found strategic AML/CFT deficiencies and insufficient progress in addressing them. Deficiencies include pending staffing of the FIU, lack of effective implementation of the AML law, and lack of criminalization of terrorist financing.

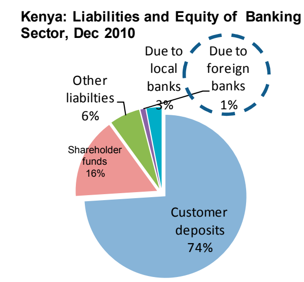
Box 4. Cross Border Linkages in the Kenyan Banking Sector

- Cross border linkages have become a prominent feature of the Kenyan banking sector. Foreign and regional banks hold 40 percent of the banking sector's assets. In recent years, six locally-owned Kenyan banks, some of systemic importance, have expanded into neighboring East African Community (EAC) countries as well as Sudan, Malawi and Mauritius by establishing 11 subsidiaries.



- At this stage, direct cross-border financial linkages between the cross-border banks are small. In terms of funding, both local and foreign banks in the region depend on local low-cost deposits rather than funding from parent banks or international markets.

- However some risks may emerge:



    - Foreign-owned banks: the risks of capital repatriation appear to be small for large foreign banks that historically have been highly profitable. However, smaller less profitable foreign banks may be exposed to contagion risks from their parent countries.

    - Local banks with subsidiaries: Problems in affiliates of Kenyan-owned banks in neighboring countries may affect the parent institution through reputational risks and the need for recapitalizing by the parent bank. This is particularly relevant because some systematically important Kenyan banks are expanding rapidly to other countries in the region. Growth, inflation, and monetary policy tightening cycles tend to be synchronized across EAC. Therefore, a parent bank and its affiliates could simultaneously face similar risks, including market risks, higher non-performing loans (NPLs) and liquidity risks, leading to compounded pressures on the parent bank's balance sheet.

- The authorities are involved in several joint initiatives with supervisors from other EAC countries and several other countries in the region to enhance joint supervision. The key supervisory priorities are: (i) mapping relationships among local groups including banks, (ii) requiring disclosure and notification of intergroup transactions, and (iii) identifying channels of regulatory arbitrage.

Topography of the Kenyan Banking Sector

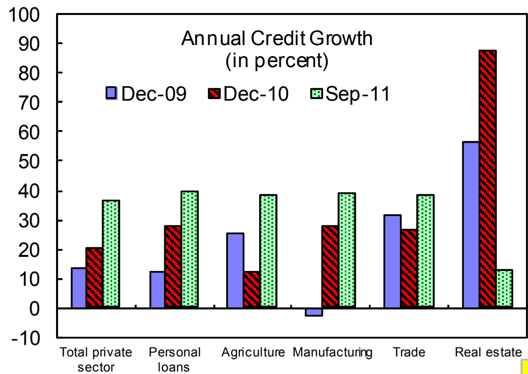
		Number of banks	Share in total banking sector assets	Size of subsidiaries assets to the parent assets
Foreign banks	Multinationals	4	12%	
	Other foreign banks	12	30%	
Local banks	Tier-1 local banks w ith subsidiaries	2	20%	12%
	Tier-2 local banks w ith subsidiaries	3	11%	22%
	Tier-3 local banks w ith subsidiaries	1	1%	n.a.
	Other local banks	22	26%	

Source: June 2011 balance sheets and staff calculations.

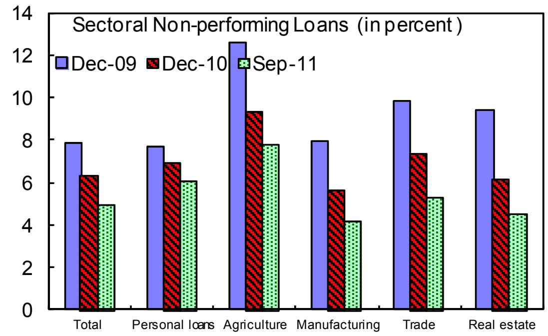
Figure 2. Kenya: Financial Risks, 2011

Credit Risk

Credit to private sector has accelerated, especially in personal loans,

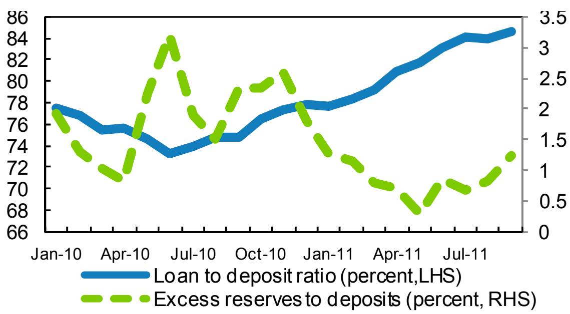


posing challenges for sectors with above-average NPLs and higher sensitivity to economic slowdown.

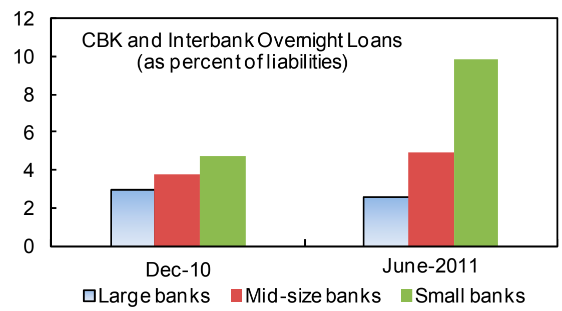


Liquidity Risk

As liquidity tightens and becomes more costly, some banks are starting to hold more excess reserves.

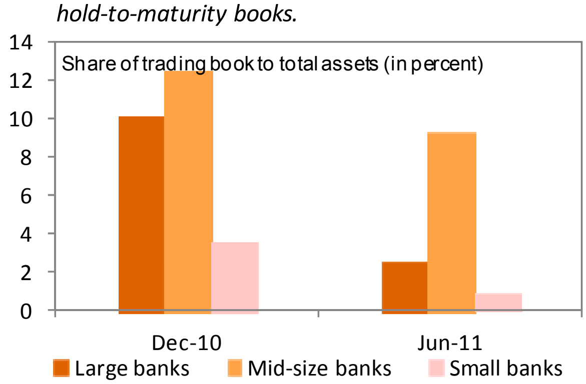


Still, small and mid-size banks are more reliant on short-term interbank and CBK funding.

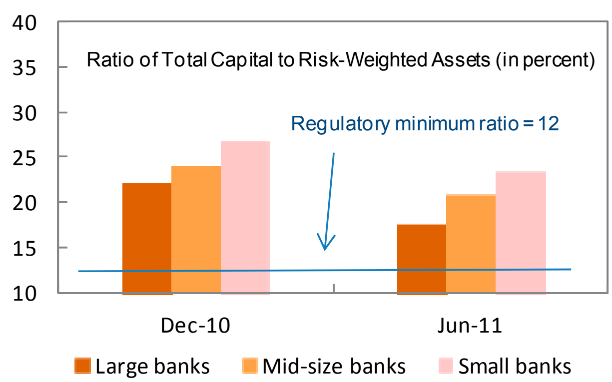


Market Risk

As interest rates increased sharply, banks reduced the size of trading books by selling or switching to hold-to-maturity books.



The decline in the valuation of government securities has brought down capital ratios across the board.



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

IV. PROGRAM ISSUES

30. **It is proposed that targets for the next two reviews are modified and that targets for end-December 2012 be established.** The authorities met all the June 2011 targets. However, NIR and NDA targets need to be revised because exchange rate pressures have made it difficult for the CBK to continue purchasing foreign exchange as planned, leading to deviations of the NIR and NDA from their September 2011 indicative targets. The new targets take into account changes in the macroeconomic outlook and a new base period for the program exchange rate from April 2011 to September 2011. The direction of macroeconomic policies under the program has not changed.

31. **Augmentation and total access**. Staff estimates external financing of US$670 million for 2011–13 to address the exogenous shocks, while preventing an abrupt adjustment in domestic demand. Reflecting the estimated financing needs and the strength of planned reforms, in particular those allowing fiscal consolidation over the medium term, staff proposes an augmentation of the equivalent of 60 percent of quota, which would lead to a total access of 180 percent of quota (SDR 488.52 million) under the ECF arrangement. Disbursements ahead would be made in five tranches, following completion of semi-annual reviews. The authorities' intention to front load their adjustment effort justifies front-loading of disbursements. Staff proposes disbursement of 30 percent of augmentation (18 percent of quota) upon approval by the Board, with remaining disbursements to take place in equal tranches.

32. **Financing.** The program would be fully financed. Of the estimated US$670 million financing gap, the IMF will finance US$250 million under the proposed 180 percent of quota access, and other development partners are expected to disburse US$420 million over the next three years.

33. **The balance of risks is tilted downward, and room for policy slippages and countercyclical policies has substantially narrowed.** If adverse risks materialize, additional external financing may well be limited. As regards the IMF, the proposed augmentation would already bring access to concessional resources close to the cumulative access limit. Policies would then have to bear the brunt of adjustment. The main risks to the program are:

- A further deterioration of the global outlook affecting not only demand for non-traditional exports but also financial inflows and jeopardizing the authorities' efforts to build external reserve buffers. Although financial spillover risks to the domestic banking sector are low (Box 4), demand for horticulture exports may be affected by developments in Europe.

- A deterioration of the political outlook in the run-up to elections in 2012 and during the implementation of fiscal decentralization, leading to lack of political support for the program. The International Criminal Court's hearings for the confirmation of charges against six high-profile individuals suspected of instigating the December 2007 post-election violence are underway, and could unsettle the political climate.

- A worsening of weather conditions, leading to stronger pressures on the external position.

- A protracted military intervention at the Somali border, translating into additional budgetary costs and heightened security concerns that may hamper tourism revenue.

34. **Capacity to repay the IMF**. Kenya has a strong capacity to repay the IMF. Its current obligations to the IMF are SDR 367 million at end-October 2011, or 135 percent of quota. The proposed access would not affect significantly the level of total debt, and the risk of debt distress is low according to the most recent Debt Sustainability Analysis. Repayment of obligations to the IMF from existing and prospective credit will remain lower than 1.3 percent of gross international reserves and 14 percent of debt service during 2011-2019. In the same period, outstanding IMF credit would remain under 3 percent of GDP (Table 8). Moreover, the additional IMF financing is part of broader efforts, in which development partners play the key role, covering two-thirds of the financing requirements net of the efforts of policy adjustments.

35. **The CBK safeguards assessment was completed in September 2011, and reported in Country Report No. 11/165.** The CBK Board and a new deputy governor have been appointed, and a new audit committee is now functional. On data, the CBK is implementing the recommendations in the transition to the new accounting system. The assessment will be updated as required in cases of augmentation under the ECF arrangement.

36. **Article VIII issues.** Kenya continues to maintain an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.

V. STAFF APPRAISAL

37. ***Achievements:*** Kenya has sustained strong growth for two years in a row, but since June policy adjustment efforts bumped into unexpected obstacles. The drought in the Horn of Africa and persistently high increases in international prices have boosted inflation and raised the country's balance of payments needs. Nevertheless, Kenya has made progress in reducing its fiscal imbalance and in pushing forward key reforms in the fiscal and financial sectors.

38. ***Challenges:*** Inflation has reached levels that threaten to bring to a halt the country's favorable growth performance. More persistent than expected increases in food prices have fed into core inflation and expectations because delays in the monetary policy response left rapid domestic demand growth unchecked. Rising inflationary expectations in a context of a widening external current account deficit have fueled pressures on the exchange rate that now risk to feed back into inflation and in turn to spiral on the exchange rate. Macroeconomic policies need to address this risk promptly by bringing under control domestic demand to reverse inflationary expectations, and stabilize the exchange rate.

39. ***Monetary policy***: Monetary policy will have to bear the brunt of the adjustment through decisive tightening, because the rapid pace of growth in credit to the private sector has played the key role in generating domestic demand pressures. The large recent increases in the CBK's policy rate are steps in the right direction that signal a shift away from the gradualist approach the CBK followed until September. The CBK will need to maintain a tightening bias in its monetary operations to keep the interbank rate above the CBR. Moreover, further increases in

the CBR may need to be considered to keep the CBK's NDA in line with the program targets that aim at bringing inflation down.

40. ***Foreign exchange policy***: The recent regulatory changes to limit the scope for shortening the shilling on forward contracts may help to assuage pressures in the short term, but they do not constitute an alternative to monetary tightening. Moreover, the CBK should reconsider these regulations once the exchange markets stabilize, to assess whether these constrain inflows and hamper the efficiency of financial intermediation. The CBK should also resume its foreign exchange purchases to gradually build a buffer in international reserves because monetary tightening will help to support the shilling.

41. ***Fiscal policy***: There is a case for accelerating fiscal consolidation to complement monetary policy to curb domestic demand. The authorities' decisions to adopt a more ambitious medium-term target, and to frontload the adjustment in FY 2011/12 are in the right direction. In particular, if achieved, the primary balance target for FY 2011/12 would allow a significant decline in the government debt-to-GDP ratio. Moreover, this target includes provisions for key outlays that should be protected. These include emergency food relief for the population hit by the drought, implementation of the new constitution, preparation of the 2012 elections, targeted transfers to the poor, ongoing security operations, and high-priority investments. The authorities need not only to continue to restrain the growth of non-priority current spending, but also to tap increasingly the domestic market by accepting interest rates on government securities that are in line with those prevailing in the interbank market.

42. ***Exchange rate assessment***: Despite the recent market turbulences, the floating exchange rate regime has, without doubt, helped the country to cope with adverse shocks. In fact, the recent real depreciation of the shilling provides incentives that should reorient economic activity toward exports, helping monetary and fiscal policies to bring under control domestic demand and lower the external current account deficit. Thus, there are no indications that the real exchange rate is misaligned.

43. ***Financial sector policies:*** The continued acceleration in credit to the private sector has heightened risks for the quality of banks' loan portfolios. These risks may become more evident as monetary policy succeeds in slowing the pace of credit expansion. Thus, it is essential that banking supervision redoubles its efforts to ensure that banks comply with provisioning practices and that the continued decline in the ratio of NPLs to assets does not reflect a deterioration of the banks' loan portfolio masked by an expanded loan base. Similarly, the growing cross-border linkages of the Kenyan banking sector call for strengthening supervision focusing on intergroup transactions and the possibility of regulatory arbitrage.

44. ***Fiscal decentralization***: The draft PFM law defines a new framework for intergovernmental relations consistent with the principles of fiscal devolution in the new Constitution. Stakeholders are still discussing the detailed modalities of devolution, but a comprehensive PFM law should be in place before the devolution process takes off. The law will allow the authorities to fully quantify the costs of the devolution process and ensure that the principles of sound fiscal management apply at both the central and the county government levels. The establishment of a Single Treasury Account is consistent with devolution and constitutes an important step toward strengthening accountability in the use of public resources and reducing the scope for corruption.

45. ***VAT reform***: Implementing the new draft VAT law will be essential to increase revenue mobilization and minimize administrative costs. The authorities have already started to modify elements of the existing collection mechanism in line with the new VAT design, in particular the withholding and refund mechanisms. These changes will certainly improve the business climate and facilitate tax compliance. However, to safeguard its revenue potential and economic efficiency features, the tax base should be as broad as possible, with very limited exemptions.

46. ***Poverty reduction***: The authorities are finalizing an update to their 2008–12 poverty reduction strategy that sets more realistic targets in light of recent macroeconomic developments and have initiated work to prepare the next five-year plan, and the report will be circulated to the Board for information before end-December 2011.

47. ***IMF support***: The proposed augmentation of access would bring access to concessional resources close to the cumulative access limit. This underscores the importance of the authorities fully implementing the program to strengthen the country's balance of payments position. If adverse shocks or policy slippages create new balance of payments needs, IMF concessional support would not be available as a cushion and the burden of adjustment would fall on policies with an impact on economic activity and living conditions.

48. ***Program performance***: All performance criteria (PCs) and indicative targets for end-June 2011 were observed. The structural benchmark was met as programmed. The CBK has made progress in implementing the recommendations of the recent safeguard assessment update. Staff recommends completion of the second review under the ECF arrangement, approval of the request for augmentation of access to IMF resources under the program, approval of the request for modification of the end-December 2011 PCs and end-June 2012 PCs, and the establishment of new PCs for end-December 2012.

49. It is proposed that the next Article IV consultation take place within 24 months, subject to the decision on consultation cycles (Decision No. 14747– (10/96), September 28, 2010).

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

		2010/11		2011/12				
	2009/10	First Review	Revised	First Review	Revised	Projections		
	Actual	(ECF)	Program	(ECF)	Program	2012/13	2013/14	2014/15
	(Annual percentage change; unless otherwise indicated)							
National accounts and prices								
Nominal GDP (market prices, in billions of Kenya shillings)	2,458	2,764	2,777	3,181	3,281	3,801	4,292	4,813
Real GDP growth (market prices)	4.1	5.4	5.3	5.7	5.3	5.8	6.2	6.4
GDP deflator (average) 2/	5.5	6.5	7.3	9.0	12.2	9.5	6.3	5.4
Consumer price index (annual average) 2/	6.7	6.8	6.9	7.4	16.2	7.0	5.0	5.0
Consumer price index (end of period) 2/	3.5	13.3	14.5	6.0	12.0	6.5	5.0	5.0
Import volume growth, goods	2.3	3.8	3.6	4.4	0.6	7.1	7.4	5.0
Import value growth, goods	2.5	22.4	20.6	13.9	10.2	6.6	6.8	4.4
Export volume growth, goods	-1.7	-1.1	-2.8	15.9	5.5	8.1	8.0	7.3
Export value growth, goods	5.3	16.7	12.6	16.7	12.6	8.8	3.4	4.0
Terms of trade, goods, and services (Base year 2000)	12.3	-0.8	-1.5	-9.8	-4.7	-3.2	-2.7	-3.8
Ksh per US$ exchange rate (end of period) 3/	81.9	…	99.6					
Nominal effective exchange rate (- depreciation; end of period)	-0.3	…	…	…	…	…	…	…
Real effective exchange rate (- depreciation; end of period)	-1.6	…	…	…	…	…	…	…
Money and credit								
M3 (broad money and foreign currency deposits, end period)	26.2	16.5	15.2	14.7	17.6			
Reserve money	31.5	3.0	4.8	8.7	14.0			
	(In percent of GDP; unless otherwise indicated)							
Investment and saving								
Investment	20.3	23.5	21.5	24.3	23.6	25.0	24.8	24.8
Central government	8.7	9.8	7.8	10.5	10.0	10.6	10.4	10.1
Other	12.1	13.7	13.7	13.8	13.6	14.4	14.4	14.7
Gross national saving	14.8	14.3	11.8	16.0	14.8	16.8	18.3	19.2
Central government	1.5	2.7	2.7	3.9	4.1	4.6	5.0	5.3
Other	13.2	11.5	9.1	12.1	10.7	12.2	13.3	13.9
Central government budget 4/								
Total revenue	22.3	24.8	24.0	24.8	24.5	24.8	25.0	25.0
Total expenditure and net lending	29.5	32.0	29.2	31.5	30.5	30.9	30.5	29.9
Overall balance (commitment basis) excluding grants	-7.2	-7.2	-5.2	-6.7	-6.0	-6.1	-5.5	-4.9
Overall balance (commitment basis) including grants	-6.4	-6.1	-4.5	-5.4	-4.7	-4.8	-4.0	-3.4
Primary budget balance	-3.8	-3.4	-1.5	-2.7	-2.2	-1.8	-1.4	-0.9
Net domestic borrowing	5.4	4.3	3.3	3.8	3.3	1.8	1.7	0.9
Balance of payments								
Exports value, goods, and services	25.6	27.8	27.8	28.4	30.8	28.2	26.7	24.5
Imports value, goods, and services	38.6	44.1	45.1	44.3	48.0	45.0	42.6	39.9
Current external balance, including official transfers	-5.6	-9.3	-9.6	-8.3	-8.8	-8.3	-6.5	-5.6
Current external balance, excluding official transfers	-5.5	-9.2	-9.6	-8.2	-8.7	-8.2	-6.4	-5.6
Gross international reserve coverage								
In billions of U.S. dollars (end of period)	3.8	4.2	4.1	4.6	4.2	5.1	6.2	7.2
In months of next year imports (end of period)	3.1	3.0	3.1	3.0	2.9	3.3	3.9	4.2
Public debt								
Total public debt, net (percent of GDP)	44.8	46.9	45.9	46.8	44.7	43.4	42.5	40.6
Of which: external debt	23.0	23.2	23.4	22.5	22.3	22.3	22.0	21.5
Domestic debt, net of deposits	21.8	23.7	22.5	24.3	22.4	21.1	20.4	19.1

Sources: Kenyan authoritie and IMF staff estimates and projections.

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

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

3/ Actual as of September 30, 2011.

4/ Revenue plus program grants minus recurrent expenditure.

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

	2009/10 Estimate	2010/11 Preliminary	2011/12 Country Report 11/165	2011/12 Revised Program	2012/13 Projections	2013/14 Projections	2014/15 Projections
	(In billions of Kenyan shillings, unless otherwise indicated)						
Revenues and grants	**568.8**	**686.3**	**830.6**	**844.9**	**992.2**	**1,135.6**	**1,277.2**
Revenue	**548.1**	**667.5**	**789.6**	**803.8**	**941.8**	**1,073.3**	**1,205.6**
Tax revenue	466.5	557.2	647.3	660.7	779.4	891.0	1,001.2
Income tax	209.1	258.7	291.8	305.3	357.9	406.7	456.8
Import duty (net)	41.3	46.1	55.4	57.6	68.9	78.4	88.8
Excise duty	74.1	80.6	98.6	93.2	109.1	124.5	140.2
Value-added tax	142.0	171.9	201.5	204.6	243.5	281.4	315.4
Nontax revenue	81.6	110.4	142.3	143.1	162.4	182.3	204.4
Investment income	8.4	11.1	11.8	13.3	12.7	14.4	16.2
Other	32.7	41.0	54.6	53.2	64.7	73.2	82.2
LATF	0.0	0.0	15.4	16.1	18.8	21.4	24.0
Ministerial and Departmental Fees (AIA) [2/]	40.6	58.3	60.5	60.6	66.2	73.3	82.0
Grants	**20.7**	**18.8**	**41.0**	41.1	**50.4**	**62.3**	**71.6**
Project grants	20.7	18.8	0.0	41.1	50.4	62.3	72.6
Program grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure and net lending	**725.2**	**811.8**	**1,001.5**	**1,000.3**	**1,175.4**	**1,308.6**	**1,436.2**
Recurrent expenditure	**504.3**	**578.5**	663.7	**664.6**	**754.3**	**845.0**	**931.5**
Interest payments	63.5	76.2	84.1	84.6	114.9	114.3	116.1
Domestic interest	57.4	69.2	76.6	76.6	104.0	99.1	93.8
Foreign interest due	6.1	7.0	7.5	8.0	10.9	15.2	22.3
Wages and benefits (civil service)	172.6	198.5	222.6	222.6	253.3	285.6	319.1
Civil service reform	0.0	0.0	0.0	0.0	0.2	0.0	0.0
Pensions, etc.	29.0	25.7	34.8	34.8	50.8	61.0	67.3
Other 2/	182.3	217.5	263.8	257.5	271.4	318.7	356.0
Defense and NSIS	56.9	60.6	58.4	65.2	63.7	65.4	73.0
Development and net lending	**214.7**	**219.4**	335.8	**332.3**	**406.6**	**448.7**	**488.5**
Domestically financed	151.9	149.9	215.5	212.0	201.7	247.6	262.8
Foreign financed	61.6	67.0	117.7	117.7	202.3	198.2	222.7
Net lending	1.2	2.5	2.6	2.6	2.6	2.9	3.0
Civil Contingency Fund	0.0	0.0	2.0	2.0	0.0	0.0	0.0
Drought expenditures	6.2	8.3	0.0	0.0	2.0	2.0	2.0
Constitutional Reform [3/]	0.0	5.6	0.0	1.4	3.0	2.0	2.0
Balance (commitment basis, excluding grants)	**-177.1**	**-144.3**	**-211.9**	**-196.5**	**-233.6**	**-235.3**	**-230.6**
Balance (commitment basis, including grants)	**-156.4**	**-125.5**	**-170.9**	**-155.4**	**-183.2**	**-173.0**	**-159.0**
Adjustments to cash basis	**0.0**	**6.8**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Balance (cash basis, including grants)	**-156.4**	**-118.8**	**-170.9**	**-155.4**	**-183.2**	**-173.0**	**-159.0**
Financing	**156.4**	**118.8**	**170.9**	**155.4**	**183.2**	**173.0**	**159.0**
Net foreign financing	22.9	28.4	51.4	46.6	114.2	99.5	117.1
Disbursements	39.8	48.2	76.7	71.9	139.3	138.2	159.7
Project loans	39.8	48.2	76.7	71.9	91.8	114.4	135.5
Program loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial borrowing [4/]	0.0	0.0	0.0	0.0	47.5	23.8	24.2
Repayments due	-18.7	-20.5	-25.8	-25.8	-25.1	-39.2	-43.1
Change in arrears	1.4	0.1	0.0	0.0	0.0	0.0	0.0
Rescheduling / debt swap	0.5	0.5	0.5	0.5	0.0	0.5	0.5
Net domestic financing	133.5	90.4	119.5	108.8	69.0	73.6	41.9
Financing gap (stat. discrepancy for outturns)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:							
Nominal GDP	2,458.3	2,776.8	3,180.8	3,281.5	3,801.3	4,292.0	4,812.8
Primary budget balance including grants	-92.9	-42.6	-86.8	-70.8	-68.3	-58.7	-42.9
Stock of domestic debt, net (end of period)	534.8	625.2	774.3	734.0	803.0	876.6	918.5
NPV of total public debt, net	913.5	1,084.9	1,283.0	1,330.4	1,500.5	1,650.2	1,773.6
Total public debt, net of deposits	1,100.4	1,275.0	1,489.9	1,466.5	1,649.7	1,822.7	1,951.7

Sources: Kenyan authorities and IMF staff estimates and projections.

1/ Fiscal year runs from July to June.

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

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

4/ Includes planned sovereign bonds.

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

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
	Estimate	Estimate	Preliminary	Revised Program	Projections	Projections	Projections
	(In percent of GDP)						
Revenues and grants	**22.7**	**23.1**	**24.7**	**25.7**	**26.1**	**26.5**	**26.5**
Revenue	**21.8**	**22.3**	**24.0**	**24.5**	**24.8**	**25.0**	**25.0**
Tax revenue	18.6	19.0	20.1	20.1	20.5	20.8	20.8
Income tax	8.2	8.5	9.3	9.3	9.4	9.5	9.5
Import duty (net)	1.6	1.7	1.7	1.8	1.8	1.8	1.8
Excise duty	3.1	3.0	2.9	2.8	2.9	2.9	2.9
Value-added tax	5.7	5.8	6.2	6.2	6.4	6.6	6.6
Nontax revenue	3.0	3.3	4.0	4.4	4.3	4.2	4.2
Investment income	0.3	0.3	0.4	0.4	0.3	0.3	0.3
Other	1.4	1.3	1.5	1.6	1.7	1.7	1.7
LATF	0.4	0.0	0.0	0.5	0.5	0.5	0.5
Ministerial and Departmental Fees (AIA) [2/]	0.9	1.7	2.1	1.8	1.7	1.7	1.7
Grants	**0.9**	**0.8**	**0.7**	**1.3**	**1.3**	**1.5**	**1.5**
Project grants	0.9	0.8	0.7	1.3	1.3	1.5	1.5
Program grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure and net lending	**26.9**	**29.5**	**29.2**	**30.5**	**30.9**	**30.5**	**29.8**
Recurrent expenditure	**19.5**	**20.5**	**20.8**	**20.3**	**19.8**	**19.7**	**19.4**
Interest payments	2.1	2.6	2.7	2.6	3.0	2.7	2.4
Domestic interest	1.8	2.3	2.5	2.3	2.7	2.3	1.9
Foreign interest due	0.3	0.2	0.3	0.2	0.3	0.4	0.5
Wages and benefits (civil service)	6.9	7.0	7.2	6.8	6.7	6.7	6.6
Civil service reform	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Pensions, etc.	1.2	1.2	0.9	1.1	1.3	1.4	1.4
Other 2/	7.1	7.4	7.8	7.8	7.1	7.4	7.4
Defense and NSIS	0.0	2.3	2.2	2.0	1.7	1.5	1.5
Development and net lending	**7.4**	**8.7**	**7.9**	**10.1**	**10.7**	**10.5**	**10.1**
Domestically financed	4.9	6.2	5.4	6.5	5.3	5.8	5.5
Foreign financed	2.4	2.5	2.4	3.6	5.3	4.6	4.6
Net lending	0.1	0.0	0.1	0.1	0.1	0.1	0.1
Civil Contingency Fund	**0.0**	**0.0**	**0.0**	**0.1**	**0.0**	**0.0**	**0.0**
Drought expenditures	**0.0**	**0.3**	**0.3**	**0.0**	**0.1**	**0.0**	**0.0**
Constitutional Reform [3/]	**0.0**	**0.0**	**0.2**	**0.0**	**0.1**	**0.0**	**0.0**
Balance (commitment basis, excluding grants)	**-5.1**	**-7.2**	**-5.2**	**-6.0**	**-6.1**	**-5.5**	**-4.8**
Balance (commitment basis, including grants)	**-4.2**	**-6.4**	**-4.5**	**-4.7**	**-4.8**	**-4.0**	**-3.3**
Adjustments to cash basis	**0.6**	**0.0**	**0.2**	**0.0**	**0.0**	**0.0**	**0.0**
Balance (cash basis, including grants)	**-3.6**	**-6.4**	**-4.3**	**-4.7**	**-4.8**	**-4.0**	**-3.3**
Financing	**4.0**	**6.4**	**4.3**	**4.7**	**4.8**	**4.0**	**3.3**
Net foreign financing	0.7	0.9	1.0	1.4	3.0	2.3	2.4
Disbursements	1.4	1.6	1.7	2.2	3.7	3.2	3.3
Project loans	1.4	1.6	1.7	2.2	2.4	2.7	2.8
Program loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial borrowing [4/]	0.0	0.0	0.0	0.0	1.2	0.6	0.5
Repayments due	-0.8	-0.8	-0.7	-0.8	-0.7	-0.9	-0.9
Change in arrears	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Rescheduling / debt swap	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net domestic financing	3.1	5.4	3.3	3.3	1.8	1.7	0.9
Financing gap (stat. discrepancy for outturns)	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:							
Nominal GDP	2,238.3	2,458.3	2,776.8	3,281.5	3,801.3	4,292.0	4,812.8
Primary budget balance	-1.5	-3.8	-1.5	-2.2	-1.8	-1.4	-0.9
Stock of domestic debt, net (end of period)	17.9	21.8	22.5	22.4	21.1	20.4	19.1
NPV of total public debt, net	31.0	37.2	39.1	40.5	39.5	38.4	36.9
Total public debt, net of deposits	**40.6**	**44.8**	**45.9**	**44.7**	**43.4**	**42.5**	**40.6**

Sources: Kenyan authorities and IMF staff estimates and projections.

1/ Fiscal year runs from July to June.

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

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

4/ Includes planned sovereign bonds.

Table 3. Kenya: Monetary Survey December 2010-December 2012

(In billions of Kenyan shillings, unless otherwise indicated)

	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
Central Bank of Kenya (CBK)									
Net foreign assets	252.4	258.7	282.8	292.0	288.0	288.8	293.5	298.3	311.0
(in millions of US dollars) [1/]	3,175	3,105	3,040	2,926	2,880	2,888	2,935	2,983	3,110
Net domestic assets	-29.8	-49.3	-62.3	-55.9	-38.6	-50.1	-42.3	-24.5	-23.7
Net domestic credit	13.2	4.9	17.7	27.4	41.4	30.0	37.7	55.5	56.3
Government (net)	-3.7	-1.5	-7.1	27.0	27.0	27.0	0.0	27.0	27.0
Commercial banks (net)	13.9	3.3	19.9	0.4	11.9	0.5	35.2	26.0	26.8
Other items (net)	-42.9	-54.2	-80.0	-83.3	-80.0	-80.0	-80.0	-80.0	-80.0
Reserve money	222.6	209.4	220.4	236.2	249.4	238.7	251.2	273.8	287.3
Currency outside banks	122.9	114.2	119.0	123.7	136.7	120.1	128.6	139.2	153.6
Bank reserves	99.7	95.2	101.5	112.4	112.6	118.6	122.6	134.6	133.7
Banks									
Net foreign assets	17.4	27.5	-0.8	18.1	16.7	16.7	17.2	19.7	22.2
(in millions of US dollars)	216.5	329.6	-9.0	181.1	167.2	167.1	171.8	196.8	221.8
Reserves	99.7	95.2	101.5	112.4	112.6	118.6	122.6	134.6	133.7
Credit to CBK	-13.9	-3.3	-19.9	-0.4	-11.9	-0.5	-35.2	-26.0	-26.8
Net domestic assets	1,033.3	1,081.1	1,170.2	1,219.6	1,239.4	1,294.2	1,372.6	1,493.1	1,482.1
Net domestic credit	1,189.1	1,259.6	1,346.4	1,427.0	1,446.7	1,501.5	1,579.9	1,700.4	1,689.4
Government (net)	281.5	291.2	284.9	250.9	252.9	261.4	290.0	322.3	320.5
Other public sector	22.2	17.0	21.7	32.8	34.8	36.8	38.8	42.8	46.8
Private sector	885.4	951.3	1,039.7	1,143.2	1,159.0	1,203.3	1,251.1	1,335.2	1,322.1
Other items (net)	-155.8	-178.5	-176.2	-207.3	-207.3	-207.3	-207.3	-207.3	-207.3
Total deposits	1,136.6	1,200.4	1,251.0	1,349.7	1,356.8	1,429.1	1,477.1	1,621.4	1,611.2
Monetary survey									
Net foreign assets	269.8	286.1	281.9	310.1	304.7	305.5	310.7	318.0	333.2
(in millions of US dollars)	3,391.4	3,435.0	3,031.0	3,107.0	3,047.0	3,054.7	3,107.1	3,179.8	3,332.2
Net domestic assets	1,001.8	1,038.6	1,098.8	1,174.1	1,187.3	1,266.0	1,313.6	1,464.9	1,438.5
Net domestic credit	1,188.4	1,261.2	1,344.2	1,482.0	1,476.2	1,531.0	1,582.4	1,729.9	1,718.9
Government (net)	277.8	289.7	277.8	277.9	279.9	288.4	290.0	349.3	347.5
Other public sector	22.2	17.0	21.7	32.8	34.8	36.8	38.8	42.8	46.8
Private	888.4	954.5	1,044.7	1,148.7	1,161.5	1,205.8	1,253.6	1,337.7	1,324.6
Other items (net)	-222.7	-222.7	-245.4	-307.9	-288.9	-265.0	-268.8	-265.0	-280.4
M1	577.2	603.4	620.1	627.7	631.0	664.6	687.0	754.0	749.3
Money and quasi-money (M2)	1,099.2	1,145.0	1,183.9	1,232.8	1,239.3	1,305.3	1,349.2	1,480.9	1,471.6
M2 plus resident foreign currency deposits (M3)	1,271.6	1,324.7	1,380.7	1,484.2	1,492.0	1,571.5	1,624.3	1,782.9	1,771.7
M3 plus nonbank holdings of government debt (L)	1,569.6	1,637.4	1,720.6	1,800.3	1,859.3	1,958.3	2,024.1	2,221.7	2,207.8
Memorandum items (Annual percent change unless otherwise specified)									
M1	30.5	29.7	21.2	16.9	9.3	10.1	10.8	20.1	18.7
M2	22.4	19.4	14.5	14.3	12.7	14.0	14.0	20.1	18.7
M3	21.6	19.6	15.2	19.3	17.3	18.6	17.6	20.1	18.7
Deposits	21.4	19.8	15.1	20.2	19.4	19.0	18.1	20.1	18.7
Reserve money	22.4	18.0	4.8	12.5	12.0	14.0	14.0	15.9	15.2
Currency outside banks	21.9	18.5	17.4	18.2	11.2	5.1	8.1	12.5	12.3
Net domestic credit	24.3	24.0	23.7	30.1	24.2	21.4	17.7	16.7	16.4
Government (net)	35.5	17.4	0.0	-0.1	0.8	-0.5	4.4	25.7	24.2
Private	20.3	25.7	30.7	36.3	30.7	26.3	20.0	16.5	14.0
Net domestic assets of the banking sector	24.9	23.7	19.6	21.6	18.5	21.9	19.5	24.8	21.2
NDA growth (as percent of the base period M3)	15.6	14.7	12.5	13.7	11.8	13.9	12.5	16.2	13.5
Multiplier (Average M3/RM)	5.9	5.9	6.1	6.1	6.2	6.3	6.3	6.4	6.4
Velocity (GDP/M2)	2.4	2.4	2.5	2.4	2.5	2.5	2.6	2.5	2.5

Source: Kenyan authorities and IMF staff estimates and projections

1/ For historical data, at implicit CBK exchange rate

Table 4. Kenya: Balance of Payments, 2008/09 - 2014/15

(In millions of US dollars, unless otherwise indicated)

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
			Prel.		Revised Program		
Current account	-2,359.7	-1,778.8	-3,138.4	-2,957.7	-3,140.7	-2,782.1	-2,696.4
Excluding official transfers	-2,338.8	-1,758.2	-3,116.4	-2,935.7	-3,118.7	-2,760.1	-2,674.4
Exports, f.o.b.	4,641.6	4,885.5	5,498.7	5,983.3	6,189.6	6,437.6	6,553.5
Coffee	179.4	194.2	212.8	273.8	271.3	259.8	211.7
Tea	876.9	1,127.2	1,108.4	1,162.6	1,099.5	1,087.6	1,132.6
Horticulture	668.2	714.8	732.0	865.7	868.6	892.9	861.3
Imports, f.o.b.	-10,308.4	-10,564.5	-12,738.1	-14,040.0	-14,965.0	-15,976.0	-16,681.1
Oil	-2,555.7	-2,635.6	-3,299.2	-3,623.0	-3,819.8	-4,156.1	-4,495.9
Other Private	-7,615.8	-7,827.6	-9,277.0	-10,205.4	-10,924.9	-11,592.6	-11,950.6
of which: special: maize & sugar	-441.5	-360.9	-198.9	-330.7	-318.9	-307.5	-304.1
Balance on goods	-5,666.8	-5,679.0	-7,239.5	-8,056.6	-8,775.3	-9,538.4	-10,127.5
Balance on Services	1,189.5	1,508.8	1,572.0	2,273.8	2,397.9	2,689.5	2,700.4
Credit	2,950.3	3,322.0	3,550.3	4,374.6	4,536.5	5,001.8	5,229.7
of which: foreign travel credit [1/]	688.2	711.8	850.5	1,080.6	1,122.6	1,275.8	1,268.6
Debit	-1,760.8	-1,813.2	-1,978.3	-2,100.9	-2,138.6	-2,312.3	-2,529.3
Balance on goods and services	-4,477.3	-4,170.3	-5,667.4	-5,782.9	-6,377.5	-6,848.9	-7,427.2
Income (net)	-76.7	-33.3	6.0	-124.9	-152.0	-183.0	-159.2
Credit	161.6	235.9	206.0	133.0	114.8	116.5	191.1
Debit	-238.3	-269.2	-200.0	-257.9	-266.8	-299.5	-350.3
of which: official interest payments	-83.3	-79.2	-79.2	-95.4	-100.6	-123.0	-158.6
Other	-155.1	-190.0	-120.8	-162.5	-166.2	-176.5	-191.7
Current transfers (net)	2,194.4	2,424.8	2,523.0	2,950.1	3,388.8	4,249.8	4,890.0
Private (net)	2,215.3	2,445.5	2,545.0	2,972.1	3,410.8	4,271.8	4,912.0
of which: remittances	981.4	1,056.1	1,158.0	1,226.9	1,445.8	1,692.6	1,894.6
Official (net)	-20.9	-20.7	-22.0	-22.0	-22.0	-22.0	-22.0
Capital and financial account	1,935.0	2,374.6	3,378.1	2,497.2	3,740.2	3,765.8	3,732.4
Capital account (incl. capital transfers)	258.2	260.1	201.6	411.1	504.0	623.0	516.0
Financial account [2/]	1,676.8	2,114.5	3,176.5	2,086.1	3,236.2	3,142.8	3,216.4
Net FDI	652.5	404.5	529.5	654.1	713.3	776.1	847.7
In Kenya	672.0	430.6	541.9	677.2	735.0	798.0	867.3
Abroad	-19.5	-26.1	-12.4	-23.1	-21.7	-21.9	-19.7
Net Portfolio investment	-10.3	-8.6	3.5	2.7	0.2	1.9	2.4
Liabilities	8.9	9.7	16.2	14.6	12.7	13.6	14.4
Assets	-19.2	-18.3	-12.7	-11.9	-12.5	-11.7	-12.0
Net other investment	614.8	1,346.5	1,903.7	1,429.3	2,522.7	2,364.8	2,366.4
Official, medium and long term	204.9	623.6	257.3	232.4	996.1	1,022.0	910.9
Inflows	417.3	843.9	520.6	511.4	1,279.7	1,310.8	1,263.0
Outflows	-212.4	-220.3	-263.3	-279.0	-283.6	-288.8	-352.1
Private, medium and long term	-23.9	-37.2	-28.1	97.4	360.6	302.7	123.1
Energy financing	65.3	61.1	63.9	69.8	75.3	83.5	88.6
Kenya Airways	-76.5	-48.2	-65.4	27.7	285.3	219.3	34.5
Other	-12.7	-50.2	-26.6	0.0	0.0	0.0	0.0
Short-term capital	433.8	760.2	1,674.5	1,099.4	1,166.0	1,040.1	1,332.4
of which: commercial banks	472.4	442.7	465.8	-181.1	-100.0	-100.0	-50.0
Errors and omissions	419.9	372.1	739.9	0.0	0.0	0.0	0.0
Overall balance	-424.7	595.7	239.7	-460.5	599.6	983.7	1,036.0
Financing items	424.7	-595.7	-239.7	460.5	-599.6	-983.7	-1,036.0
Reserve assets (gross)	224.0	-579.6	-321.9	-60.8	-908.4	-1,107.9	-971.0
Use of Fund credit and loans to the Fund (net)	194.8	-22.3	76.5	30.7	-43.5	-56.9	-70.0
Disbursements	209.1	0.0	101.4	66.0	0.0	0.0	0.0
Repayments	-14.4	-22.3	-24.9	-35.3	-43.5	-56.9	-70.0
Rescheduling /debt swap	5.9	6.1	5.7	5.0	0.0	5.0	5.0
IMF ECF financing	0.0	0.0	0.0	278	214	107	0
Program support by other development partners	0.0	0.0	0.0	208	138	69	0
Memorandum items:							
Gross official reserves (end of period)	3,219	3,799	4,120	4,181	5,090	6,198	7,169
(in months of following year's imports of goods and services)	3.1	3.1	3.1	2.9	3.3	3.9	4.2
Current account balance (excl. official transfers, percent of GDP)	-7.9	-5.5	-9.6	-8.7	-8.2	-6.4	-5.6
Import volume growth, goods and services (percent)	14.2	8.2	2.1	0.3	6.4	7.5	5.6
Import value growth, goods and services (percent)	10.0	2.6	18.9	9.7	6.0	6.9	5.0
Export volume growth, goods and services (percent)	-1.8	1.2	-3.9	10.5	7.5	10.2	7.7
Export value growth, goods and services (percent)	0.3	8.1	10.3	14.5	3.6	6.7	3.0
Change in the terms of trade (goods and services, percent) [3/]	6.6	12.3	-1.5	-4.7	-3.2	-2.7	-3.8

Sources: Kenyan authorities and IMF staff estimates and projections.

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

2/ Historical figures include errors and omissions.

3/ Base year: 2000.

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

	Dec-07	Dec-08	Dec-09	Jun-10	Dec-10	Jun-11	Sep-11
Capital adequacy							
Regulatory capital to risk-weighted assets	18.0	18.9	19.5	19.6	20.8	19.0	18.1
Regulatory tier 1 capital to risk-weighted assets	16.8	16.9	17.2	17.5	18.7	16.9	16.0
Total capital to total assets	12.0	12.6	12.7	14.0	13.2	12.8	12.4
Asset quality							
Non performing loans to total gross loans	10.6	9.0	7.9	7.4	6.2	5.4	4.9
Non performing loans net of provisions to capital	12.8	11.3	12.6	10.0	6.4	5.8	5.0
Earning assets to total assets	79.4	88.6	85.0	85.1	88.8	89.5	88.5
Earning and profitability							
Return on assets (ROA)	3.0	2.8	2.9	3.5	3.7	3.3	3.1
Return on equity (ROE)	27.5	25.2	24.8	31.4	30.7	30.8	30.2
Interest margin to gross income	34.6	34.9	35.6	33.2	34.7	40.9	40.5
Non interest expenses to gross income	50.6	51.7	50.8	47.1	48.2	48.2	47.7
Liquidity							
Liquid assets to total assets	37.5	36.4	35.9	39.7	38.4	34.9	33.8
Liquid assets to short-term liabilities	40.0	37.0	39.8	45.1	44.5	38.9	37.3
liquid assets to total deposits	47.4	46.4	46.3	50.4	51.0	46.3	44.9
Total loans to total deposits	71.3	73.3	72.4	68.0	72.5	76.6	78.1
Sensitivity to market risk							
Net open position in foreign exchange to capital	…	5.6	4.9	4.9	4.3	4.6	6.4
Interest bearing assets to interest bearing liabilities	100.5	113.0	113.2	111.6	117.8	117.9	117.4
FX currency denominated assets to total assets	8.7	9.7	8.1	10.1	10.6	12.4	13.5
FX currency denominated liabilities to total liabilities	16.3	20.2	18.1	16.3	17.1	18.2	20.6
Spread between lending and deposit rate	7.5	7.8	8.7	9.4	9.3	8.8	8.4

Source: Central Bank of Kenya.

Table 6. Kenya: Performance Criteria for the Second Review under the 2011/14 ECF Arrangement

(In billions of Kenyan shillings; unless otherwise indicated)

	2010		2011				
	Projection End-Dec.	Actual End-Dec.	Performance Criteria End-March	Actual End-March	Performance Criteria End-June	Actual End-June	met/ not met
Quantitative performance criteria							
Fiscal targets							
Primary budget balance of the central government (-=deficit, floor) 1/ 2/ 3/ 4/	-20.7	-20.7	-55.0	-11.6	-25.0	-13.7	met
Monetary targets 5/ 6/							
Stock of central bank net international reserves (floor, in millions of US$) 7/8/	3,505	3,314	3,450	3,263	3,515	3,528	met
Stock of net domestic assets of the central bank (ceiling)	-45.0	-27.5	-40.0	-28.0	-50.0	-50.0	met
Public debt targets							
Contracting or guaranteeing of medium- and long-term nonconcessional external debt by the central government (ceiling; millions of US$) 9/10/	…	0	450	0	700	84.6	met
New central government and central government guaranteed external payment arrears (ceiling, millions of US$) 11/	0	0	0	0	0	0	met
Indicative targets							
Priority Social Expenditures of the central government(floor) 2/ 3/ 4/	5.9	5.9	17.6	19.6	24.8	27.0	met

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

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

Date of Availability	Conditions for Fund Disbursement	Original ECF disbursement: Millions of SDRs	Original ECF disbursement: Percent of quota 1/	Proposed ECF augmentation: Millions of SDRs	Proposed ECF augmentation: Percent of quota	Total disbursement: Millions of SDRs	Total disbursement: Percent of quota
January 31, 2011	Board approval of the arrangement	65.136	24.00	-	-	65.14	24.00
June 29, 2011	Observance of the end-March 2011 performance criteria and structural benchmarks, and completion of first review	43.424	16.00	-	-	43.42	16.00
December 15, 2011	Observance of the end-June 2011 performance criteria and structural benchmarks, and completion of second review	43.424	16.00	48.852	18.00	92.276	34.00
April 15, 2012	Observance of the end-December 2011 performance criteria and structural benchmarks, and completion of third review	43.424	16.00	28.497	10.50	71.921	26.50
October 15, 2012	Observance of the end-June 2012 performance criteria and structural benchmarks, and completion of fourth review	43.424	16.00	28.497	10.50	71.921	26.50
April 15, 2013	Observance of the end-December 2012 performance criteria and structural benchmarks, and completion of fifth review	43.424	16.00	28.497	10.50	71.921	26.50
October 15, 2013	Observance of the end-June 2013 performance criteria and structural benchmark, and completion of the sixth review	43.424	16.00	28.497	10.50	71.921	26.50
Total		**325.680**	**120.00**	**162.840**	**60.00**	**488.520**	**180.00**

1/ Kenya's quota is SDR 271.4 million.

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

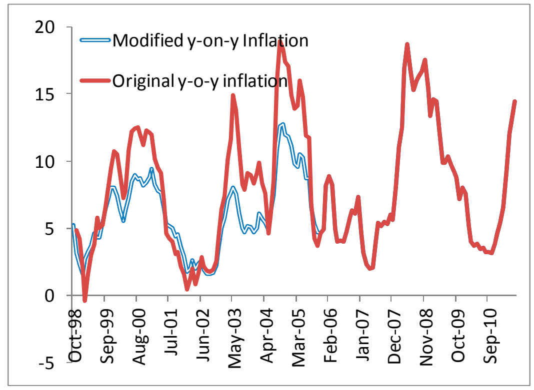
		Projections								
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Fund obligations based on existing credit										
(In millions of SDRs)										
Principal	16.7	2.5	18.8	30.0	25.0	20.0	21.5	33.0	21.7	21.7
Charges and interest	0.0	0.2	1.6	1.5	1.4	1.3	1.2	1.1	0.9	0.8
Obligations to the Fund from existing and prospective credit 1/										
(In millions of SDRs)	2.5	2.5	20.0	31.6	40.3	48.7	50.1	87.1	104.4	112.1
Principal	2.5	2.5	18.8	30.0	38.6	47.1	48.7	85.8	103.3	111.3
ESF Rapid Access Component (RAC)	0.0	0.0	0.0	0.0	13.6	27.1	27.1	27.1	27.1	13.6
ECF Arrangements	2.5	2.5	18.8	30.0	25.0	20.0	21.5	58.6	76.1	97.7
Charges and interest	0.0	0.0	1.3	1.6	1.7	1.6	1.5	1.3	1.1	0.8
Obligations to the Fund from existing and prospective credit 1/										
In millions of U.S. dollars	3.9	3.9	31.4	49.5	63.1	76.4	78.6	136.5	163.6	175.7
In percent of gross international reserves	0.1	0.1	0.7	0.9	1.0	0.8	0.7	1.2	1.3	1.3
In percent of exports of goods and services	0.0	0.0	0.3	0.4	0.5	0.6	0.6	0.8	0.9	0.9
In percent of debt service	1.1	1.0	7.0	10.6	12.1	11.8	9.7	13.4	13.6	12.9
In percent of GDP	0.0	0.0	0.1	0.1	0.1	0.2	0.1	0.2	0.2	0.2
In percent of quota	0.9	0.9	7.4	11.6	14.8	18.0	18.5	32.1	38.4	41.3
Outstanding Fund credit (end-of-period) 1/										
In millions of SDRs	270.7	469.0	594.1	708.0	669.4	622.3	573.6	487.9	384.6	273.3
In millions of U.S. dollars	424.4	735.3	931.4	1109.9	1049.4	975.5	899.2	764.8	602.9	428.5
In percent of gross international reserves	10.7	18.3	20.9	19.9	16.6	10.4	8.5	6.7	4.8	3.1
In percent of exports of goods and services	4.9	7.5	9.0	10.0	9.1	7.9	7.0	4.6	3.3	2.1
In percent of GDP	1.3	2.2	2.6	2.7	2.3	1.9	1.6	1.2	0.9	0.5
In percent of quota	99.7	172.8	218.9	260.9	246.6	229.3	211.4	179.8	141.7	100.7
Memorandum items:										
Nominal GDP	32,115	32,923	35,604	40,421	45,420	50,837	56,866	63,667	70,918	78,978
Exports of goods and services	8,655	9,799	10,325	11,132	11,582	12,292	12,874	16,520	18,409	20,538
Gross international reserves	3,960	4,029	4,454	5,572	6,313	9,369	10,536	11,487	12,525	13,817
Debt service (in millions of U.S. dollars) 2/	356	392	447	466	522	648	806	1,019	1,202	1,367
Quota (in millions of SDRs)	271.4	271.4	271.4	271.4	271.4	271.4	271.4	271.4	271.4	271.4

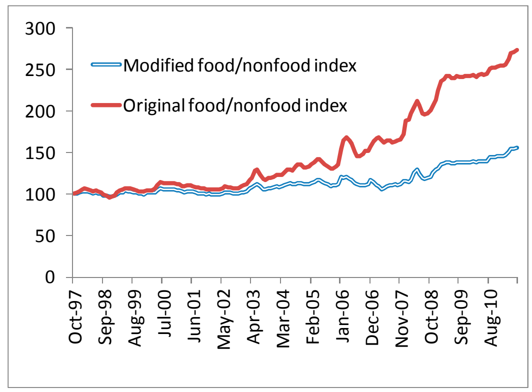
Sources: Fund staff estimates and projections.

1/ Assumes access of 180 percent of quota during 2011–13 w ith 30 percent of the proposed augmentation of 60 percent of quota to be disbursed in December 2011, w hile the remaining 4 disbursements w ill be phased in equally. Outstanding credit at Sept-2011 stands at SDR 377 million, equivalent to 135 percent of quota.

2/ Total debt service includes repayments to the IMF.

APPENDIX I. Constructing a Consistent CPI Time Series for Kenya

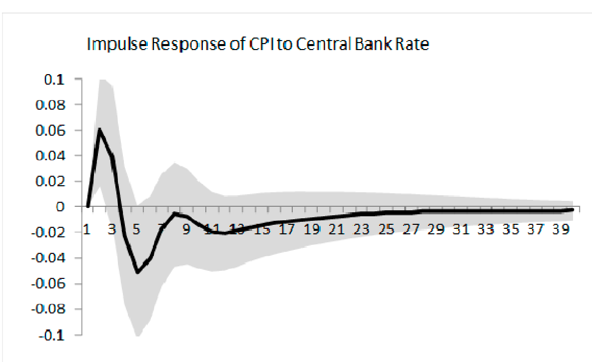


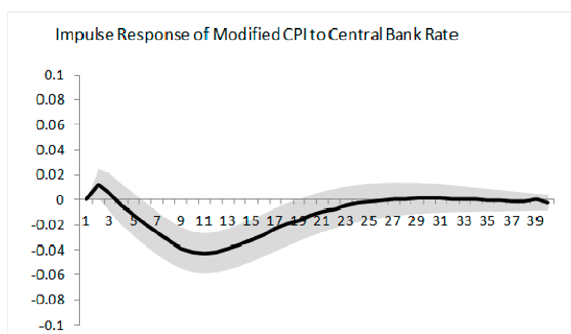


We calculate a modified CPI time series to address inconsistencies in the historical CPI as a result of several changes in the CPI basket and calculation methodology. The new CPI methodology and basket, which came to use in February 2009, has been applied by KNBS to recalculate the CPI index going back to October 2005. However data limitations and the differences in coverage and formulas made it difficult to apply the methodology further back. The spliced time series is therefore not methodologically consistent. This old methodology generated a substantial upward bias to the measurement of inflation, particularly for volatile items such as food prices.

To provide a roughly consistent CPI time series, we apply simple regressions to measure the upward bias for different ranges of food inflation, in periods where CPI data using old and new methodologies were available. By comparing the two overlapped series, we are able to calculate a modified food CPI for periods before October 2005. Maintaining the same non-food CPI across the board, we arrived at a new CPI.[1]

For illustrative purposes, we use the modified CPI to study the relation between CBR and inflation. The revised CPI series responds significantly to changes in the CBR, whereas the old CPI does not.





Impulse response functions caluclated from an SVAR estimation, represent changes in CPI from an steady state value of 100, in response to a 100 bp increase in central bank rate.

[1] The modified CPI series for data points before October 2005 is used in this Staff Report. The methodology was agreed upon with the authorities and will be reflected in the next publications of the World Economic Outlook.

APPENDIX II. LETTER OF INTENT

Nairobi, Kenya
November 18, 2011

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

Dear Ms. Lagarde:

Kenya's economy continues to recover steadily despite new challenges stemming from the severe drought in the Horn of Africa, higher food and fuel prices, and rapidly deteriorating global conditions. Our economy grew by 4.5 percent in the first half of 2011, spurred by a dynamic private sector and the recovery in tourism and agricultural production. We remain sanguine on the growth outlook, although there are formidable downside risks to the ongoing economic expansion.

Our program under the Extended Credit Facility (ECF) arrangement remains broadly on track. All quantitative performance criteria and indicative targets for end-June 2011 have been met. Our fiscal position at end-June was significantly better than envisaged under the program, despite additional spending pressures to support the implementation of our new constitution and the need to cushion vulnerable households from the impact of the drought and higher food and fuel prices. In addition, our fiscal structural reforms remain on track. However, the increased global market turbulence since June together with rising inflationary expectations have placed growing pressures on the Shilling and on the demand for government securities. Inflation has reached levels that could threaten the economic expansion, while the external current account deteriorated on the back of higher import prices and strong domestic demand.

To confront these challenges and to protect the ongoing economic expansion, we require further assistance with external BOP financing to cushion the economy from the impact these exogenous shocks. We request augmenting our access under the existing ECF arrangement by 60 percent of quota over the remaining two years of the program (for a total of 180 percent of quota). Moreover, we would also request that the disbursements of the additional amount to be front loaded to enable us to deal with current challenges more effectively.

We remain committed to the economic reform program set out in the ECF arrangement to achieve macro-economic stability and sustainable growth crucial for poverty reduction. To achieve these objectives, we will implement and monitor policies set out in the attached Memorandum of Economic and Financial Policies (MEFP). We will maintain close policy dialogues with the Fund on the adoption of measures, and in advance of revisions of the policies contained in this Letter of Intent and its attachments, in accordance with the Fund's policies on such consultation.

Based on our additional BOP needs and policies described in this letter of intent and its attachments, we request that the Executive Board complete the second review of the ECF arrangement and approve the corresponding disbursement of SDR 92.27 million, augmentation of our three-year arrangement under the ECF to the amount of 488.52 million SDR in total for the period January 2011-December 2013. We also request modifications of the end-December 2011 and end-June 2012, as well as establishment of performance criteria for end-December 2012. It is expected that the third review will be completed by April 15, 2012, based on end-December 2011 performance criteria, the fourth review will be completed by October 15, 2012, based on end-June 2012 performance criteria, and the fifth review will be completed by April 15, 2013, based on end-December 2012 performance criteria.

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

Sincerely yours,

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

Attachments:
Updated Memorandum of Economic and Financial Policies
Technical Memorandum of Understanding

Attachment I. Memorandum of Economic and Financial Policies for 2011–13 under the Three-Year Program of the Extended Credit Facility Arrangement

This memorandum updates and complements the policies set forth in the MEFP under the original ECF arrangement, as well as the Letter of Intent, attached to the First Review under the ECF arrangement.

I. Background

1. Despite the severe drought in the arid and semi-arid parts of the country, high food and oil prices, and rapidly deteriorating global conditions, our economy has shown resilience with continued strong growth. We project real GDP growth to remain around 5 percent in FY 2011/12, supported by robust public and private investment. We therefore remain positive on the growth outlook, but we believe that the downside risks have risen, and need to be addressed to preserve and sustain the ongoing expansion in economic activity. Coping with the impact of persistently high international prices, the drought in the Horn of Africa, and the security threats coming from the Somali border, poses formidable challenges to macroeconomic policies.

2. **Progress in implementing our reform program under the ECF arrangement has continued.** All quantitative performance criteria and indicative targets for June 2011 have been met. In particular, we have managed to improve our fiscal position, despite the necessary measures taken to protect the vulnerable from high food and fuel prices, and the expenses associated with the implementation of the new constitution. Structural reforms have also moved forward and we are set to meet the benchmark on the submission of the VAT law for the second program review.

3. **However, since June the increased global market turbulence together with rising inflationary expectations has placed growing pressures on the shilling and on the demand for government securities.** As a result, we have not been able to accumulate international reserves as programmed and the government has fully utilized its overdraft facility with the CBK. Therefore, the CBK's net international reserves (NIRs) have fallen below the September indicative floor, and the CBK's net domestic assets (NDAs) have risen above the September indicative ceiling.

4. **Since the program first review, the country's macroeconomic outlook has worsened with respect to inflation and the external position:**

- Inflation has intensified and reached levels that could threaten the economic expansion. First-round effects from the increased food and fuel prices have fed into core inflation because of strong domestic demand fueled by the rapid growth in credit to the private sector.

- The country's external position has deteriorated not only because of higher than originally expected international prices and drought-related import needs but also because of the strength of domestic demand.

5. **The shilling's exchange rate has depreciated substantially in response to a widening current account deficit.** The shilling's slide has added immediate pressures on domestic prices that, if not addressed, could feed back on the external position and the exchange rate raising the risk of destabilizing macroeconomic conditions. To address this risk and protect the ongoing economic expansion we intend to promptly adjust our macroeconomic policy stance by:

- Further tightening monetary policy as needed to stem inflationary expectations; and
- Cutting back on non-priority government spending to contribute to lower domestic demand and mitigate the impact of monetary tightening on market interest rates.

6. **We remain committed to a policy regime free from controls on prices, interest rates, and the exchange rate.** We are convinced that price controls do not work, may be detrimental to economic activity, reduce access to essential goods, and hurt the poor most.

II. The Economic Program for 2011/12

A. Monetary Policy

7. **Policy objective:** The CBK will aim at bringing down annual inflation to 7 percent (within the CBK's inflation target) by end-2012. Monetary policy will continue relying on NDA as an intermediate target (performance criterion). In addition, the CBK has modified the monetary policy framework to give more prominence to the central bank policy rate (CBR) to help anchor inflation expectations. In the new framework, monetary operations to mop up liquidity (repos) as well as to inject liquidity (reverse repos) are conducted using the CBR as a pivot rate to guide interbank market interest rates to a level consistent with the monetary policy stance.

8. **Tightening monetary policy:** The CBK has raised the CBR by a total of 9½ percentage points in the last two MPC meetings. The CBK will maintain a tightening bias promptly absorbing liquidity surplus when needed to induce a deceleration in credit growth and the demand for foreign exchange. The interest rate on the overnight window facility will be maintained at a penalty with respect to the CBR.

9. **International reserve accumulation:** We will continue with our efforts to gradually accumulate international reserves through regular purchases of foreign exchange from the interbank market. We also remain committed to our medium-term objective to increase reserve coverage to four months of prospective imports, but the pace of reserve accumulation will need to take into account the impact of the external supply shocks that has created instability and volatility in the foreign exchange market. We are also committed to maintaining a floating exchange rate regime.

B. Fiscal Policy

10. **Policy objective:** The primary fiscal balance will remain well below the original target for FY 2011/12, as a part of policy adjustment ***(performance criterion)***. We have revised our medium-term consolidation target to partially offset the permanent part of the increase in commodity prices. In addition, we have front-loaded the fiscal consolidation in 2011/12 in order to deal with the temporary demand and BOP pressures. We will maintain our efforts to reduce the public debt-to-GDP ratio to below 45 percent by end 2012/13, but we will provide sufficient resources for the necessary investment in infrastructure, food security and implementation of our Constitution. We will continue to invest in infrastructure, which will increase the growth prospects of the country, relying on mainly concessional financing from our development partners.

11. **Fiscal reforms:** We will maintain our policy of rationalizing recurrent expenditure, and we will restrain growth of the wage bill. Expenditure management control will be enhanced with the implementation of new legislation on public finance management (PFM), to be submitted before the end of the fiscal year ***(structural benchmark for the third review)***. To complement this effort, we are in the process of incorporating suggestions to a new draft VAT law to parliament that will remove a number of ad hoc exemptions and zero rated goods that have undermined revenue collection ***(structural benchmark)***. In addition, we will also examine our broad tax administration framework in order to increase efficiency in revenue administration, including in customs administration.

12. **We are actively preparing for the fiscal decentralization, which in line with the constitutional implementation process, will start following the elections in 2012.** In this regard, the new PFM legislation will strengthen expenditure control at both the Central and County government level. In addition, we will implement the Integrated Financial Management Information System (IFMIS) across Ministries and Departments. We remain committed to implementing a single treasury account (TSA) by June 2012 ***(structural benchmark).***

13. **Emergency relief expenditure:** In order to provide emergency relief following the drought, we removed duties on wheat and maize to keep prices affordable. Moreover, we removed and lowered excise taxes, on kerosene and diesel respectively, to counter the increase in fuel prices. We plan to phase out these measures by the end of the fiscal year and instead scale up targeted interventions, including expanding our existing food safety net programs covering all vulnerable groups in both urban and rural areas. .

14. **Poverty reduction:** Consistent with our Vision 2030, we are updating the Poverty Reduction Strategy Paper (PRSP) taking into account current macroeconomic conditions and emerging challenges. This framework will provide for social expenditure in the transition towards a new government following elections in 2012, consistent with the overall poverty reduction strategy of the country.

15. **Financing policy:** We will remain prudent in approving new project loans to ensure public debt dynamics remain sustainable. We will aim at obtaining the necessary domestic financing by accepting interest rates on our securities that are consistent with money market rates in order to reduce reliance on the use of the overdraft facility at the CBK. We will also monitor closely the risks related to contingent liabilities exposure, including through the integration of projects funded through public private partnerships into the medium term debt management strategy. We continue to maintain non-concessional financing, including guarantees, below US$700 million for the remainder of 2011/12 ***(performance criterion).*** While we still plan to issue a sovereign bond in 2012/13, we will monitor developments in the international markets with the view to issuing the bond early to take advantage of the favorable interest rates, market conditions permitting. The non-concessional financing, including the sovereign bond proceeds, will be limited to investment projects that demonstrate revenue streams and are of high social returns. As before, we will continue with our policy of not incurring external arrears ***(performance criterion)***.

C. Financial Sector Policy

16. **Policy objective:** We remain committed to the twin objectives of promoting financial inclusion and strengthening financial stability. Following the introduction of legislation allowing the Central Bank to take prompt corrective action to deal with problem banks, we will sustain ongoing initiatives to upgrade crisis management frameworks to deal with the challenges of cross-border operations and mobile banking. We will increase the use of stress testing and improve the evaluation of provisioning practices by financial institutions. As we transition to a higher interest rate environment we will monitor the banks' liquidity position, any deterioration in the quality of the loan portfolio, and the impact on profitability of changes in the valuation of assets.

17. **Financial development policies:** We will make further progress in deepening our financial sector to transform it into a regional hub for financial services. We expect the process of demutualization of the Nairobi Stock Exchange to be completed during the FY 2011/12. This will convert our stock exchange into a for-profit entity and open it to participation from a wider range of investors, contributing to greater transparency, accountability and liquidity. Other measures we plan to implement in the near term include the raising of capital requirements for listed companies and the introduction of a new framework allowing for more issuance and OTC trading.

18. **Pension reform:** A comprehensive reform of social security policy is ready for cabinet discussion. The new framework will redefine pension schemes, including by transforming the National Social Security Fund (NSSF) from a provident fund into a social insurance pension scheme. Reform of the NSSF has already started under a new management that has radically improved the Fund's governance environment, including by appointing fund managers and custodians, fully complying with requirement set by the Retirement Benefits Authority (RBA), the pension funds regulator.

III. Program Issues

19. **Safeguards assessment.** The latest safeguards assessment of the Central Bank of Kenya was completed on September 9, 2011. We are in the process of implementing the recommendations of the assessment.

20. **Program monitoring.** Our program will be monitored using the definitions, data sources, and frequency of monitoring set out in the accompanying revised TMU. The government will make available to Fund staff all data appropriately reconciled and on a timely basis, as specified in the TMU. Table 1 shows the quantitative performance criteria to be used in monitoring performance in 2011/12, and structural benchmarks, with corresponding dates, are identified in Table 2. Fiscal performance criteria will cover the budgetary central government, but the authorities will prepare to expand coverage to include the budget of national government and county governments as early as possible in anticipation of fiscal decentralization. The third review under the ECF arrangement, assessing end-December performance criteria, is expected to be completed by April 15, 2012, the fourth review will be completed by October 15, 2012, based on end-June 2012 performance criteria, and the fifth review will be completed by April 15, 2013, based on end-December 2012 performance criteria., the fourth review will be completed by October 15, 2012, based on end-June 2012 performance criteria, and the fifth review will be completed by April 15, 2013, based on end-December 2012 performance criteria.

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

(In billions of Kenyan shillings; unless otherwise indicated)

	2011				2012					
	Indicative Targets		Performance Criteria		Indicative Targets		Performance Criteria		Indicative Targets	Performance Criteria
	End-September		End-December		End-March		End-June		End-Sept.	End-Dec.
	First Review	Second Review	First Review	Second Review	First Review	Second Review	First Review	Second Review	New Targets	New Targets
Quantitative performance criteria										
Fiscal targets										
Primary budget balance of the central government (-=deficit, floor) 1/ 2/ 3/ 4/	-30.0	-30.0	-30.0	-10.0	-50.0	-32.0	-15.0	0.0	5.0	15.0
Monetary targets 5/ 6/										
Stock of central bank net international reserves (floor, in millions of US$) 7/8/	3,600	3,600	3,700	3,125	3,700	3,125	3,700	3,170	3,500	3,325
Stock of net domestic assets of the central bank (ceiling)	-45	-45	-30	-40	-50	-40	-45	-35	-55	-25
Public debt targets										
Contracting or guaranteeing of medium- and long-term nonconcessional external debt by the central government (ceiling; millions of US$) 9/10/	700	700	700	700	700	700	700	700	700	700
New central government and central government guaranteed external payment arrears (ceiling, millions of US$) 11/	0	0	0	0	0	0	0	0	0	0
Indicative targets										
Priority Social Expenditures of the central government(floor) 2/ 3/ 4/	12.1	12.1	13.5	13.5	22.5	22.5	26.1	26.1	12.1	15.0

1/ The primary budget balance of the central government is defined as overall balance including grants, minus concessional project loans, plus interest payments.
2/ Targets for end-December 2010, end-March 2011, and end-June 2011 are cumulative flow, from October 1, 2010 (beginning of the second quarter of the 2010/2011 fiscal year).
3/ Targets for end-September 2011, end-December 2011, end-March 2012, and end-June 2012 are cumulative flow from July 1, 2011 (beginning of the 2011/2012 fiscal year).
4/ Targets for end-September 2012 and end-December 2012 are cumulative flow from July 1, 2012 (beginning of the 2012/13 fiscal year).
5/ For program monitoring, the daily average for the month when testing dates are due.
6/ The NIR floor will be adjusted upward (downward) by the excess (shortfall) of external budgetary support (grants and loans) and external commercial debt relative to the programmed amounts. The NDA ceiling will be adjusted downward (upward) by the excess (shortfall) of external budgetary support (grants and loans) and external commercial debt relative to the programmed amounts.
7/ Excludes encumbered reserves.
8/ First review targets at April 29, 2011 exchange rates. Second review targets at September 30, 2011 exchange rate.
9/ Cumulative flow of contracted debt, from January 1, 2011.
10/ The targets on the ceiling non-concessional external debt do not include the planned issue of sovereign bond that is now scheduled for 2012/13 fiscal year.
11/ Continuous.

Table 2. Kenya: Structural Benchmarks for the ECF Arrangement

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

Attachment II. Updated Technical Memorandum of Understanding

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

I. Quantitative Performance Criteria and Benchmarks

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

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

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

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

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

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

5. For program purposes, the **central government primary balance excluding external concessional project loans** on cash basis is cumulative from July 1, 2011 and will be measured from the financing side as the sum of the following: (a) the negative of **net domestic financing** of the central government; (b) the negative of **net external financing of the central government, excluding external concessional project loans;** and (c) **domestic and external interest payments** of the central government. For the December 31, 2012 test

date, the central government primary balance including grants excluding external concessional loans will be measured cumulative from July 1, 2012.

The above items are defined as follows:

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

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

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

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

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

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

III. Performance Criterion on the Net International Reserves of the Central Bank of Kenya

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

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

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

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

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

- **Gross official international reserves** exclude:

  - the reserve position in the IMF;

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

  - deposits with Crown agents; and

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

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

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

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

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

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

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

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

7. **NIR are monitored in U.S. dollars,** and, for program monitoring purposes, assets and liabilities in currencies other than the U.S. dollar shall be converted into dollar equivalent

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

values, using the exchange rates as specified in Table 1, and net international reserves will be computed as the daily average for the month when the testing date is due.

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

8. **Net domestic assets** are defined as reserve money minus NIR converted in shillings at the accounting exchange rate of 99.7 shillings for one U.S. dollar, plus medium- and long-term liabilities (i.e., liabilities with a maturity of one year or more) of the CBK, including those arising from the August 28, 2009 SDR General allocation and the September 9, 2009 SDR Special allocation; minus the value in shillings of encumbered reserves converted at the accounting exchange rate of 99.7 shillings for one U.S. dollar.

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

- Reserve money is defined as the sum of:
  - currency in circulation; and
  - required and excess reserves.

- The following **adjustors** will apply to the target for NDA:
  - If budgetary support (external grants and loans) and external commercial debt exceed the programmed amounts, the target for NDA will be adjusted downward by the difference.

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

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

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

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

- Debt is understood to mean a direct, that is, not contingent, liability, created under a contractual agreement through the provision of value in the form of assets (including currency) or services, which requires the obligor to make one or more payments in the form of assets (including currency) or services at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows:

    - loans, that is, advances of money to the obligor by the lender made on the basis of a undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans, and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements);

    - suppliers' credits, that is, contracts where the supplier permits the obligor to defer payments until sometime after the date on which the goods are delivered or services are provided; and

    - leases, that is, arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lesser retains title to the property. For the purpose of this guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property.

- Under the definition of debt set out above, arrears, penalties, and judicially awarded damages arising from failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (for example, payment on delivery) will not give rise to debt.

11. Debt is considered concessional if, on the date on which the contract was signed, the ratio of the present value of the loan, based on the commercial interest reference rates (CIRRs), to the nominal value of the loan is less than 65 percent (that is, the grant element of the loan is at least equal to 35 percent of its nominal value). The present value of the loan will be calculated by discounting future payments of interest and principal using the CIRRs established by the Organization for Economic Cooperation and Development (OECD). Specifically, the 10-year average of CIRRs reported by the OECD will be used for loans with maturities longer than 15 years while the six-month average of CIRRs will be used for loans with shorter maturities. To both the 10-year and 6-month averages of the reference rate, the margin for different repayment periods will be added, as established by the OECD

(0.75 percent for repayment periods of less than 15 years; 1 percent for repayment periods of 15–19 years; 1.15 percent for repayment periods of 20–29 years; and 1.25 percent for repayment periods of 30 years or more).

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

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

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

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

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

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

VII. Indicative Target on Priority Social Spending

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

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

VIII. Coverage

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

Table 1. Kenya: (Program) Exchange Rates for the ECF
(Rates as of September 30, 2011)

Currency	Kenyan Shillings per curreny unit	Dollars per curreny unit
Canadian dollar	95.93	0.963
Danish krone	18.13	0.182
Euro	135.09	1.356
Japanese yen	1.30	0.013
Pound sterling	155.42	1.560
Swedish krone	14.52	0.146
SDR	156.18	1.567
US dollar	99.65	1.000

Table 2. Kenya: Summary of Data to Be Reported

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

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

INTERNATIONAL DEVELOPMENT ASSOCIATION
INTERNATIONAL MONETARY FUND

KENYA

Joint IMF/World Bank Debt Sustainability Analysis

Prepared by the Staffs of the International Monetary Fund and the World Bank

Approved by Saul Lizondo and Dominique Desruelle (IMF)
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November 23, 2011

This analysis updates the previous joint Bank/Fund debt sustainability analysis (DSA) submitted to the Executive Board in January 2011(Country Report No. 11/48).[1] *Compared to the January 2011 analysis, overall debt sustainability indicators have not changed significantly. Lower than anticipated fiscal deficit in 2010 was offset by an increase in external debt-to- GDP ratio due to exchange rate depreciation and increased IMF financing. Risks are somewhat greater for external debt, particularly in the historical scenario, as the current account deficit has widened in 2010. Nevertheless, Kenya remains at low risk of external and domestic debt distress.*[2,3] *Strategies to guard against shocks could include a build-up in international reserves as envisaged in the ECF framework.*

I. Background

1. **At end-2010, nominal public external debt was estimated at $7.3 billion (24 ¼ percent of GDP)**. About 60 percent of this debt was to multilateral creditors (including 43 percent owed to the World Bank) and 39 percent to bilateral creditors. A small share of this debt (under 2 percent) represents disputed arrears on security-related contracts, owed to commercial creditors.

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[1] It has benefited from consultation with African Development bank staff.

[2] World Bank classifies Kenya as a medium performer in terms of the quality of its policies and institutions as measured by a three-year average of the World Bank's Country Policy and Institutional Assessment (CPIA) index. (available at http://go.worldbank.org/AXO6I14PK0)

[3] For a medium performer, the indicative thresholds for external debt sustainability are a net present value (NPV) of debt-to-GDP ratio of 40 percent, an NPV of debt-to-exports ratio of 150 percent, an NPV of debt-to-revenue ratio of 250 percent, a debt service-to-exports ratio of 20 percent, and a debt service-to-revenue ratio of 30 percent.

2. **Kenya has managed its debt relatively well and has regularly met its obligations, except for some disputed commercial arrears**. Its external debt-to GDP ratio was 24 percent at end-2010, mainly a result of prudent external borrowing, and Kenya has a more manageable debt ratio than most of its low-income country peers. Kenya did not qualify for heavily indebted poor countries (HIPC) debt relief, as its debt indicators have been below the HIPC Initiative thresholds, but it benefited from Paris club rescheduling in 2004.

3. **The disputed external commercial arrears, estimated at US$242 million, are subject of ongoing investigations and litigation**. The timeline for clearance of these arrears has not been determined. The amount of arrears has been revised upward from an earlier estimate of US$91 million, following completion of independent valuation of works, goods, and services delivered under each contract. The authorities think that it is more prudent to estimate a higher figure to reflect the likelihood of court rulings in favor of all creditors.

4. **Kenya's net domestic debt stood at Ksh 580 billion at end-2010 (24¾ percent of GDP), but potential domestic contingent liabilities due to pensions could be large.** During 2003–07, domestic debt declined to 13½ percent of GDP, as a result of strong economic growth, prudent fiscal policies, and lower interest rates. The downward trend was reversed during 2008–09 reflecting fiscal stimulus measures implemented to mitigate the impact of the global financial crisis. Despite relatively low domestic debt-to-GDP ratio, Kenya may be vulnerable to possible realization of contingent liabilities associated with unfunded obligations of the National Social Security Fund and government's current pay-as-you-go pension scheme for civil servants as well as domestic debt of parastatal companies.

5. **The DSA is based on non-reconciled debt data provided by the authorities, and staff estimates**. It consists of two parts**—external and fiscal**.

- The external DSA covers external debt of the central government and the central bank. External debt sustainability is assessed in relation to policy-dependent debt-burden thresholds. A single discount rate of 4 percent is used.

- The fiscal DSA covers total debt—external and domestic—incurred or guaranteed by the central government.[4]

[4] Public domestic debt comprises central government debt. In this analysis, total public debt refers to the sum of public domestic and public external debt, but does not cover the entire public sector (e.g., parastatal borrowing without a government guarantee is not covered).

II. Macroeconomic Assumptions

6. **Key medium-term assumptions underlying the DSA are consistent with the Staff Report for the 2011 Article IV Consultations, Second Review Under the Three-Year Arrangement Under the Extended Credit Facility and Request for Modification of Performance Criteria and Augmentation of Access. These assumptions are:**

- Real GDP growth is projected at around 5 percent for 2011, 5 ½ in 2012, and about 6 percent afterwards. The projected growth remains, on average, about the same as the pre-crisis five-year average of just above 6 percent and represents a deceleration from the 2007 growth of 7 percent. As such, the projected growth reflects in part a resumption of the momentum that was abruptly disrupted by the 2007 post-elections violence.[5]

- Average inflation, as measured by the GDP deflator, is projected at about 12 percent in 2012, 7 percent for 2013, and 5 percent after 2014.

- The exchange rate is assumed to remain constant in real terms over the medium term.

- The noninterest external current account deficit rises to about 9¾ percent of GDP in 2011, before falling to about 3 percent of GDP by 2015.

- Broadly constant revenue and grants as a share of GDP (about 26 percent);[6] the primary fiscal deficit is 1.5 percent of GDP in 2010/11 and gradually declines to 1.1 percent by the end of the forecast period.

- Development spending increasing from just about 8.0 percent of GDP in 2010 to about 10 percent by 2012; a constant wage bill of 7.1 percent of GDP after 2012 compared to 6.8 percent in the 2011/12 budget, and a gradual decline in other recurrent spending from 8.9 percent of GDP in 2008 to 7.2 percent of GDP over the long-term, in line with the government's budget strategy.

- Real interest rates on domestic public debt are assumed at about 3 percent for short-term debt and about 5 percent for medium- and long-term debt.

- New domestic borrowings consists of 30 percent short-term debt and 70 percent of medium- and long-term debt, with the latter having an average maturity of about seven years. The NPV of domestic debt is assumed to be equal to its face value.

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[5] The likelihood of the domestic shocks of this nature has been reduced following the August 2010 ratification of the new constitution.

[6] The increase from the average of about 23 percent of GDP in the past three years reflect an expected improvement in the revenue mobilization effort stemming from tax reforms, as well as in the capacity to absorb project grants.

- New external borrowing as a share of GDP (including nonconcessional borrowing described below) increases over the medium and then declines gradually. It is projected to average 3 percent of GDP during 2011–15, up from 2 ¼ percent of GDP in 2010. It subsequently declines, falling below 1 percent by the end of the forecast period. New external borrowing assumptions include sovereign bond issuance of $500 million in 2012, additional commercial borrowing of about US$450 million during 2013–14 and about US$200 million per year in the long run. Assumptions on the debt terms include a 7½ percent fixed interest rate 10 year maturity and a bullet amortization.

7. Continued eligibility for concessional borrowing from the International Development Association is assumed, although achievement of assumed growth rates could imply graduation during the forecast period.

III. External Debt Sustainability

8. **Kenya faces a low risk of external debt distress reflecting the limited reliance on external borrowing and an expected improvement in macroeconomic performance**.

- Under the *baseline scenario***,** initial debt ratios are well below all of the indicative thresholds for a medium performer, even if they increase over the medium-term reflecting a higher rate of debt accumulation (see Figure 1 and Table 2a and 2b).

- **Alternative scenarios and stress tests indicate that Kenya's external debt situation is generally resilient.** Standard stress tests reveal an initial upward trend for the debt indicators but do not result in a breach of the thresholds during the projection period. Over the period 2011–15, a shock combining lower GDP growth, weaker exports, a lower GDP deflator, and a fall in non-debt creating flows would push the NPV of public external debt as a share of GDP from 18 percent to 26 percent, and the NPV of debt-to-exports from almost 57 percent to 89 percent. The most extreme shocks to debt dynamics by 2021 generally stem from a one-time 30 percent depreciation in 2011 or from a one standard deviation shock to the growth of exports proceeds.[7]

[7] The most extreme shock to the NPV of debt-to-GDP, the NPV of debt-to-revenue, and debt service-to-revenue results from a 30 percent exchange rate depreciation in 2011, whereas the most extreme shock to the PV of debt-to-exports results from an exports growth subdued during 2011–12 at only 1.3 percent (the historical average minus one standard deviation).

Summary: External Debt Sustainability Assessment
(Percent of GDP)

	2011	2012	2013	2014	2015	2016
NPV of PPG External Debt						
In percent of GDP (threshold=40)						
Baseline	17.7	18.7	19.1	18.9	18.7	18.0
Combined shocks	17.7	21.8	26.1	25.5	25.0	23.9
In percent of exports (threshold=150)						
Baseline	57.0	65.3	68.9	73.4	76.4	78.2
Combined shocks	57.0	69.1	81.0	85.3	87.9	89.5
PPG External Debt Service						
In percent of exports (threshold=20)						
Baseline	3.8	4.2	4.2	4.7	4.8	4.9
Combined shocks	3.8	4.1	4.3	4.9	5.0	5.2

IV. PUBLIC DEBT SUSTAINABILITY

9. **Kenya's public debt shows some vulnerability to growth shocks.**

- Under the *baseline scenario*, the NPV of total public debt-to-GDP, at 40½ percent in 2010, increases and peaks at almost 42 percent in 2012 and gradually trends down to 40 percent of GDP by 2014. Afterwards, it trends down to around 25 percent by 2031 (Figure 2 and Table 1a). Given Kenya's relatively strong revenue performance, the NPV of debt-to-revenue ratio declines to below 150 percent in 2013. The debt service-to-revenue ratio falls to 22 percent by 2015, from 25 in 2009. It declines to below 20 percent by 2030.

- *Alternative scenarios* and *stress tests* indicate that Kenya's debt indicators are vulnerable to slower growth, keeping the primary balance fixed to a historical average, and materialization of contingent liabilities (see Figure 2 and Table 1b). A scenario assuming that 10 percent of 2010 GDP in potential domestic currency liabilities as of end-2010 would be paid by the government in equal tranches over a 10-year period shows that debt indicators deteriorate notably compared with the baseline. An alternative scenario shows that a two-year growth shock leads to a rise in the NPV of debt-to-GDP ratio to 55 percent by 2014, an NPV of debt-to-revenue ratio to over 200 percent by 2020, and a rise in the debt service-to-revenue ratio to over 31 percent by 2030. Also, the scenario of permanently lower growth—baseline minus half a percentage point—results in debt indicators that are considerably higher in the long-term (e.g., by the end of the forecast period, the NPV of debt-to-GDP ratio would be 50 percent). This result reinforces the importance of implementing fiscal consolidation and expanding productive capacity in the medium term, in addition to pursuing a prudent borrowing approach, to avoid a rising debt burden.

V. Conclusions

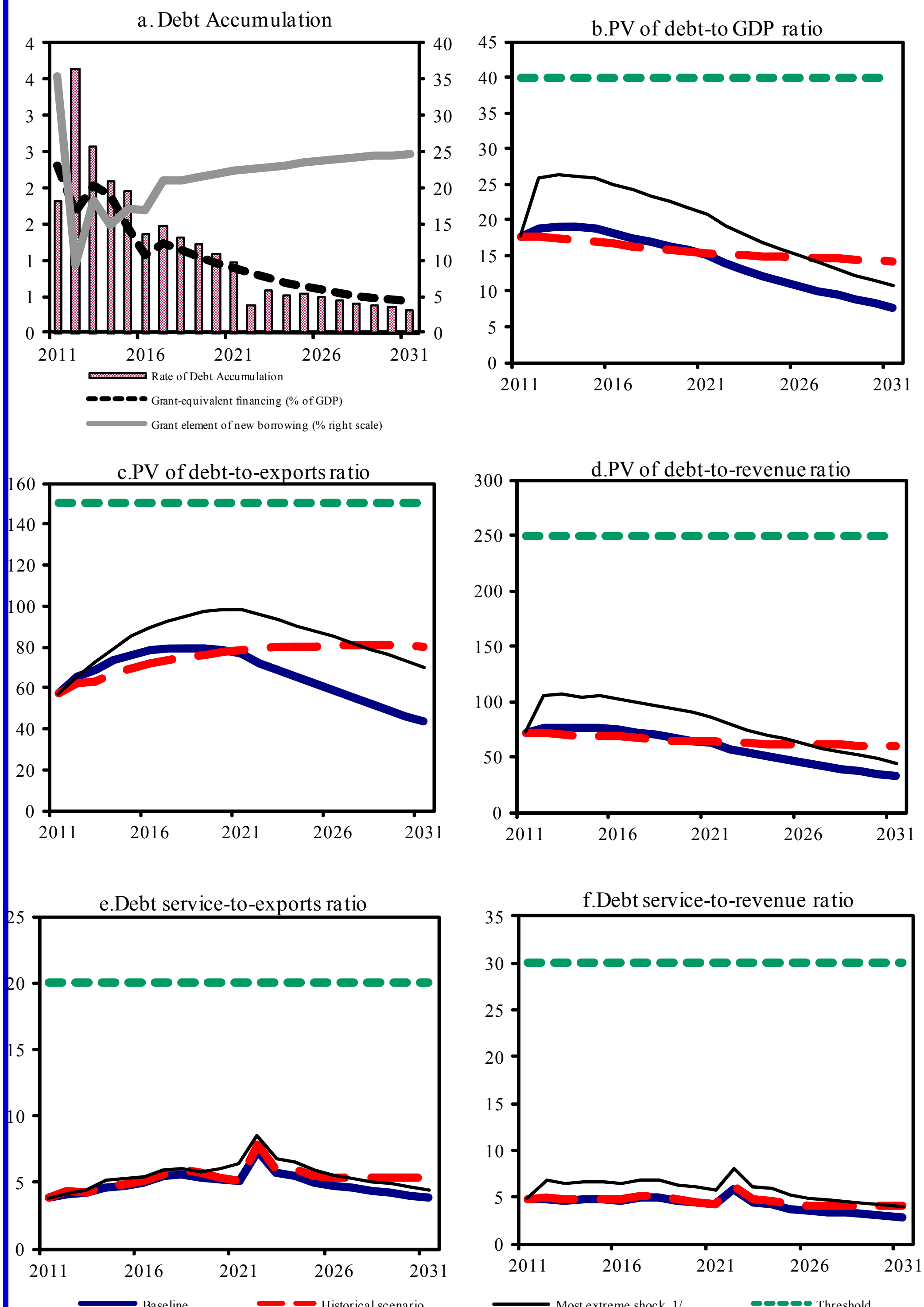
10. **Kenya faces a low risk of external debt distress, reflecting the limited reliance on external borrowing and an expected improvement in macroeconomic performance**. All external public debt indicators remain below the relevant country-specific debt burden thresholds. Further, although standard stress tests reveal a worsening in debt indicators, they do not result in a breach of the thresholds during the projection period.

11. **Total public debt, however shows greater risk of unfavorable debt developments, especially under a shock to GDP growth, unchanged fiscal policy, or materialization of some contingent liabilities**. Even temporarily lower GDP growth would set the NPV of public debt-to-GDP, the NPV of debt-to-revenue, and the ratio of debt service-to-revenue on a sharply increasing trend. A permanently unchanged primary balance from its 2010 level worsens debt dynamics notably. Potentially large but unreported contingent liabilities also pose additional risks to the sustainability of public debt.

12. **The sustainability of Kenya's debt depends on macroeconomic performance and a prudent borrowing strategy**. The projected investment in infrastructure and the assumed improvement in the investment climate would be crucial to sustaining strong exports and GDP growth. Additionally, Kenya's success in avoiding unsustainable debt to date reflects good management, but also limited willingness on the part of creditors to provide financing, at times due to governance concerns.

13. **The authorities were involved in the DSA exercise and concur with its conclusions.** The staffs encourage Kenyan authorities to build on their recent medium-term debt strategy and to use tools such as the joint IMF/WB DSA template to help maintain a prudent borrowing strategy. Such a strategy should continue to consider the total concessionality and interest costs of Kenya's borrowing, maturity structure, and steps that would help guard against volatility, whether due to shocks such as droughts or to fluctuations in external assistance. Strategies to guard against shocks could include a build-up in international reserves as envisaged in the ECF framework.

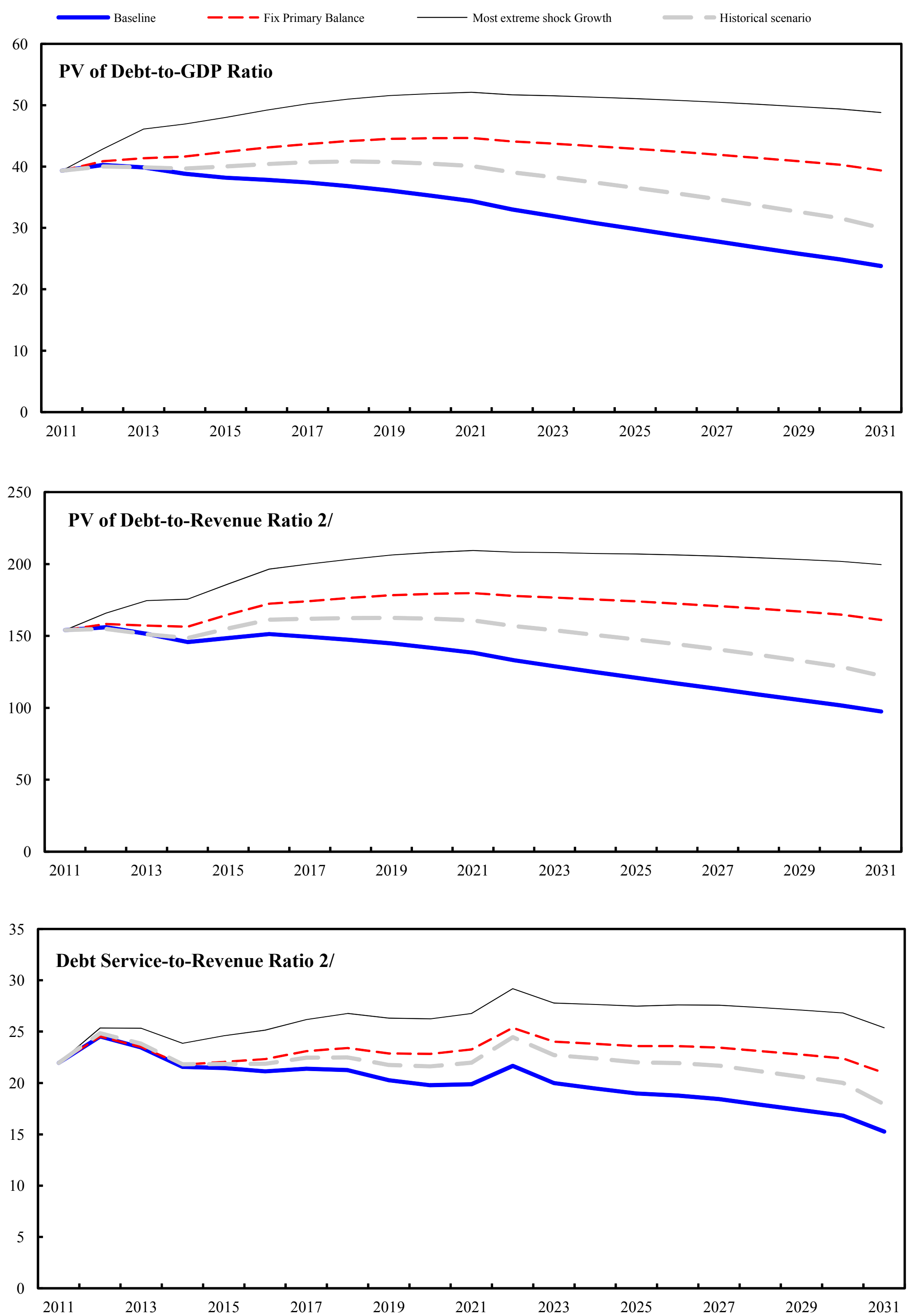
Figure 1. Kenya: Indicators of Public and Publicly Guaranteed External Debt Under Alternatives Scenarios, 2011–31[1]



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2021. In figure b. it corresponds to a One-time depreciation shock; in c. to a Terms shock; in d. to a One-time depreciation shock; in e. to a Non-debt flows shock and in figure f. to a One-time depreciation shock

Figure 2.Kenya: Indicators of Public Debt Under Alternative Scenarios, 2011-2031 1/



Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio in 2021.
2/ Revenues are defined inclusive of grants.

Table 1a.Kenya: Public Sector Debt Sustainability Framework, Baseline Scenario, 2008–31
Percent of GDP, unless otherwise indicated)

	Actual			Average[5]	Standard Deviation[5]	Estimate	Projections								
	2008	2009	2010			2011	2012	2013	2014	2015	2016	2011–16 Average	2021	2031	2017–31 Average
Public sector debt [1]	41.3	42.7	45.7			47.5	47.5	46.7	45.0	43.8	43.1		39.0	28.1	
Off Which : foreign-currency denominated	23.7	22.9	22.9			25.9	25.9	25.9	25.2	24.6	23.5		19.3	10.2	
Change in public sector debt	2.1	1.4	3.0			1.8	0.0	-0.8	-1.8	-1.2	-0.7		-0.9	-1.0	
Identified debt-creating flows	2.1	-0.6	3.2			1.0	-2.2	-1.2	-1.8	-1.7	-1.2		-0.7	0.5	
Primary deficit	2.1	3.1	2.8	1.0	1.9	2.5	2.3	1.9	1.2	1.0	1.5	1.8	1.4	1.9	1.6
Revenue and grants	23.2	22.8	24.6			25.5	25.8	26.3	26.6	25.7	25.0		24.7	24.1	
Of which: grants	1.1	0.9	0.8			1.0	1.3	1.4	1.5	1.0	0.6		0.5	0.2	
Primary (noninterest) expenditure	25.4	25.8	27.4			28.0	28.1	28.2	27.8	26.7	26.4		26.1	26.1	
Automatic debt dynamics	1.7	-3.7	0.3			-1.5	-4.6	-3.1	-3.0	-2.8	-2.7		-2.1	-1.5	
Contribution from interest rate/growth differential	-1.2	-1.4	-0.7			-3.2	-3.0	-2.1	-2.0	-1.9	-2.0		-1.5	-1.1	
Of which: contribution from average real interest rate	-0.6	-0.3	1.5			-1.0	-0.5	0.6	0.8	0.8	0.7		0.7	0.5	
Of which: contribution from real GDP growth	-0.6	-1.1	-2.2			-2.2	-2.5	-2.7	-2.8	-2.7	-2.7		-2.3	-1.7	
Contribution from real exchange rate depreciation	2.9	-2.3	1.0			1.7	-1.6	-1.0	-1.0	-0.8	-0.7		...	...	
Other identified debt-creating flows	-1.8	0.1	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	-1.8	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)	0.1	0.1	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	0.0	2.0	-0.2			0.8	2.3	0.4	0.0	0.5	0.5		-0.2	-1.5	
Other Sustainability Indicators															
PV of public sector debt	...	...	38.5			39.3	40.3	39.9	38.7	37.9	37.6		34.7	25.6	
Off which : foreign-currency denominated	...	...	15.8			17.7	18.7	19.1	18.9	18.7	18.0		15.0	7.7	
Off which : external	...	...	15.8			17.7	18.7	19.1	18.9	18.7	18.0		15.0	7.7	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need[2]	11.4	17.6	14.8			15.2	15.4	15.1	13.8	13.2	13.2		13.0	11.9	
PV of public sector debt-to-revenue and grants ratio (in percent)	…	…	156.5			154.2	156.1	151.5	145.6	147.8	150.5		140.4	106.1	
PV of public sector debt-to-revenue ratio (in percent)	…	…	161.6			160.5	164.3	160.0	154.2	153.6	154.5		143.3	107.1	
Off which : external[3]	…	…	66.1			72.2	76.2	76.6	75.4	75.8	74.0		62.0	32.3	
Debt service-to-revenue and grants ratio (in percent)[4]	18.4	41.7	25.5			21.9	24.5	23.5	21.6	21.5	21.1		20.0	15.5	
Debt service-to-revenue ratio (in percent)[4]	19.4	43.3	26.4			22.8	25.8	24.8	22.9	22.3	21.7		20.4	15.6	
Primary deficit that stabilizes the debt-to-GDP ratio	0.1	1.7	-0.1			0.7	2.3	2.7	3.0	2.2	2.2		2.4	3.0	
Key macroeconomic and fiscal assumptions														1.1	
Real GDP growth (in percent)	1.5	2.6	5.6	4.2	2.2	5.0	5.6	6.0	6.4	6.4	6.5	6.0	6.1	6.1	6.1
Average nominal interest rate on forex debt (in percent)	1.5	0.5	1.0	1.4	1.0	1.0	1.3	1.5	1.7	1.9	2.0	1.6	2.4	2.1	2.2
Average real interest rate on domestic debt (in percent)	-1.7	0.0	8.4	2.2	3.1	-3.6	-2.5	1.8	3.2	3.3	3.3	0.9	3.1	2.7	3.1
Real exchange rate depreciation (in percent, + indicates depreciation)	14.1	-10.3	4.8	-2.5	7.9	7.9	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	11.9	10.9	2.2	5.9	3.7	12.1	12.3	7.1	5.6	5.2	5.0	7.9	5.0	5.0	5.0
Growth of real primary spending (deflated by GDP deflator, in percent)	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.1	0.1	0.1	0.1	0.1
Grant element of new external borrowing (in percent)	...	...	...	…	…	35.4	9.3	18.3	14.9	17.2	17.0	18.7	22.3	24.7	...

Sources: Country authorities; and staff estimates and projections.

[1] Public debt refers to net 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 1b.Kenya: Sensitivity Analysis for Key Indicators of Public Debt 2011–31

	Projections							
	2011	2012	2013	2014	2015	2016	2021	2031
PV of Debt-to-GDP Ratio								
Baseline	39	40	40	39	38	38	35	26
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	39	40	40	40	40	40	40	30
A2. Primary balance is unchanged from 2011	39	41	41	42	42	43	45	39
A3. Permanently lower GDP growth[1]	39	41	41	41	41	41	44	47
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2012–13	39	43	46	47	48	49	52	50
B2. Primary balance is at historical average minus one standard deviations in 2012–13	39	41	42	41	41	40	38	29
B3. Combination of B1-B2 using one half standard deviation shocks	39	41	42	43	43	44	46	43
B4. One-time 30 percent real depreciation in 2012	39	48	47	46	45	44	41	31
B5. 10 percent of GDP increase in other debt-creating flows in 2012	39	50	49	48	47	46	42	32
PV of Debt-to-Revenue Ratio[2]								
Baseline	154	156	151	146	148	151	140	106
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	154	155	151	149	156	161	162	122
A2. Primary balance is unchanged from 2011	154	158	157	157	165	173	181	162
A3. Permanently lower GDP growth1	154	159	157	154	159	166	176	195
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2012–13	154	166	175	175	185	196	212	209
B2. Primary balance is at historical average minus one standard deviations in 2012–13	154	160	160	155	158	162	154	121
B3. Combination of B1-B2 using one half standard deviation shocks	154	160	160	160	168	177	188	179
B4. One-time 30 percent real depreciation in 2012	154	185	179	172	174	177	165	130
B5. 10 percent of GDP increase in other debt-creating flows in 2012	154	193	187	180	183	186	171	131
Debt Service-to-Revenue Ratio[2]/								
Baseline	22	25	23	22	21	21	20	15
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	22	25	24	22	22	22	22	17
A2. Primary balance is unchanged from 2011	22	25	24	22	22	22	23	20
A3. Permanently lower GDP growth1	22	25	24	22	22	22	23	24
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2012–13	22	25	25	24	25	25	27	26
B2. Primary balance is at historical average minus one standard deviations in 2012–13	22	25	24	22	22	22	20	16
B3. Combination of B1-B2 using one half standard deviation shocks	22	25	25	22	23	23	24	22
B4. One-time 30 percent real depreciation in 2012	22	25	25	24	24	24	23	19
B5. 10 percent of GDP increase in other debt-creating flows in 2012	22	25	26	26	26	25	22	17

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.

Table 2a.: External Debt Sustainability Framework, Baseline Scenario, 2008-2031[1]
(In percent of GDP, unless otherwise indicated)

	Actual			Historical[6] Average	Standard[6] Deviation	Projections									
	2008	2009	2010			2011	2012	2013	2014	2015	2016	2011–16 Average	2021	2031	2017–31 Average
External debt (nominal)[1]/	**23.7**	**22.9**	**22.9**			**25.9**	**25.9**	**25.9**	**25.2**	**24.6**	**23.5**		**19.3**	**10.2**	
Of which : public and publicly guaranteed (PPG)	23.7	22.9	22.9			25.9	25.9	25.9	25.2	24.6	23.5		19.3	10.2	
Change in external debt	2.6	-0.8	0.0			2.9	0.1	0.0	-0.8	-0.6	-1.1		-0.9	-0.7	
Identified net debt-creating flows	2.5	3.6	4.5			7.0	6.6	3.1	3.9	0.4	0.8		0.7	-0.8	
Non-interest current account deficit	**6.4**	**5.3**	**6.5**	**2.5**	**2.9**	**9.9**	**9.5**	**5.9**	**6.8**	**3.2**	**3.6**		**3.1**	**0.6**	2.4
Deficit in balance of goods and services	14.2	12.6	14.5			18.2	17.7	15.9	16.7	13.9	15.3		14.1	9.3	
Exports	27.6	24.2	26.9			31.0	28.6	27.7	25.8	24.5	23.0		19.6	17.7	
Imports	41.8	36.8	41.4			49.2	46.3	43.6	42.5	38.5	38.3		33.7	27.0	
Net current transfers (negative = inflow)	-7.7	-7.3	-7.6	-6.8	0.9	-7.0	-7.4	-8.1	-8.5	-9.0	-8.9		-8.3	-6.5	-7.9
Of which : official	0.1	0.1	0.1			0.1	0.1	0.1	0.0	0.0	0.0		0.0	0.0	
Other current account flows (negative = net inflow)	-0.1	0.0	-0.4			-1.3	-0.9	-1.9	-1.4	-1.7	-2.9		-2.7	-2.2	
Net FDI (negative = inflow)	**-2.2**	**-1.5**	**-1.2**	**-1.4**	**1.0**	**-2.0**	**-1.9**	**-1.9**	**-1.8**	**-1.8**	**-1.7**		**-1.7**	**-1.0**	-1.5
Endogenous debt dynamics[2]	**-1.8**	**-0.2**	**-0.9**			**-0.9**	**-1.0**	**-1.0**	**-1.1**	**-1.0**	**-1.0**		**-0.7**	**-0.4**	
Contribution from nominal interest rate	0.3	0.2	0.3			0.3	0.3	0.4	0.4	0.4	0.4		0.4	0.2	
Contribution from real GDP growth	-0.3	-0.6	-1.2			-1.2	-1.3	-1.4	-1.5	-1.4	-1.4		-1.1	-0.6	
Contribution from price and exchange rate changes	-1.7	0.2	0.1			…	…	…	…	…	…		…	…	
Residual (3-4)[3]	**0.1**	**-4.4**	**-4.4**			**-4.1**	**-6.5**	**-3.1**	**-4.6**	**-1.0**	**-1.9**		**-1.6**	**0.2**	
Of which : exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.4		0.0	0.0	
PV of external debt[4]	...	...	15.8			17.7	18.7	19.1	18.9	18.7	18.0		15.0	7.7	
In percent of exports	...	...	58.5			57.0	65.3	68.9	73.4	76.4	78.2		76.5	43.5	
PV of PPG external debt	**...**	**...**	**15.8**			**17.7**	**18.7**	**19.1**	**18.9**	**18.7**	**18.0**		**15.0**	**7.7**	
In percent of exports	**...**	**...**	**58.5**			**57.0**	**65.3**	**68.9**	**73.4**	**76.4**	**78.2**		**76.5**	**43.5**	
In percent of government revenues	**...**	**...**	**66.1**			**72.2**	**76.2**	**76.6**	**75.4**	**75.8**	**74.0**		**62.0**	**32.3**	
Debt service-to-exports ratio (in percent)	**10.8**	**19.0**	**5.0**			**5.1**	**4.8**	**4.8**	**5.2**	**5.2**	**5.2**		**5.1**	**3.9**	
PPG debt service-to-exports ratio (in percent)	**7.8**	**17.6**	**4.0**			**3.8**	**4.2**	**4.2**	**4.7**	**4.8**	**4.9**		**5.1**	**3.9**	
PPG debt service-to-revenue ratio (in percent)	**9.8**	**19.5**	**4.5**			**4.8**	**4.9**	**4.7**	**4.8**	**4.7**	**4.7**		**4.2**	**2.9**	
Total gross financing need (Billions of U.S. dollars)	2.2	2.6	2.1			3.0	3.2	2.2	2.8	1.3	1.7		2.3	0.7	
Non-interest current account deficit that stabilizes debt ratio	3.9	6.1	6.5			7.0	9.4	5.9	7.5	3.8	4.7		4.0	1.3	
Key macroeconomic assumptions															
Real GDP growth (in percent)	1.5	2.6	5.6	4.2	2.2	5.0	5.6	6.0	6.4	6.4	6.5	6.0	6.1	6.1	6.1
GDP deflator in US dollar terms (change in percent)	8.9	-0.8	-0.4	5.6	5.9	-6.4	8.1	5.0	5.2	4.8	4.6	3.6	4.7	4.6	4.7
Effective interest rate (percent)[5]	1.3	0.8	1.3	1.4	0.9	1.2	1.4	1.6	1.7	1.9	2.0	1.6	2.4	2.1	2.2
Growth of exports of G&S (US dollar terms, in percent)	17.4	-10.6	16.8	12.5	9.4	13.2	5.4	7.8	4.0	6.1	4.7	6.9	8.3	10.6	9.2
Growth of imports of G&S (US dollar terms, in percent)	24.6	-10.4	18.4	14.3	13.4	16.7	7.5	4.8	8.9	1.0	11.2	8.3	8.3	8.8	8.5
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	35.4	9.3	18.3	14.9	17.2	17.0	18.7	22.3	24.7	23.0
Government revenues (excluding grants, in percent of GDP)	22.1	21.9	23.8			24.5	24.5	24.9	25.1	24.7	24.3		24.2	23.9	24.1
Aid flows (in Billions of US dollars)[7]	0.3	0.6	0.2			0.7	0.7	0.8	0.9	0.6	0.4		0.9	1.4	
Of which : Grants	0.3	0.3	0.2			0.3	0.5	0.6	0.7	0.5	0.4		0.5	0.6	
Of which : Concessional loans	0.0	0.4	0.0			0.4	0.2	0.3	0.2	0.1	0.1		0.4	0.8	
Grant-equivalent financing (in percent of GDP)[8]	...	...	...			2.3	1.7	2.0	1.9	1.4	1.1		0.9	0.4	0.7
Grant-equivalent financing (in percent of external financing)[8]	...	...	...			49.0	30.7	41.7	44.2	38.9	33.7		40.1	39.6	39.7
Memorandum items:															
Nominal GDP (Billions of US dollars)	30.0	30.6	32.2			31.6	36.1	40.1	44.9	50.1	55.9		94.8	270.7	
Nominal dollar GDP growth	10.5	1.8	5.2			-1.7	14.1	11.3	11.9	11.5	11.5	9.8	11.0	11.1	11.1
PV of PPG external debt (in Billions of US dollars)			5.0			5.6	6.7	7.7	8.5	9.4	10.1		14.2	20.9	
(PVt-PVt-1)/GDPt-1 (in percent)						1.8	3.6	2.6	2.1	2.0	1.4	2.2	1.0	0.3	0.7
Gross workers' remittances (Billions of US dollars)	1.0	1.0	1.1			1.2	1.3	1.6	1.8	2.0	2.3		3.6	8.0	
PV of PPG external debt (in percent of GDP + remittances)	...	...	15.2			17.0	18.0	18.4	18.2	18.0	17.3		14.5	7.5	
PV of PPG external debt (in percent of exports + remittances)	...	...	51.8			50.9	58.1	60.1	63.7	65.6	66.5		64.1	37.3	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	3.6			3.4	3.7	3.7	4.0	4.1	4.2		4.3	3.3	

Sources: Country authorities; and staff estimates and projections.

[1] Includes both public and private sector external debt.

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

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

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

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

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

[7] Defined as grants, concessional loans, and debt relief.

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

Table 2b.Kenya: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2011–31
(Percent)

	Projections							
	2011	2012	2013	2014	2015	2016	**2021**	2031
				PV of debt-to GDP ratio				
Baseline	17.7	18.7	19.1	18.9	18.7	18.0	**15.0**	7.7
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2011–31[1]	17.7	17.7	17.4	17.2	16.9	16.6	**15.4**	14.2
A2. New public sector loans on less favorable terms in 2011–31[2]	17.7	18.5	20.0	20.4	20.8	20.6	**19.3**	12.5
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2012–13	17.7	19.3	20.5	20.3	20.1	19.4	**16.1**	8.3
B2. Export value growth at historical average minus one standard deviation in 2012–13[3]	17.7	19.2	21.1	20.7	20.4	19.6	**16.0**	7.9
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012–13[3]	17.7	20.3	21.8	21.6	21.4	20.6	**17.1**	8.8
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012–13[4]	17.7	21.2	24.5	23.9	23.3	22.3	**17.8**	8.3
B5. Combination of B1-B4 using one-half standard deviation shocks	17.7	21.8	26.1	25.5	25.0	23.9	**19.3**	9.2
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012[5]	17.7	25.9	26.4	26.2	25.9	24.9	**20.8**	10.7
				PV of debt-to-exports ratio				
Baseline	57.0	65.3	68.9	73.4	76.4	78.2	**76.5**	43.5
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2011–31[1]	57.0	62.0	62.8	66.8	69.1	72.2	**78.3**	80.1
A2. New public sector loans on less favorable terms in 2011–31[2]	57.0	64.7	72.3	79.2	85.0	89.4	**98.4**	70.2
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2012–13	57.0	65.3	68.9	73.4	76.4	78.2	**76.5**	43.5
B2. Export value growth at historical average minus one standard deviation in 2012–13[3]	57.0	68.5	81.2	86.0	89.0	90.8	**87.3**	47.8
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012–13[3]	57.0	65.3	68.9	73.4	76.4	78.2	**76.5**	43.5
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012–13[4]	57.0	74.0	88.2	92.7	95.1	96.7	**90.5**	46.7
B5. Combination of B1-B4 using one-half standard deviation shocks	57.0	69.1	81.0	85.3	87.9	89.5	**84.7**	44.8
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012[5]	57.0	65.3	68.9	73.4	76.4	78.2	**76.5**	43.5
				PV of debt-to-revenue ratio				
Baseline	72.2	76.2	76.6	75.4	75.8	74.0	**62.0**	32.3
A. Alternative Scenarios								
A1. Key variables at their historical average in 2011–31[1]	72.2	72.4	69.9	68.6	68.6	68.4	**63.5**	59.4
A2. New public sector loans on less favorable terms in 2011–31[2]	72.2	75.5	80.4	81.3	84.4	84.7	**79.8**	52.1
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2012–13	72.2	78.9	82.4	81.1	81.5	79.6	**66.7**	34.7
B2. Export value growth at historical average minus one standard deviation in 2012–13[3]	72.2	78.3	84.5	82.7	82.6	80.5	**66.2**	33.2
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012–13[3]	72.2	82.6	87.6	86.2	86.6	84.6	**70.9**	36.9
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012–13[4]	72.2	86.4	98.2	95.2	94.4	91.6	**73.4**	34.7
B5. Combination of B1-B4 using one-half standard deviation shocks	72.2	89.1	104.5	101.8	101.3	98.4	**79.7**	38.6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012[5]	72.2	105.5	106.1	104.4	104.9	102.5	**85.9**	44.7

Table 2b.Kenya: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2011-2031 (continued)
(Percent)

Debt service-to-exports ratio

Baseline	3.8	4.2	4.2	4.7	4.8	4.9	**5.1**	3.9
A. Alternative Scenarios								
A1. Key variables at their historical average in 2011–31[1]	3.8	4.3	4.3	4.7	4.8	5.0	**5.2**	5.4
A2. New public sector loans on less favorable terms in 2011–31[2]	3.8	4.2	3.9	4.6	4.9	5.3	**6.2**	5.4
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2012–13	3.8	4.2	4.2	4.7	4.8	4.9	**5.1**	3.9
B2. Export value growth at historical average minus one standard deviation in 2012–13[3]	3.8	4.2	4.5	5.2	5.3	5.5	**6.0**	4.3
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012–13[3]	3.8	4.2	4.2	4.7	4.8	4.9	**5.1**	3.9
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012–13[4]	3.8	4.2	4.4	5.2	5.3	5.5	**6.4**	4.4
B5. Combination of B1-B4 using one-half standard deviation shocks	3.8	4.1	4.3	4.9	5.0	5.2	**5.9**	4.1
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012[5]	3.8	4.2	4.2	4.7	4.8	4.9	**5.1**	3.9

Debt service-to-revenue ratio

Baseline	4.8	4.9	4.7	4.8	4.7	4.7	**4.2**	2.9
A. Alternative Scenarios								
A1. Key variables at their historical average in 2011–31[1]	4.8	5.0	4.7	4.8	4.8	4.8	**4.2**	4.0
A2. New public sector loans on less favorable terms in 2011–31[2]	4.8	4.9	4.3	4.8	4.9	5.1	**5.1**	4.0
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2012–13	4.8	5.0	5.0	5.1	5.1	5.0	**4.5**	3.1
B2. Export value growth at historical average minus one standard deviation in 2012–13[3]	4.8	4.9	4.7	5.0	4.9	4.9	**4.5**	3.0
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012–13[3]	4.8	5.3	5.3	5.5	5.4	5.3	**4.8**	3.3
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012–134	4.8	4.9	4.9	5.3	5.3	5.2	**5.2**	3.2
B5. Combination of B1-B4 using one-half standard deviation shocks	4.8	5.2	5.5	5.9	5.8	5.7	**5.6**	3.6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012[5]	4.8	6.7	6.5	6.6	6.5	6.5	**5.8**	4.0
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline)[6]	17.1	17.1	17.1	17.1	17.1	17.1	**17.1**	17.1

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.

INTERNATIONAL MONETARY FUND

KENYA

Staff Report for the 2011 Article IV Consultation, Second Review Under the Three-Year Arrangement Under the Extended Credit Facility and Requests for Modification of Performance Criteria and Augmentation of Access

Informational Annex

Prepared by the African Department

Approved by Saul Lizondo and Dominique Desruelle

November 23, 2011

Contents Page

I. KENYA: RELATIONS WITH THE FUND

(As of October 31, 2011)

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

II. General Resources Account:	SDR million	Percent of quota
Quota	271.40	100.00
Fund holdings of currency	258.43	95.22
Reserve Tranche Position	13.00	4.79

III. SDR Department:	SDR million	Percent of allocation
Net cumulative allocation	259.65	100.00
Holdings	13.73	5.29

IV. Outstanding Purchases and Loans:	SDR million	Percent of quota
ESF RAC Loan	135.70	50.00
ECF Arrangements	231.06	85.14

V. Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
ECF	Jan 31, 2011	Jan 30, 2014	325.68	108.56
ECF[1]	Nov 21, 2003	Nov 20, 2007	150.00	150.00
ECF[1]	Aug 4, 2000	Aug 3, 2003	190.00	33.60
ECF[1]	Apr 26, 96	Apr 25, 99	149.55	24.93

[1] Former PRGF

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

VI. Projected Obligations to Fund[2]

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

	2011	2012	2013	2014	2015
Principal	2.50	18.75	30.00	38.57	47.14
Charges/interest	0.22	1.65	1.59	1.52	1.41
Total	2.72	20.40	31.59	40.09	48.55

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

VII. Implementation of HIPC Initiative: Not Applicable

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

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

X. Safeguards Assessments

An update safeguards assessment of the Central Bank of Kenya (CBK) was completed on September 9, 2011 with respect to the ECF Arrangement approved on January 31, 2011. As reported in Country Report No. 11/165, the assessment identified heightened safeguards risks since the 2009 assessment in the form of governance gaps and monetary program data uncertainties which were resolved before the first review. Key governance bodies, including the CBK Board and the Audit Committee, were not in place between September 2010 and June 2011. Three Board vacancies were filled in April and the remaining two in mid-June. The newly reconstituted Board has since met in June 2011 at which time it established a new audit committee. The reliability of financial data was temporarily hampered during the transition to a new accounting system. The assessment recommended that data reports be closely monitored in the period ahead, and that internal audit should review reporting procedures as a priority, including data reported to the Fund. The government is involved in Kenya’s currency printing arrangements, in addition to the CBK, and sole sourced contracts persist. In this environment, the assessment recommended that controls over currency printing and delivery to the CBK be audited by external and internal audit to ensure security. The assessment will be updated as required in cases of augmentation under the ECF arrangement.

XI. Exchange Arrangements

Kenya's currency is the shilling, which floats against other currencies. The official exchange rate, which is set at the previous day’s average market rate, applies only to government and government-guaranteed external debt-service payments and to government imports for which there is a specific budget allocation. The exchange rate regime is a float, in which the U.S. dollar is the principal intervention currency. Kenya has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on payments and transfers for current international transactions, other than restrictions notified to the Fund under Decision No. 144 (52/51). On September 30, 2011, the exchange rate was KSh 99.67=US$1.00.

XII. Article IV Consultations

The last Article IV consultation with Kenya concluded on December 22, 2009. Kenya is subject to a 24-month consultation cycle.

XIII. 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.

XIV. Technical Assistance

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

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

XV. Resident Representative

Mr. Ragnar Gudmundsson, since August 2010.

II. Kenya: Joint WB–IMF Management Action Plan October 2010– September 2011

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

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

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

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

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

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

- **Infrastructure reform:** Infrastructure has been identified as one of the most problematic factors for doing business in Kenya. Reforms focus in three specific areas

(i) improvements at the Mombasa port; (ii) strengthening Kenya's infrastructure in transportation, energy, water and sanitation; and (iii) improving PPP institutional capacity at the ministries.

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

The teams agreed on the following division of labor:

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

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

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

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

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

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

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

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

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

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

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

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

Title	Products	Provisional Timing of Mission	Expected Delivery Dates
1. WB Work Program	Kenya economic update (bi-annually)	N/A	Dec. 2010 & June 2011
	Institutional reform and Capacity building: which has two components (i) PFM; (ii) institutional reform and capacity building	N/A	Continuous
	Public expenditure review	November 2010	April 2011
	Development Policy Loan (DPL)	N/A	July 2011
	PPPs/Infrastructure Finance	N/A	July 2011
	FLSTAP—financial regulators and market development (i.e., insurance, banking, capital markets); housing finance. analysis	N/A	Continuous
	MSME, KICP, analytical work on investment climate		Continuous
2. Fund Work Program	**Missions**		
	Article IV consultation		October 2011
	TA provision on fiscal regulations; program budgeting; fiscal decentralization; IFMIS and treasury single account support	Ongoing	Implementation throughout fiscal year 2011
	TA provision on customs administration and modern risk management	November 2010	TA report in February 2011
	TA provision on crisis management framework	November 2010	January 2011
3. Joint Work Program	Various TA provisions on PFM reforms, fiscal decentralization, crisis management framework (FLSTAP, FIRST) and Pensions (NSSF and contingent liabilities)	December 2010 as part of the DPL and continuous	Continuous
	Public and external debt Sustainability Analysis	November 2010 October 2011	January 2011 November 2011

III. Kenya: Key Statistical Issues

(As of November 14, 2011)

A. Assessment of Data Adequacy for Surveillance

General

1. Data provision has some shortcomings, 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

2. 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 are major constraints. A-Statistics Department (STA) advisor assisted the authorities in rebasing the national accounts estimates at constant 2001 prices and compiling institutional accounts for the general government sector. As a result, national accounts estimates for the years 1996–2010 in current and constant (2001) prices~~)~~ have been published. KNBS has made progress in developing estimates of quarterly GDP at constant prices that are now published. However, there is still need for improvements in the corresponding quarterly GDP in current prices and from the expenditure side. Additionally, better coverage of the informal sector in GDP estimates is highly desirable.

Price statistics

3. 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. In March 2008, a Technical Assistance (TA) mission assisted the authorities in identifying the methodological issues relating to the measurement of inflation. The current methodology of aggregating prices at the elementary level was found to impart a substantial upward bias on CPI measurement. In line with STA recommendations, the KNBS released a revised series that is consistent with international best practices in November 2009. By February 2010, KNBS began to publish another series with rebasing and reweighing of the CPI basket using the geometric mean method. The current series does not extend beyond February 2009 and KNBS only plans to publish a historical series based on this methodology in 2012.

4. Import and export price indexes are compiled on a base year of 1982, based on annual customs value and quantity data. A TA mission in June 2011 made recommendations for improving the methodology; KNBS will seek additional resources for FY 2012-13 to develop indexes that conform to international good practice. A mission may be undertaken in mid 2012 to provide training and assist in implementing appropriate methodology.

5. No PPI is compiled at present. A TA mission in August 2011 provided recommendations developing a prices survey and a PPI.

Government finance statistics

6. The 2005 ROSC Data Module mission recommended: compiling fiscal statistics following the *Government Finance Statistics Manual* (*GFSM) 2001* classifications and tables; compiling annual fiscal statistics for extra-budgetary units, social security funds, consolidated central government, and consolidated general government; investigating the discrepancy between deficit/surplus and financing; obtaining more complete information on external financing and expenditure directly financed from abroad; reconciling data discrepancies between the Ministry of Finance (MOF) and the Central Bank of Kenya (CBK) on a regular basis; compiling and disseminating monthly and quarterly budget execution data on a discrete (non-cumulative) basis; and preparing and disseminating a document on data sources and methods. Limited progress has been made implementing these recommendations.

7. A GFS TA mission that visited Nairobi in October 2011 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; develop the necessary modules to access the general ledger information in the implementation of the Integrated Financial Management Information System (IFMIS) for purposes of monthly and quarterly budget monitoring and reporting; 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.

8. The country reports data to STA for the budgetary central government for inclusion in the GFS Yearbook, the last data reported were for the year ending June 2010. The KNBS compiles the aggregate annual GFS revenue and expenditure data for the budgetary central government based on detailed data in the reports of the Controller and Auditor General. The data are currently submitted for publication in the GFS Yearbook in *GFSM 2001* format, using bridge tables developed by technical assistance missions.

Monetary statistics

9. Progress has been shown in the improvement of monetary data and development of the standardized report forms (SRFs). Kenya benefited from participation in the monetary statistics module in the 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. The principal achievements were (1) the completion of the SRF for the Central Bank of Kenya (1SR); (2) the design and implementation of a new reporting system for other depository corporations (ODCs) that meets the needs of statistics and bank supervision; (3) completion of the 2SR for ODCs; and (4) production of a revised depository corporation survey. Limited work was done on expanding the ODC sector to include Savings and Credit Cooperatives (SACCO), on developing harmonized monetary statistics for members of the East African Community, and compiling data for other financial corporations (OFCs).

10. The mission in August 2011 further improved the ODC reporting system introduced in 2008, in particular with respect to reporting the repo and financial derivatives positions. The mission also assisted in setting procedures for improvements of internal data consistency. In addition, the mission met with the supervisory authorities of various groups of other deposit taking financial institutions and designed reporting forms that meet the needs of the SRFs, but are much simplified to reflect the limited transactions of these deposit takers. With regard to the OFCs, the mission designed a reporting form for non-money market unit trusts and reviewed in detail a new reporting system for pension funds produced by the Retirement Benefits Authority.

Balance of payments

11. 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.

12. Although the overall quality of trade data may be reasonably good, data for other current account and many financial account transactions are rather weak. 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.

13. Kenya participates in the external sector module of the DFID Project. Three TA missions have been conducted under the auspices of this project to undertake a comprehensive enterprise survey of cross-border financial flows and stocks with a view to significantly improving the quality of balance of payments and to compile international investment position statistics. The latest November 8-19, 2010 TA mission assessed the results of the 2009 IIP survey and the 2010 Foreign Investment Survey (FIS), and designed the frame for a 2011 FIS.

14. The establishment of a database developed by the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI) for use within the region for private capital flows surveys and for generating reports proved very effective. This database generates tables that are needed to review reported data to assess gaps.

B. Data Standards and Quality

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

C. Reporting to STA

16. 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.

IV. Table of Common Indicators Required For Program Monitoring

(AS OF November 14, 2011)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]	Memo Items[7]	
						Data Quality— Methodological soundness[8]	Data Quality— Accuracy and reliability[9]
Exchange Rates	Oct. 2011	11/1/11	D	D	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]			NA	NA	NA		
Reserve/Base Money	Sept. 2011	10/17/11	D	D	M	LO, LO, LO, LO	LO, LO, O, O, NO
Broad Money	Sept. 2011	10/17/11	M	M	M		
Central Bank Balance Sheet	Sept. 2011	10/17/11	D	D	M		
Consolidated Balance Sheet of the Banking System	Sept. 2011	10/17/11	M	M	M		
Interest Rates[2]	Aug. 2011	10/4/11	D	D	M		
Consumer Price Index	Sept. 2011	10/18/11	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	2009	Jan. 2010	Q	I	Q		
Stocks of Central Government and Central Government Guaranteed Debt[5]			NA	NA	NA		
External Current Account Balance	2010	Oct. 2011	M	A	A	O, LO, O, LO	LNO ,LO, LO, LO, LO
Exports and Imports of Goods and Services	2010	Oct. 2011	M	Q	A		
GDP/GNP	2010	Jun. 2011	M	A	A	O, LNO, LNO, LO	LNO, LO, LNO, LO, LNO
Gross External Debt			NA	NA	NA		
International Investment Position			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.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 12/1
FOR IMMEDIATE RELEASE
January 17, 2012

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

IMF Executive Board Concludes 2011 Article IV Consultation with Kenya

On December 9, 2011 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Kenya.[15]

Background

Kenya's economy has continued to expand, but high inflation and exchange rate pressures have come to threaten the growth outlook. GDP growth has shown little sign of slowing down so far and is estimated at 5.3 percent in 2010/11. Private investment has remained dynamic and has supported growth of above 5 percent across all non-agricultural sectors. Agricultural sector has begun to recover from the downturn in the first quarter of 2011.

Inflation reached 19.7 percent in November, well above the Central Bank of Kenya (CBK) target range. Food and fuel inflation have remained higher than anticipated, and exchange rate depreciation has led to higher inflation expectations and an acceleration of core inflation. In response, the CBK has raised its policy rate (CBR) by 11 percentage points since October to contain demand pressures and rein in inflationary expectations.

Fiscal policy has moved towards consolidation. The primary deficit declined from 3.8 percent of GDP in FY 2009/10 to 1.5 percent of GDP in FY 2010/11 as a result of delays in domestically financed investment, restraint in current spending, and strong tax revenue performance.

[15] 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. 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 summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Higher drought-related food and energy imports coupled with higher international prices, and strong domestic demand, swelled the external current account deficit to an estimated 9½ percent of GDP in 2010/11 from 5½ percent the previous year. The combined impact of these shocks has led Kenya to request an augmentation of access under the Extended Credit Facility (ECF) arrangement.

The nominal effective exchange rate depreciated by 15 percent this year through September 2011, reflecting BOP pressures and high inflation. The CBK's intervention in the foreign exchange market has been limited, and this has allowed the exchange rate to adjust to absorb the external shocks. Since mid-October, the exchange has stabilized on the back of CBK policy rate hike.

The implementation of structural reforms under the program has progressed. A new value-added tax (VAT) bill is almost ready to be sent to parliament, and a Public Finance Management (PFM) bill has been submitted to the Commission for the Implementation of the Constitution.

Executive Board Assessment

Executive Directors commended Kenya's strong economic growth and satisfactory program implementation despite challenges posed by the severe drought in the Horn of Africa and higher than expected food and fuel prices. However, the combination of external shocks and strong domestic demand, fueled by rapidly expanding credit, has led to a sharp increase in inflation, a widening current account deficit, and currency depreciation. Directors welcomed the authorities' firm commitment to address these imbalances, stressing the need for continued steadfast implementation of their economic program.

Directors welcomed the recent decisive steps taken to rein in inflation and noted that further tightening of monetary policy should anchor inflation expectations. They commended the Central Bank of Kenya for raising its policy rate to help absorb liquidity and discourage excessive credit growth and demand for foreign exchange. A gradual accumulation of international reserves and maintaining the existing floating exchange rate regime will mitigate the impact of external shocks.

Directors agreed that fiscal policy should continue to focus on medium-term consolidation and complement monetary policy to curb domestic demand. Noting the progress made in reducing the primary deficit, they welcomed the authorities' plans to adopt a more ambitious medium-term target by rationalizing non-priority expenditure and front-loading adjustment. Directors underscored the importance of protecting key outlays, in particular emergency food relief for the population, targeted transfers to the poor, implementation of the new constitution, and high-priority investments.

Directors observed that Kenya's financial system remains sound. They supported the efforts to monitor credit risks more closely and to strengthen the supervision of intergroup transactions. They also looked forward to the capital markets reform which will allow small and medium-sized enterprises to expand their access to new sources of financing. Directors urged the authorities to address deficiencies in the AML/CFT framework.

Directors noted the progress in structural reforms. They stressed that prompt implementation of the new legislation on public finance management and the draft VAT law will be important to ensure sound expenditure management in the context of fiscal decentralization and to strengthen revenue mobilization. Directors underscored that additional reforms to improve the business environment and adopt long-term solutions to the recurring droughts, including investment in infrastructure, will enhance Kenya's prospects for growth and poverty reduction.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Table 1. Kenya: Selected Economic Indicators, 20008/09–2012/2013[1]

	2008/09 Actual	2009/10 Actual	2010/11 Est.	2011/12 Proj.	2012/13 Proj.
	(Annual percentage change; unless otherwise indicated)				
National accounts and prices					
Nominal GDP (market prices, in billions of Kenya shillings)	2,238	2,458	2,777	3,281	3,801
Real GDP growth (market prices)	2.1	4.1	5.3	5.3	5.8
GDP deflator (average) [2]	11.3	5.5	7.3	12.2	9.5
Consumer price index (annual average) [2]	14.2	6.7	6.9	16.2	7.0
Consumer price index (end of period) [2]	9.9	3.5	14.5	12.0	6.5
Import value growth, goods		2.5	20.6	10.2	6.6
Export value growth, goods		5.3	12.6	12.6	8.8
Terms of trade, goods, and services (Base year 2000)	6.6	12.3	-1.5	-4.7	-3.2
Ksh per US$ exchange rate (end of period) [3]	77.2	81.9	99.6		
Nominal effective exchange rate (- depreciation; end of period)	-10.4	-0.3	…	…	…
Real effective exchange rate (- depreciation; end of period)	-4.7	-1.6	…	…	…
Money and credit					
M3 (broad money and foreign currency deposits, end period)	13.0	26.2	15.2	17.6	
Reserve money		31.5	4.8	14.0	
	(In percent of GDP; unless otherwise indicated)				
Investment and saving					
Investment	19.3	20.3	21.5	23.6	25.0
Central government	7.3	8.7	7.8	10.0	10.6
Other	11.9	12.1	13.7	13.6	14.4
Gross national saving	11.2	14.8	11.8	14.8	16.8
Central government	2.2	1.5	2.7	4.1	4.6
Other	9.1	13.2	9.1	10.7	12.2
Central government budget [4]					
Total revenue	21.8	22.3	24.0	24.5	24.8
Total expenditure and net lending	27.1	29.5	29.2	30.5	30.9
Overall balance (commitment basis) excluding grants	-5.3	-7.2	-5.2	-6.0	-6.1
Overall balance (commitment basis) including grants	-4.4	-6.4	-4.5	-4.7	-4.8
Primary budget balance	-1.5	-3.8	-1.5	-2.2	-1.8
Net domestic borrowing	3.0	5.4	3.3	3.3	1.8
Balance of payments					
Exports value, goods, and services	25.8	25.6	27.8	30.8	28.2
Imports value, goods, and services	41.0	38.6	45.1	48.0	45.0
Current external balance, including official transfers	-8.0	-5.6	-9.6	-8.8	-8.3
Current external balance, excluding official transfers	-7.9	-5.5	-9.6	-8.7	-8.2
Gross international reserve coverage					
In billions of U.S. dollars (end of period)	3.2	3.8	4.1	4.2	5.1
In months of next year imports (end of period)	3.1	3.1	3.1	2.9	3.3
Public debt					
Total public debt, net (percent of GDP)	40.6	44.8	45.9	44.7	43.4
Of which: external debt	22.6	23.0	23.4	22.3	22.3
Domestic debt, net of deposits	17.9	21.8	22.5	22.4	21.1

Sources: Kenyan authorities and IMF staff estimates and projections.

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

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

[3] Actual as of September 30, 2011.

[4] Revenue plus program grants minus recurrent expenditure.

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

Press Release No. 11/457
FOR IMMEDIATE RELEASE
December 9, 2011

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Second Review Under the Extended Credit Facility for Kenya and Approves Request for Augmentation of Access and US$143.67 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the second review of Kenya's economic performance under a three-year arrangement under the Extended Credit Facility (ECF). The Board also approved an augmentation of access equal to 60 percent of quota, which would lead to a total access of 180 percent of quota, an amount equivalent to SDR 488.52 million (about US$760.63 million), under the ECF arrangement. The Board's decision enables the immediate disbursement of an amount equivalent to SDR 92.276 million (about US$143.67 million), bringing total disbursements under the ECF arrangement to an amount equivalent to SDR 200.836 million (about US$312.7 million).

In completing the review, the Board also approved a modification of three performance criteria for end-December 2011 and end-June 2012 related to the net international reserves, the net domestic assets of the central bank, and the primary budget balance of the central government. The three-year arrangement under the ECF for Kenya was originally approved by the IMF Executive Board on January 31, 2011 (see Press Release No. 11/21).

Following the Executive Board's approval of the arrangement with Kenya, Mr. David Lipton, First Deputy Managing Director and Acting Chair, issued the following statement:
"Kenya's economy has continued to expand despite the challenges posed by the drought in the Horn of Africa, higher than expected food and fuel prices, and the uncertain global environment. The combination of external shocks and strong domestic demand, fueled by rapidly expanding credit has led to sharp increase in inflation, a widening of the current account deficit, and currency depreciation. The authorities are taking decisive measures to address these imbalances and to preserve macroeconomic stability.

"Program implementation during the first half of 2011 was in line with the objectives of the ECF-supported program. The fiscal position at end-June was significantly better than expected, as a result of strong revenue performance and strict expenditure control. Beginning September, the Central Bank of Kenya increased its policy rate substantially and maintained a tightening bias to discourage excessive credit growth, which had contributed to inflation and the current account deficit.

"Sustaining high growth will require addressing macroeconomic vulnerabilities. The impact of the increase in international prices on the country's external position will require fiscal and monetary policy adjustment. Monetary policy will need to remain geared towards reining in inflationary expectations. It will be complemented by strengthened fiscal consolidation to curb domestic demand, while protecting key outlays, including emergency food relief.

"Important structural reforms are under way. The Public Financial Management Law has been submitted to the Committee for the Implementation of the Constitution. The benchmark on the submission of VAT law is set to be met by end-January 2012," Mr. Lipton said.

Statement by Mr. Moeketsi Majoro, Executive Director for Kenya
December 9, 2011

My authorities continue to demonstrate strong commitment to sound macroeconomic policies and program implementation. Economic growth has remained strong and fiscal imbalances have narrowed on account of revenue buoyancy and spending restraint despite considerable budgetary pressures. However, balance of payments challenges remain. The balance of payments needs have intensified stemming from the impact of severe drought conditions in the Horn of Africa and high food and fuel prices. These shocks have exerted pressure on macroeconomic stability and are threatening to slow Kenya's strong economic growth unless urgently addressed. It is in this regard that my authorities request augmentation of access under the existing Extended Credit Facility (ECF) program to help reverse the deteriorating balance of payments and stabilise the exchange rate. On account of their strong commitment to the implementation of the program, my authorities request Directors' support in concluding the second review under the ECF, augmentation of access and modification of performance criteria.

Program performance

My authorities met all quantitative performance criteria and indicative targets for end-June 2011. The fiscal position was significantly strong, despite heightened spending pressures to cushion vulnerable households from the impact of the drought and persistently higher food and fuel prices. Fiscal structural reforms moved forward with the new VAT bill set to be submitted to parliament before the end of this fiscal year, while the new PFM bill is ready for submission to the Constitution Implementation Commission (CIC).

Recent economic developments and medium term outlook

Kenya's economic growth is vulnerable to prevailing external shocks including the severe drought in the Horn of Africa, persistently higher food and fuel prices, rapidly deteriorating global conditions, and the security threats from the immediate neighborhood. Although the economy recorded strong growth of 4.5 percent in the first half of 2011, spurred by recovery in tourism and agricultural production, the expected growth for the FY 2011/12 has been revised downwards to 5.3 percent from 5.7 percent due largely to the impact of these external shocks. My authorities consider faster, stable and inclusive growth as a key objective of economic policy. In this regard, they remain committed to the implementation of the policies under the ECF program to maintain macroeconomic stability, foster sustainable and inclusive growth which is crucial for employment generation and poverty reduction.

Since the beginning of the second quarter of 2011, inflationary pressures have intensified with inflation rising from 12 percent in April to 19.7 percent in November, 2011. In recognition of the current macroeconomic challenges and rising inflationary pressures, the Minister for Finance has set an inflation target of 9 percent for the fiscal year 2011/12 and 5 percent in the medium term. Further, my authorities are committed to free market prices and have indicated that they will refrain from using the powers provided under the recently enacted Price Controls (Essential Goods) Act 2011 to regulate prices of essential commodities. Instead, they will rely on targeted subsidies and cash transfers to protect the poor and studiously implement the recently enacted Competition Act.

The current account deficit has widened to almost 9 percent of GDP in 2010/11 from 5.5 percent in 2009/10, due mainly to higher drought-related energy and food imports and slow recovery in export growth. The exchange rate depreciated to a historic high of KES 107 to the US dollar in October but has since appreciated by about 15 percent due to recent monetary policy tightening and review of foreign exchange guidelines. However, international reserves have remained low especially since June 2011 when the CBK suspended purchases of foreign exchange reserves from the market while capital flows have moderated.

The fiscal position remains strong with the primary deficit contracting by more than 2 percentage points to 1.5 percent of GDP in 2010/11 from its 2009/10 level, reflecting good revenue performance. My authorities target a fiscal primary deficit of 2.2 percent in 2011/12 a downward revision from the 2.7 percent envisaged at the beginning of the program.

Monetary policy developments

My authorities consider price stability as the key objective of monetary policy. As such the current monetary policy calibration is aimed at stabilising inflation and the exchange rate. During the global financial crisis the Central Bank of Kenya (CBK) rightly adopted an accommodative monetary policy which saw the Monetary Policy Committee (MPC) drop the policy rate from 9 percent in December 2008 to just under 6 percent in January 2011. However, as conditions have begun to change, the stance of monetary policy has tightened: since the beginning of second quarter 2011 the policy rate has begun to rise, reaching 18 percent in November 2011. This has led to an increase in short term interest rates while commercial banks have revised upwards their base lending rates. In addition, the MPC has raised the cash reserve requirement by 0.5 percent effective December 15, 2011.

The authorities have also adopted a new framework for monetary policy giving more prominence to the policy rate. In addition, various administrative measures were implemented, in particular the review of the foreign exchange guidelines, to streamline foreign exchange trading including a reduction in foreign exchange exposure from 20 to 10 percent. My authorities are committed to a floating exchange rate regime and accumulation of foreign reserves as a measure to better manage exchange rate volatility.