

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

In the context of the third review under the three-year arrangement under the extended credit facility and request for modification of performance criteria, the following documents have been released and are included in this package:

- The staff report for the Third Review Under the Three-Year Arrangement Under the Extended Credit Facility and Request for Modification of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on March 12, 2012, with the officials of Kenya on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on March 30, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A Press Release dated April 17, 2012.

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

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

*Also included in Staff Report

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: <http://www.imf.org>

**International Monetary Fund
Washington, D.C.**



KENYA

THIRD REVIEW UNDER THE THREE-YEAR ARRANGEMENT UNDER THE EXTENDED CREDIT FACILITY AND REQUEST FOR MODIFICATION OF PERFORMANCE CRITERIA

March 30, 2012

KEY ISSUES

Background: Kenya has started to implement the 2010 Constitution that overhauls the form of government it inherited at independence and to introduce fiscal decentralization. General elections are scheduled to take place by March 2013. Economic activity has continued to expand vigorously despite the drought that hit the Horn of Africa and high international commodity prices. But, the combination of external shocks, the impact of the drought and still strong domestic demand caused inflation to rise sharply in the second half of 2011 and worsened the external current account balance. Growth is projected to remain at about 5 percent, and tight monetary policy should bring inflation down to one digit levels before the end of the year.

Program: The Executive Board approved a three-year Extended Credit Facility (ECF) arrangement for Kenya on January 31, 2011 (120 percent of quota), which was augmented on Dec. 9, 2011 for a total of SDR 488.520 (180 percent of quota). All end-December 2011 quantitative targets were met. The authorities' primary fiscal balance outcome was in line with the program and consistent with a decline in the government debt-to-GDP ratio. Implementation of structural benchmarks has overall proceeded as expected. The Public Finance Management bill was submitted to the Commission for the Implementation of the Constitution (structural benchmark for the 3rd Review), and has been sent to the National Assembly for its approval. The VAT reform bill has been approved by Cabinet and will be submitted to the National Assembly soon.

Staff views: The staff recommends completion of the review and disbursement of SDR 71.921 million, and modification of all performance criteria and indicative targets for the next 12 months to fit the revised balance of payments outlook. The authorities have consented to publication of the staff report and Letter of Intent and its attachments.

Approved By
**Roger Nord (AFR) and
 Dominique Desruelle
 (SPR)**

A staff team comprising Messrs. Fanizza (head), Morales, Milkov and Ms. Raei (all AFR) and Ms. Bouza (SPR) visited Nairobi from February 29 through March 12, 2012. Mr. Gudmundsson (Resident Representative) participated in the discussions, and Ms. Rose Ngugi from the Executive Director's office joined the mission. The mission met Prime Minister Odinga, Minister of Finance Githae, Central Bank Governor Ndung'u, the National Assembly's Finance and Budget Committees, other senior officials, representatives of the private sector including financial institutions, and the donor community.

CONTENTS

MACROECONOMIC OUTLOOK AND PROGRAM IMPLEMENTATION	4
POLICY DISCUSSIONS AND RISKS	6
A. Dealing with a deterioration of the global economy	6
B. Pressing Ahead with Fiscal Consolidation and Reform	8
C. Managing Liquidity under a Tight Monetary Policy	10
D. Preventing Financial Stress	11
PROGRAM ISSUES AND RISKS	14
STAFF APPRAISAL	15

TABLES

1. Selected Economic Indicators, 2009/10–2014/2015	18
2a. Central Government Financial Operations	19
2b. Central Government Financial Operations	22
3. Monetary Survey	21
4. Balance of Payments	22
5. Financial Soundness Indicators of the Banking Sector	23
6. Performance Criteria for the Third Review under the 2011–14 ECF Arrangement	24
7. Proposed Timing of Disbursements and Reviews under the 2011–14 ECF Arrangement	25

FIGURES

1. Growth and Inflation	4
2. Balance of Payments Developments	8
3. Fiscal Developments	10
4. Money Market Rates and Yield Curve	11
5. Financial Developments	13

BOXES

1. External Vulnerabilities to a Global Downturn in Economic Activity _____ 7
2. Financial Risks in a Tight Monetary Policy Environment _____ 12

APPENDIX

- Letter of Intent _____ 26
- Attachment. Updated Technical Memorandum of Understanding _____ 34

MACROECONOMIC OUTLOOK AND PROGRAM IMPLEMENTATION

1. **Economic growth likely slowed in FY 2011/12, but is projected to remain above 5 percent.** Strong domestic activity has offset the impact of the severe drought in Horn of Africa on both agriculture and hydro-power generation. Growth is expected to pick up in 2012/13 on the back of normal rains, improved macroeconomic stability, and better security conditions in the Northern part of the country.

2. **After reaching almost 20 percent year-on-year up to November 2011, inflation has declined for three consecutive months, reaching 16.6 percent in February, 2012.** Both annualized three-month headline and core inflation from Dec 2011–February 2012 are in single digits. Headline inflation is expected to decline to 10–12 percent by June 2012 helped by normal rains.

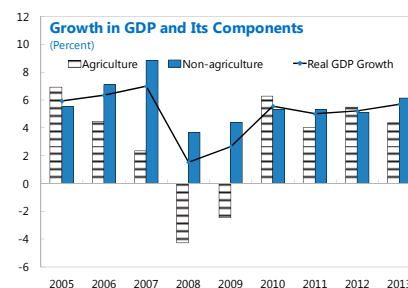
3. **The drought coupled with high international commodity prices is likely to widen Kenya's current account deficit to almost 11 percent of GDP in FY 2011/12.**

The external current account balance is expected to improve in FY 2012/13, because the drought-related one-off factors that swelled the current account deficit in the first half of the fiscal year should not recur in FY 2012/13. These factors included: (a) large food imports for humanitarian assistance, (up

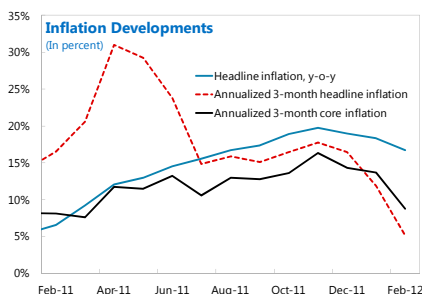
17 percent in volume), (b) large fuel imports to replace hydro with thermal power electricity generation (up 15 percent in volume), and (c) lower tea export volumes. Horticulture exports were hit by non-tariff trade barriers in the European Union (EU). In addition, the recent monetary policy tightening should reduce private imports, thus alleviating current account pressures. Capital inflows have remained strong, allowing the central bank to accumulate reserves above the Net International Reserves (NIR) floor target under the program.

Figure 1. Growth and Inflation

Economic expansion remains relatively strong...



...and inflation has started to abate.



4. **Fiscal policy maintained a restrictive stance in the first half of FY 2011/12, resulting in a somewhat smaller primary deficit than in the same period in**

FY 2010/11. Despite revenue shortfalls mainly from the elimination of the VAT withholding regime, the December target on the primary fiscal balance was met thanks to cuts in both non-priority current and capital outlays. The indicative floor on pro-poor spending has also been met. After a period of stress, conditions in the market for government securities have improved, with declining yields and oversubscribed auctions. Contracting of non-concessional debt remains within the program ceilings.

5. **Monetary policy tightening curbed annual credit growth to 28 percent up to January 2012, eight percentage points down from the previous three months.**

This decline reflects mainly a contraction in credit for construction and real estate, whereas credit to the corporate sector has held on. By using its new framework, the CBK has succeeded in keeping Net Domestic Assets (NDA) below the program's ceiling for December, slowing credit growth, and reducing volatility in the interbank market.

6. **The government has pursued reform on a number of fronts following the approval of the new constitution.**

The Public Finance Management (PFM) bill is expected to be approved by the National Assembly before the end of the FY 2011/12. The VAT bill has been approved by cabinet and is currently being reviewed by the Attorney General Office before being submitted to the National Assembly. In addition, pension reform and reform of the pay for civil servants have advanced.

7. **The authorities have recently announced a major regional project that over a 15–20 year horizon would create a new transportation corridor connecting**

South Sudan and Ethiopia to the port of Lamu (still to be built). The new corridor could affect favorably Kenya's long-term growth prospects by easing the existing transportation bottlenecks and by increasing regional integration. The public finance impact at the early stages of implementation of the project appears limited, and is fully taken into account under the program's medium-term expenditure envelope.

POLICY DISCUSSIONS AND RISKS

Kenya has maintained fiscal discipline in the face of persistent shocks and lingering demand pressures. The unwinding of the one-off impact of the drought should improve the external current account balance in FY 2012/13, but policies under the program continue to aim at reducing domestic absorption. Monetary policy will continue to bear the brunt of the adjustment until expectations of low inflation take hold and the external current account deficit shrinks. Supported by key tax and expenditure reforms, gradual fiscal consolidation would complement monetary policy in keeping domestic demand in check. The planned path of fiscal consolidation strikes a balance among providing resources for implementing the constitution, preparing for the 2013 elections, and contributing to the adjustment. Financial supervision and overall soundness of the financial system have kept emerging credit risks contained so far. Contingency plans are needed in case a further deterioration of the global economic environment threatens macroeconomic stability and hard-earned gains in reducing poverty.

A. Dealing with a deterioration of the global economy

8. **The authorities intend to meet the program objectives even if global economic conditions further deteriorate.** They are working on contingency plans that would rely on larger reductions of non-priority expenditures and scaling down of investment projects in the event this adverse scenario materializes. However, in the event of a contraction in domestic demand that would diminish pressures on inflation and the external position, the authorities will avoid pro-cyclical policies that could worsen the prospects of recovery, but will ensure that the fiscal position remains sustainable.

remittances from Europe. Policy space is limited because inflation remains high and domestic growth remains strong.

9. **Kenya remains vulnerable to a decline in external demand and persistent volatility in global commodity prices.** A further deepening of the European crisis would tilt to the downside the risk for non-traditional exports, tourism earnings and

Box 1. Kenya: External Vulnerabilities to a Global Downturn in Economic Activity

Kenya is vulnerable to a weakening of global growth and rising pressures in international oil prices:

- **Trade balance.** Export earnings coverage of the import bill has been steadily declining, from 70 percent in 2002 to about 40 percent in 2011. Moreover, about 82 percent of horticulture exports are sold to the European Union, which recently raised non-tariff barriers.
- **Tourism.** The sources of tourism inflows have diversified away from Europe, toward Asia and the Middle East. Nevertheless, a global economic downturn would not spare emerging markets and would still hurt Kenya's tourism receipts.
- **Fuel imports.** The share of oil in total imports remains at 30 percent. Vulnerability to unfavorable weather conditions exacerbates the exposure to international fuel price volatility as reliance on diesel fuel imports for thermal power generation increases.
- **Remittance inflows.** Remittances inflows have reached 20 percent of total exports. They are vulnerable to a sharp downturn in economic activity in source countries.
- **Banking spillovers.** Foreign banks in Kenya largely depend on local funding rather than on their parent banks in Europe, therefore the banking spillover channel is likely to be negligible. However, a global slowdown in capital flows still will have an impact on Kenya's securities and capital markets.

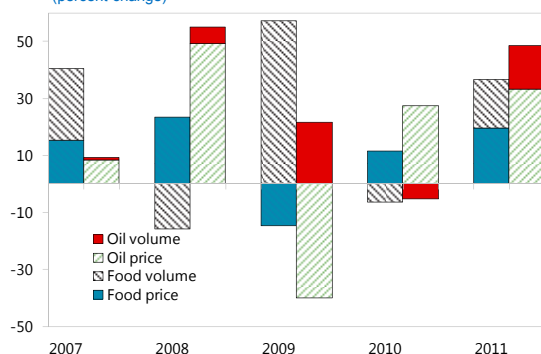
A deterioration of the global outlook could raise the current account deficit by about 1.5 percent of GDP annually over the medium term. The direct impact on the fiscal position is moderate, but additional spending pressures may arise associated with slower growth by 0.7–1 percent in the next two years.

	Medium Term Projections						Adverse Scenario			
	Actual 2009/10	Actual 2010/11	Baseline				Projections			
			2011/12	2012/13	2013/14	2014/15	2011/12	2012/13	2013/14	2014/15
(Annual percentage change; unless otherwise indicated)										
National accounts and prices										
Real GDP growth (market prices)	4.1	5.3	5.1	5.5	6.0	6.3	4.5	4.5	5.7	6.4
(In percent of GDP; unless otherwise indicated)										
Central government budget										
Overall balance (commitment basis) excluding grants	-7.2	-5.2	-6.3	-5.7	-5.5	-4.8	-6.4	-5.8	-5.6	-4.9
Primary Budget Balance	-3.8	-1.5	-2.2	-1.8	-1.4	-0.9	-2.3	-1.9	-1.5	-0.9
Balance of payments										
Current external balance, excluding official transfers	-5.3	-9.3	-11.4	-8.9	-7.7	-6.5	-11.4	-9.5	-8.9	-7.9
Gross international reserve coverage										
In billions of U.S. dollars (end of period)	3.8	4.1	5.1	5.5	6.0	6.8	4.5	4.9	5.4	6.2
In months of next year imports (end of period)	3.1	3.0	3.6	3.7	3.9	4.1	3.3	3.4	3.6	3.9
Public debt										
Total public debt, net (percent of GDP)	44.8	45.9	44.6	42.9	41.7	39.8	44.9	43.7	42.7	40.7

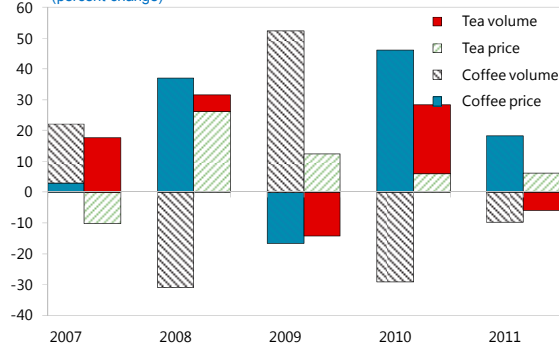
Sources: Kenyan authorities; and IMF staff estimates and projections.

Figure 2. Balance of Payments Developments

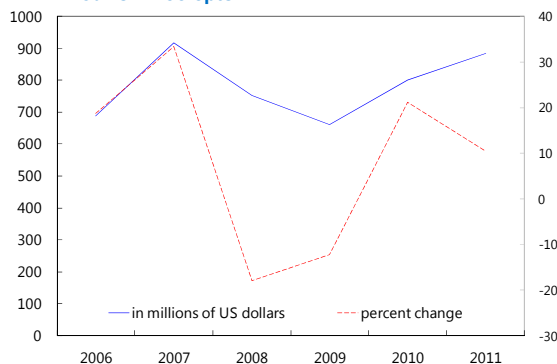
The drought led to higher fuel and food imports volumes at a time of higher international prices...

Import Volumes and Prices
(percent change)

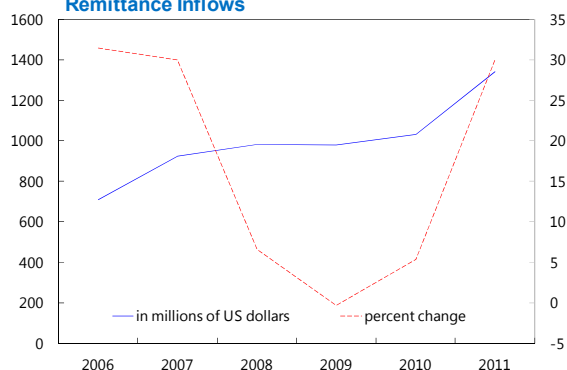
...and also to lower export volumes, widening the current account deficit.

Export Volumes and Prices
(percent change)

Tourism receipts are increasing as countries in Asia and the Middle East become more important as sources of tourists...

Tourism Receipts

...and remittance inflows picked up partly helped by lower costs of money transfers brought about by financial innovation.

Remittance Inflows

B. Pressing Ahead with Fiscal Consolidation and Reform

10. **Despite revenue shortfalls and growing expenditure pressures, the authorities plan to maintain their original program targets for the primary balance in both the supplementary budget for FY 2011/12 and the draft budget for FY 2012/13.** The supplementary budget for FY2011/12 reprioritized expenditures. The draft budget for FY2012/13, which will be presented to the National Assembly in April, targets a central-government primary balance deficit of 1.8 percent of GDP in FY 2012/13, which is consistent with program targets and is almost

½ percentage point of GDP down from FY 2011/12. Additional savings on non-priority outlays will offset the budget impact of postponing the reinstatement of the excise tax on diesel fuel because of persistently high fuel prices.

11. **In the medium term, the authorities plan to bring the fiscal primary deficit to 0.9 percent of GDP.** Under current projections this would be consistent with a reduction of the government debt-to-GDP ratio below 40 percent in FY 2014/15.

12. **The authorities plan to enhance revenue mobilization through comprehensive tax and administration reforms.** In addition to the new VAT design, plans to reform the excise and income tax regimes and their administration in the next fiscal year are poised to steadily increase tax revenue over the medium term.

13. **The PFM bill currently under consideration by the National Assembly will provide the foundations of sound financial management both at the central and county government levels.** The creation of a Treasury Single Account (included in the PFM bill) will enhance transparency in public finances. The re-engineering of the Integrated Financial Management and Information System (IFMIS) has already improved efficiency in public administration, including by introducing program-based budgeting in 24 agencies covering more than 50 percent of the budget.

14. **Pension reform and the rationalization of salary scales would contain contingent liabilities and ensure consistency of wage structures across government bodies.** A pension reform bill has been submitted to the National Assembly, and aims at phasing out the non-contributory, defined-benefit pension scheme for civil servants. It would reduce government contributions by an equivalent of 22 percent of GDP in present-value terms over the medium term. The planned rationalization of salary scales, for which the authorities have

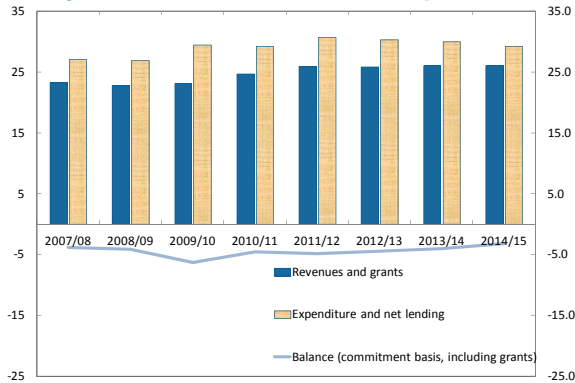
requested FAD technical assistance, should be ready before end of end of FY 2012/13.

15. **The updated medium term debt strategy prioritizes domestic financing.** The contracting of a 2-year US\$600 million syndicated loan with foreign banks at London Interbank Offered Rate (LIBOR) plus 475 basis points will help reduce domestic financing requirements in this fiscal year. However, as inflation declines, the authorities intend to resume domestic security issuance at longer maturities, in line with their medium-term debt strategy. The authorities stressed that the syndicated loan does not modify the favorable assessment of the recent Debt Sustainability Analysis (contained in IMF Country Report No. 12/14) because the loan replaces the originally envisaged Eurobond issuance.

Figure 3. Fiscal Developments

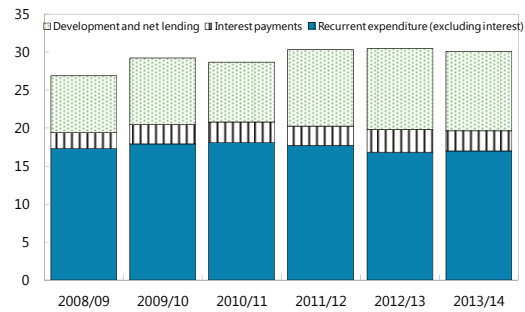
After fiscal expansion in 2009/10, Kenya has started to implement its fiscal consolidation plans that rely on revenue mobilization.

Kenya: Fiscal Balance, Revenues and Expenditures



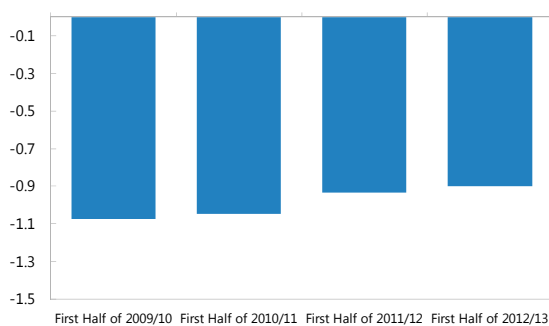
...while increasing capital spending.

Kenya: Fiscal Expenditures Decomposition (percent of GDP)



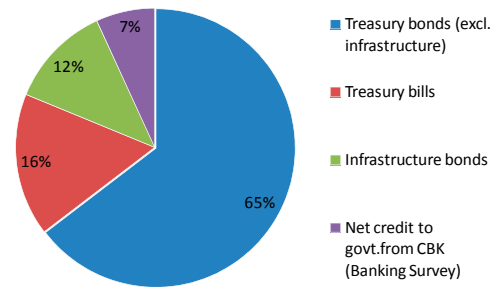
...and lowering the primary balance,

Kenya: Primary Fiscal Balance (percent of GDP)



...while relying on long-term financing.

Kenya: Composition of Domestic Debt by Instrument (December, 2011)



C. Managing Liquidity under a Tight Monetary Policy

16. **The CBK intends to maintain the policy interest rate at 18 percent until there is clear evidence of a sustained decline in inflationary expectations.** Declining market interest rates, a downward shift in the yield curve, and market surveys, suggest that inflationary expectations have started to abate. However, the CBK believes that reducing the

policy rate prematurely may quickly translate into a reversal of this trend.

17. **The CBK remains committed to accelerating the accumulation of international reserves in line with the program.** Proceeds from the syndicated loan to the government will boost CBK's foreign exchange reserves but will also increase liquidity as foreign exchange is converted into

Shillings and spent by the government, which will require a proactive sterilization policy and a close coordination between the treasury and the CBK.

18. **The CBK intends to fine tune the new framework for monetary policy operations.** While tightening its monetary policy stance, the CBK has refrained from liquidity injections through money market operations to avoid confusing signals on its stance. As a result, the interbank rate was subject to large fluctuations in response to cyclical peaks in banks' liquidity demand. Going forward, the CBK plans to resume injections of liquidity to reduce these fluctuations by fine tuning the conduct of monetary operations (for which it has sought technical assistance from MCM). Coordination between the CBK and treasury should ensure timely repayment of overdraft obligations and a less intensive use of this facility over time.

19. **The authorities plan to enhance disclosure, competition, and information sharing as a means to avoid excessively high interest rates.** This approach will address

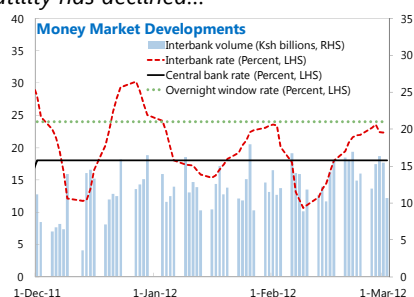
D. Preventing Financial Stress

20. **Banking supervision has focused on emerging credit risk.** Banks remain sound and profitable, and have continued to grow strongly in 2011, with several systemically important banks increasing their capital. Non-performing loans (NPLs) remain low at 4.5 percent of total loans. The impact of a reduced

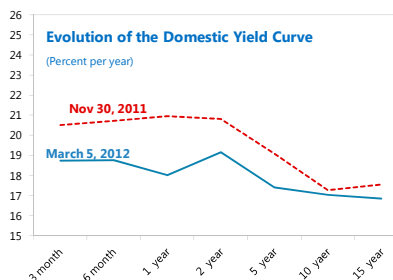
underlying concerns in the National Assembly that motivated proposals to introduce caps on commercial banks' interest rates. The authorities have strongly resisted this proposal.

Figure 4. Money Market Rates and Yield Curve

Interbank interest rates have remained around the CBR, and volatility has declined...



...and the yield curve reflects declining inflationary expectations.



availability of credit since the beginning of the tightening and higher interest rates may be yet to come, because credit risk may not be evenly distributed across banks.

21. **Thus, the Banking Supervision Department has intensified the monitoring**

of banks with higher exposure to sectors more sensitive to interest rate increases, such as personal and real estate loans. The CBK is also monitoring provisioning practices in small banks and is ready to adopt timely prompt corrective action if these banks face difficulties.

22. **The recently introduced agency-banking scheme has contributed to financial deepening.** Most large banks are

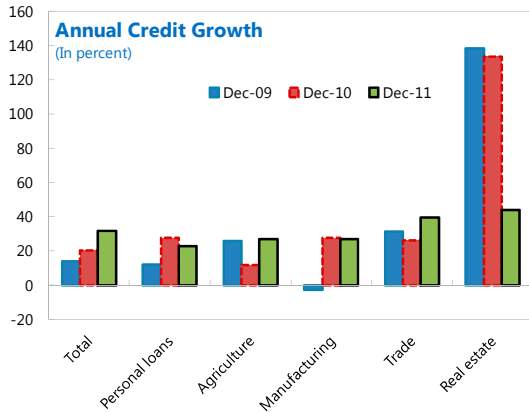
intensifying the use of agents in remote areas, improving financial inclusion. On capital markets, the Capital Markets Authority (CMA) has overcome temporary difficulties in proceeding with the demutualization of the stock exchange caused by an injunction raised at the courts. The authorities expect now to proceed swiftly with the process of demutualization after issuing the needed regulations in the next months.

Box 2. Kenya: Financial Risks in a Tight Monetary Policy Environment

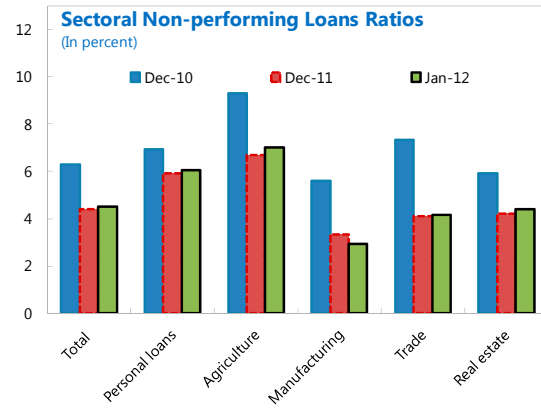
- **Credit risk:** Non-performing loans (NPLs) continued to decline up to December, reaching 4.4 percent, but edged slightly up to 4.5 percent in January 2012. Some mitigating factors are in place:
 - The top 6 banks, which hold 85 percent of all loans, have sound standards of risk assessment, collection practices and provisioning policies.
 - Banks are taking pre-emptive actions to change the terms of loans before they become non-performing or doubtful. The maturity of about 10 percent of loans has been increased so that average payments remain unchanged.
 - Current capital buffers are more than sufficient to manage a moderate increase in NPLs, expected to be around 1-1.5 percent.
- **Banking soundness:** The average capital adequacy ratio as of January 2012 is 20 percent on average, well above the 12 percent regulatory minimum requirement. Tier 1 and 2 banks remain highly profitable and have been able to raise capital. Capital adequacy ratios have rebounded and banks have reallocated their portfolios away from trading.
- **Liquidity risk:** Liquidity ratios have declined following monetary policy tightening. As a response, banks have reduced holdings of government securities, liquidated foreign exchange positions and slowed lending.
- **Spillovers from Europe:** Banks fund themselves mainly from domestic deposits, including subsidiaries of foreign banks. Short term funding from abroad has been less than 2 percent of liabilities.
- **Risks:** Weaknesses in small banks facing higher costs of funding would require the Central Bank of Kenya to closely watch the impact of rising credit and liquidity risks on their soundness.

Figure 5. Financial Developments

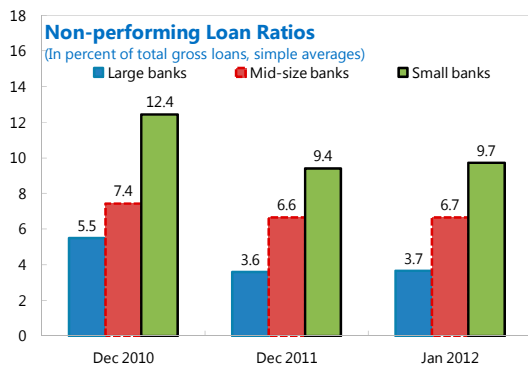
Credit rapidly expanded in all sectors during 2009-2011...



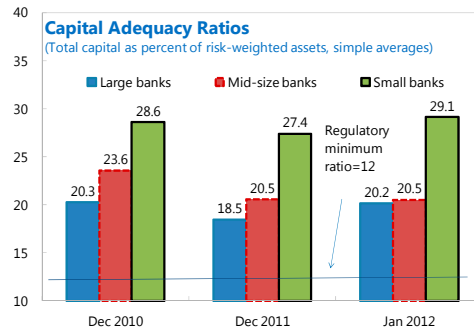
...but NPLs have not shown yet increasing credit risk.



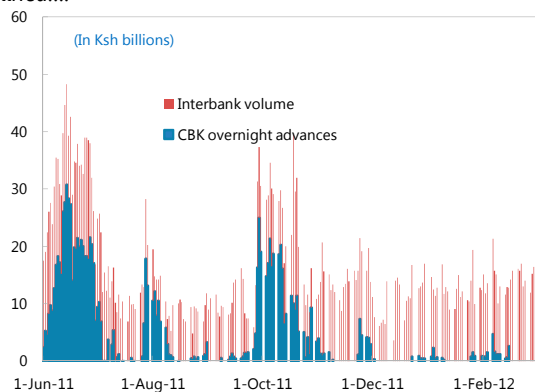
...except recently in small banks, showing NPLs edging up slightly in January 2012...



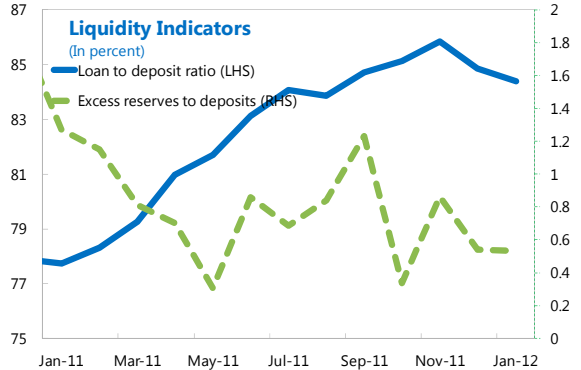
However, banks appear sufficiently capitalized to absorb increasing risks.



The cost of funding has increased because of monetary policy tightening, and use of the overnight window has declined....



... as banks try to restore liquidity by slowing credit growth.



PROGRAM ISSUES AND RISKS

23. **Staff proposes to modify the targets for the next two reviews and establish targets for June 2013.**

All December 2011 targets were met. For 2012, NIR and NDA targets need to be revised mainly to accommodate foreign exchange inflows from the US\$600 million syndicated loan before the end of FY 2011/12. The fiscal target has been revised to incorporate changes in GDP while keeping the primary balance unchanged as a percent of GDP. The target for non-concessional loans is modified to US\$1.3 billion for end June 2012 and US\$1.5 billion for end December 2012 to incorporate new commercial borrowing, and to integrate the originally planned sovereign bond issuance under the program, which was initially excluded from that ceiling. The new targets take into account changes in the macroeconomic outlook and a new base period for the program exchange rate from September 2011 to February 2012. The direction of macroeconomic policies under the program has not changed.

24. **Delays in submitting the VAT bill for approval by the National Assembly (structural benchmark for the second review) are explained by the heavy load of legal reform mandated by the new constitution.**

Although at a slower pace, the process to approve the bill is proceeding as planned and the new VAT legislation should be in place ahead of the FY 2012/13 budget.

The authorities remain committed to the fiscal program targets even if delays in the implementation of the new VAT law take place.

25. **The balance of risks remains tilted downward.** Main risks to the program are:

- A further deterioration of the global outlook, which would affect demand for non-traditional exports, remittances and tourism. Although financial spillover risks to domestic banks are low, overall financial inflows may decelerate, exerting pressure on the exchange rate.
- A further increase in oil prices related to tensions in the Middle East that could complicate the external adjustment process.
- A deterioration of the political outlook in the run-up to elections in 2013 and during the implementation of fiscal decentralization, compromising political support for the program.
- A worsening of weather conditions, leading to stronger pressures on growth, inflation, and the external position.
- A protracted intervention in Somalia, translating into budget pressures and heightened security concerns that may affect tourism revenue.

26. **An update of the safeguards assessment of the CBK was completed in March 2012.** The assessment found that the temporary governance gaps of the Board and Audit Committee identified in the 2011 assessment have been rectified. These oversight bodies have now been fully restored to support effective discipline and responsibility. The Audit Committee concluded satisfactorily on its ex-post assessment of the gaps, and the external auditor issued an unqualified audit opinion for 2011. The assessment recommended adopting an action plan to resolve the large stock of

pending audit recommendations. Aside from amending the CBK Act, almost all recommendations of the earlier assessment have been implemented on schedule. Internal audit has resumed certifying reconciliations supporting the monetary data reported to the Fund. The authorities have committed to revise the CBK Act to adapt it to the new constitution and to incorporate recommendations from the safeguards assessment.

STAFF APPRAISAL

27. **Achievements:** Kenya's economic reform program has started to yield results. Inflation is abating, the shilling has strengthened, international reserves are on the rise, the debt-to-GDP ratio is declining, and the government securities market has thawed. More importantly, economic expansion and growth have held up despite the drought and the increased global financial and economic uncertainty. Key reforms in the fiscal and financial sector are moving forward.

28. **Challenges and risks:** The uncertain global outlook – in particular the European sovereign-debt crisis and the risk of further increases in oil prices—could affect Kenya by dampening growth and widening the deficit of the external current account. Thus, policies

should continue to aim at ensuring that domestic demand grows in line with supply to reduce the external imbalance and keep inflationary pressures in check. In the event global economic conditions take a turn for the worse, leading to further pressures on the external current account, the authorities should stand ready to step up their adjustment efforts, including further tightening of the monetary and fiscal policies if necessary, to ensure macroeconomic stability as a prerequisite for maintaining and possibly improving the country's relatively favorable economic performance.

29. **Monetary and exchange rate policies:** The decline in headline inflation from its November peak augurs well. This decline

reflects the tightening in the monetary policy stance since October 2011. But it will take time before monetary tightening fully works through inflation expectations. Provided the CBK maintains its current stance, the authorities' inflation target for this year appears within reach. Thus, the CBK should move to lower its policy rate only when there is clear evidence of falling inflationary expectations because the cost of premature loosening would be high. Moreover, maintaining the current stance should help to bring down the still rapid pace of growth in credit to the private sector, to reduce pressures on the external position. Because of this, the CBK should be prepared to sterilize the monetary impact of increased foreign government financing inflows. The CBK should also intervene in the foreign exchange market to reach its reserve accumulation targets, and only occasionally to smooth excess volatility in the exchange rate.

30. **Fiscal policy:** Revenue performance has been disappointing during FY 2011/12, while expenditure pressures have been building, particularly because of Kenya's intervention in Somalia. The authorities' decision to, nevertheless, stick to the primary deficit targets for both FY 2011/12 and FY 2012/13 in terms of GDP demonstrates their commitment to fiscal consolidation. The 2011/12 supplementary budget reallocates expenditure priorities maintaining overall consistency with the intended decline in the government debt-to-GDP ratio. The primary-

deficit reduction envisaged for FY 2012/13 should complement monetary policy to reduce the external imbalance, by raising government savings, while providing sufficient scope for key investment in infrastructures, pro-poor spending, and outlays to implement the constitution. However, it will be essential to address the underlying reasons for the lower than expected VAT collection by implementing as soon as possible the proposed VAT reform, which should not only simplify administration, but also boost its yield. In the event the National Assembly delays approval of the VAT bill beyond the current fiscal year, or modifies substantially its content, reductions in non-priority expenditure—as a result of the progress in implementing IFMS—should offset the resulting revenue shortfall. The authorities' intention not to reintroduce the excise on kerosene and diesel reflects the recent pick up in international oil prices, but it should be reversed as soon as feasible.

31. **Expenditure reforms:** Adoption of the PFM bill, currently before the National Assembly, would establish a Single Treasury Account and constitutes a milestone toward increased accountability, stricter expenditure control, and reduced scope for corruption. Moreover, the bill should facilitate an orderly transition to a decentralized fiscal system with clearly defined intergovernmental relations and responsibilities for service delivery. The ongoing review of the salary scheme should facilitate the implementation of the PFM bill, but it will be important that the

recommendations to rationalize the salary schemes remain expenditure neutral. The authorities' decision to move to a contribution-based pension system for civil servants should have a favorable impact on Kenya's long-term fiscal position. In the short term, it will be essential to ensure that the transitional costs of this reform remain within the budgeted amount.

32. **Financial sector:** The recent high volatility in interbank rates appears not to have caused significant stress in the banking system as a whole. Nevertheless, banking supervision should intensify its monitoring of banks with higher exposure to personal loans and real estate. Moreover, the recently adopted framework for the conduct of CBK monetary operations should increasingly lower volatility in the interbank market and foster better liquidity management in commercial banks. The demutualization of the Nairobi Stock exchange should have a favorable impact on nonbank financial intermediation that together with better sharing of information on

borrowers' credit risk should help reduce still high spreads on lending rates.

33. **Poverty Reduction:** The authorities have prepared an update of their 2008–12 poverty reduction strategy paper, circulated to the Board in December, 2011 (IMF Country Report No. 12/10), that sets more realistic targets in light of the recent macroeconomic developments. This document should guide the dialogue with Kenya's development partners.

34. **Program Performance:** All performance criteria and structural benchmarks for December 2011 were observed. The CBK is in the process of implementing the recommendations from the 2012 Safeguards Assessment. Staff recommends completion of the third review under the ECF arrangement, and approval of the request for modification of end-June and end-December 2012 performance criteria.

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

	2009/10 ¹	2010/11		2011/12		2012/13	2013/14	2014/15
	Actual	Second Review	Estimate	Second Review	Revised Program	Projections		
(Annual percentage change; unless otherwise indicated)								
National accounts and prices								
Nominal GDP (market prices, in billions of Kenya shillings)	2,458	2,777	2,776	3,281	3,274	3,832	4,369	4,903
Real GDP growth (market prices)	4.1	5.3	5.3	5.3	5.1	5.5	6.0	6.3
GDP deflator (average) ²	5.5	7.3	7.3	12.2	12.2	11.0	7.5	5.5
Consumer price index (annual average) ²	6.7	6.9	6.9	16.2	15.8	6.5	5.0	5.0
Consumer price index (end of period) ^{2/}	3.5	14.5	14.5	12.0	10.8	5.0	5.0	5.0
Import volume growth, goods	5.9	3.6	6.1	0.6	-1.2	1.2	9.3	6.4
Import value growth, goods	2.5	20.6	20.6	10.2	11.6	2.5	5.9	4.5
Export volume growth, goods	-0.4	-2.8	-1.2	5.5	-0.5	8.6	10.0	8.2
Export value growth, goods	6.0	12.6	12.6	12.6	3.1	0.9	7.3	5.2
Terms of trade, goods, and services (Base year 2000)	14.9	-1.5	0.6	-4.7	-8.0	-7.2	1.0	-0.2
Ksh per US\$ exchange rate (end of period) ³	81.9	99.6	99.6	...	...	...	...	...
Nominal effective exchange rate (- depreciation; end of period)	-0.3	...	-14.3	...	...	...	...	...
Real effective exchange rate (- depreciation; end of period)	-1.6	...	-6.9	...	...	...	...	...
Money and credit								
M3 (broad money and foreign currency deposits, end period)	26.2	15.2	15.2	17.6	18.7	17.0		
Reserve money	31.5	4.8	4.8	14.0	16.7	14.6		
(In percent of GDP; unless otherwise indicated)								
Investment and saving								
Investment	20.3	21.5	21.5	23.6	23.5	24.0	24.9	24.9
Central government	8.7	7.8	7.8	10.0	9.5	9.6	10.5	10.2
Other	12.1	13.7	13.7	13.6	14.0	14.4	14.4	14.7
Gross national saving	15.1	11.8	12.1	14.8	12.0	15.1	17.1	18.3
Central government	1.5	2.7	2.7	4.1	3.3	4.0	5.1	5.5
Other	13.5	9.1	9.4	10.7	8.7	11.1	12.1	12.8
Central government budget⁴								
Total revenue	22.3	24.0	24.0	24.5	24.4	24.6	24.9	24.9
Total expenditure and net lending	29.5	29.2	29.2	30.5	30.7	30.3	30.3	29.7
Overall balance (commitment basis) excluding grants	-7.2	-5.2	-5.2	-6.0	-6.3	-5.7	-5.5	-4.8
Overall balance (commitment basis) including grants	-6.4	-4.5	-4.5	-4.7	-4.8	-4.5	-4.1	-3.3
Primary budget balance	-3.8	-1.5	-1.5	-2.2	-2.2	-1.8	-1.4	-0.9
Net domestic borrowing	5.4	3.3	3.3	3.3	1.9	3.0	2.3	0.9
Balance of payments								
Exports value, goods, and services	26.0	27.8	28.2	30.8	25.0	20.9	19.7	18.5
Imports value, goods, and services	38.7	45.1	45.3	48.0	43.7	36.4	33.8	31.5
Current external balance, including official transfers	-5.3	-9.6	-9.4	-8.8	-11.5	-8.9	-7.8	-6.6
Current external balance, excluding official transfers	-5.3	-9.6	-9.3	-8.7	-11.4	-8.9	-7.7	-6.5
Gross international reserve coverage								
In billions of U.S. dollars (end of period)	4	4.1	4.1	4.2	5.1	5.5	6.0	6.8
In months of next year imports (end of period)	3.1	3.1	3.0	2.9	3.6	3.7	3.9	4.1
Public debt								
Total public debt, net (percent of GDP)	44.8	45.9	45.9	44.7	44.6	42.9	41.7	39.8
Of which: external debt	23.0	23.4	23.4	22.3	23.5	22.0	21.1	20.5
Domestic debt, net of deposits	21.8	22.5	22.5	22.4	21.0	20.9	20.7	19.3

Sources: Kenyan authorities and IMF staff estimates and projections.

¹ Fiscal year is from July 1st through June 30th.² The consumer price index series was revised in November 2009 based on a new methodology.³ Actual as of June 30, 2012.⁴ Revenue plus program grants minus recurrent expenditure.

Table 2a. Kenya: Central Government Financial Operations

	2009/10	2010/11	2011/12	2011/12	2012/13	2013/14	2014/15
	Estimate	Preliminary	Second Review (ECF)	Revised Program	Projections	Projections	Projections
(In billions of Kenyan shillings, unless otherwise indicated)							
Revenues and grants	568.8	686.3	844.9	847.9	989.2	1,148.7	1,291.8
Revenue	548.1	667.5	803.8	799.8	942.0	1,086.4	1,220.2
Tax revenue	466.5	557.2	660.7	640.6	765.8	904.1	1,015.8
Income tax	209.1	258.7	305.3	308.4	369.2	419.8	471.5
Import duty (net)	41.3	46.1	57.6	56.6	63.5	78.4	88.8
Excise duty	74.1	80.6	93.2	81.8	96.3	124.5	140.2
Value-added tax	142.0	171.9	204.6	193.8	236.8	281.4	315.3
Nontax revenue	81.6	110.4	143.1	159.2	176.2	182.3	204.4
Investment income	8.4	11.1	13.3	13.6	15.9	14.4	16.2
Other	32.7	41.0	53.2	66.0	68.9	73.2	82.2
LATF	0.0	0.0	16.1	15.3	19.4	21.4	24.0
Ministerial and Departmental Fees (AIA) ¹	40.6	58.3	60.6	64.3	72.0	73.3	82.0
Grants	20.7	18.8	41.1	48.1	47.2	62.3	71.6
Project grants	20.7	18.8	41.1	47.0	47.2	62.3	72.6
Program grants	0.0	0.0	0.0	1.1	0.0	0.0	0.0
Expenditure and net lending	725.2	811.8	1,000.3	1,006.6	1,160.4	1,326.1	1,450.5
Recurrent expenditure	504.3	578.5	664.6	678.1	765.2	849.4	931.2
Interest payments	63.5	76.2	84.6	85.2	101.3	114.3	116.1
Domestic interest	57.4	69.2	76.6	77.7	89.7	99.1	93.8
Foreign interest due	6.1	7.0	8.0	7.5	11.6	15.2	22.3
Wages and benefits (civil service)	172.6	198.5	222.6	229.4	262.1	290.0	319.1
Pensions, etc.	29.0	25.7	34.8	32.6	50.9	61.0	67.3
Other ¹	182.3	217.5	257.5	255.0	285.7	318.7	355.7
Defense and NSIS	56.9	60.6	65.2	75.9	65.2	65.4	73.0
Development and net lending	214.7	219.4	332.3	312.2	371.6	461.8	503.0
Domestically financed	151.9	149.9	212.0	195.8	238.2	247.6	262.8
Foreign financed	61.6	67.0	117.7	113.8	130.6	211.3	237.2
Net lending	1.2	2.5	2.6	2.6	2.8	2.9	3.0
Civil Contingency Fund	0.0	0.0	2.0	0.0	3.6	0.0	0.0
Drought expenditures	6.2	8.3	0.0	8.3	2.0	2.0	2.0
Constitutional Reform ²	0.0	5.6	1.4	8.0	8.0	2.0	2.0
Balance (commitment basis, excluding grants)	-177.1	-144.3	-196.5	-206.8	-218.4	-239.7	-230.3
Balance (commitment basis, including grants)	-156.4	-125.5	-155.4	-158.7	-171.2	-177.4	-158.7
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	-155.4	-158.7	-171.2	-177.4	-158.7
Financing	156.4	118.8	155.4	158.7	171.2	177.4	158.7
Net foreign financing	22.9	28.4	46.6	95.5	58.1	75.7	114.2
Disbursements	39.8	48.2	71.9	120.4	86.2	165.4	156.8
Project loans	39.8	48.2	71.9	69.4	86.2	114.4	135.5
Commercial borrowing ³	0.0	0.0	0.0	51.0	0.0	51.0	21.3
Repayments due	-18.7	-20.5	-25.8	-25.4	-28.6	-90.2	-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	0.5	0.5	0.5
Net domestic financing	133.5	90.4	108.8	63.2	113.1	101.7	44.5
<i>Memorandum items:</i>							
Nominal GDP	2,458.3	2,775.7	3,281.5	3,274.2	3,832.4	4,369.4	4,903.3
Primary budget balance including grants	-92.9	-42.6	-70.8	-73.5	-69.9	-63.1	-42.6
Stock of domestic debt, net (end of period)	534.8	625.2	734.0	688.4	801.5	903.1	947.7
Total public debt, net of deposits	1,100.4	1,275.0	1,466.5	1,458.9	1,645.6	1,822.9	1,951.6

Sources: Kenyan authorities and IMF staff estimates and projections.

Fiscal year runs from July to June.

¹ Coverage increased in FY 2010/11 to incorporate tuitions and fees to universities and hospitals, and associated expenditure.² Includes estimated expenditures associated with the implementation of the new constitution.³ Includes planned sovereign bonds and proceeds from syndicated loan.

Table 2b. Kenya: Central Government Financial Operations

	2009/10	2010/11	2011/12	2011/12	2012/13	2013/14	2014/15
	Estimate	Preliminary	Second Review (ECF)	Revised Program	Projections	Projections	Projections
(In percent of GDP)							
Revenues and grants	23.1	24.7	25.7	25.9	25.8	26.3	26.3
Revenue	22.3	24.0	24.5	24.4	24.6	24.9	24.9
Tax revenue	19.0	20.1	20.1	19.6	20.0	20.7	20.7
Income tax	8.5	9.3	9.3	9.4	9.6	9.6	9.6
Import duty (net)	1.7	1.7	1.8	1.7	1.7	1.8	1.8
Excise duty	3.0	2.9	2.8	2.5	2.5	2.8	2.9
Value-added tax	5.8	6.2	6.2	5.9	6.2	6.4	6.4
Nontax revenue	3.3	4.0	4.4	4.9	4.6	4.2	4.2
Investment income	0.3	0.4	0.4	0.4	0.4	0.3	0.3
Other	1.3	1.5	1.6	2.0	1.8	1.7	1.7
LATF	0.0	0.0	0.5	0.5	0.5	0.5	0.5
Ministerial and Departmental Fees (AIA) ¹	1.7	2.1	1.8	2.0	1.9	1.7	1.7
Grants	0.8	0.7	1.3	1.5	1.2	1.4	1.5
Project grants	0.8	0.7	1.3	1.4	1.2	1.4	1.5
Program grants	0.0	0.0	0.0	0.03	0.0	0.0	0.0
Expenditure and net lending	29.5	29.2	30.5	30.7	30.3	30.3	29.6
Recurrent expenditure	20.5	20.8	20.3	20.7	20.0	19.4	19.0
Interest payments	2.6	2.7	2.6	2.6	2.6	2.6	2.4
Domestic interest	2.3	2.5	2.3	2.4	2.3	2.3	1.9
Foreign interest due	0.2	0.3	0.2	0.2	0.3	0.3	0.5
Wages and benefits (civil service)	7.0	7.2	6.8	7.0	6.8	6.6	6.5
Civil service reform	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Pensions, etc.	1.2	0.9	1.1	1.0	1.3	1.4	1.4
Other ¹	7.4	7.8	7.8	7.8	7.5	7.3	7.3
Defense and NSIS	2.3	2.2	2.0	2.3	1.7	1.5	1.5
Development and net lending	8.7	7.9	10.1	9.5	9.7	10.6	10.3
Domestically financed	6.2	5.4	6.5	6.0	6.2	5.7	5.4
Foreign financed	2.5	2.4	3.6	3.5	3.4	4.8	4.8
Net lending	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Civil Contingency Fund	0.0	0.0	0.1	0.0	0.1	0.0	0.0
Drought expenditures	0.3	0.3	0.0	0.3	0.1	0.0	0.0
Constitutional Reform ²	0.0	0.2	0.0	0.2	0.2	0.0	0.0
Balance (commitment basis, excluding grants)	-7.2	-5.2	-6.0	-6.3	-5.7	-5.5	-4.7
Balance (commitment basis, including grants)	-6.4	-4.5	-4.7	-4.8	-4.5	-4.1	-3.2
Adjustments to cash basis	0.0	0.2	0.0	0.0	0.0	0.0	0.0
Balance (cash basis, including grants)	-6.4	-4.3	-4.7	-4.8	-4.5	-4.1	-3.2
Financing	6.4	4.3	4.7	4.8	4.5	4.1	3.2
Net foreign financing	0.9	1.0	1.4	2.9	1.5	1.7	2.3
Disbursements	1.6	1.7	2.2	3.7	2.3	3.8	3.2
Project loans	1.6	1.7	2.2	2.1	2.3	2.6	2.8
Commercial borrowing ³	0.0	0.0	0.0	1.6	0.0	1.2	0.4
Repayments due	-0.8	-0.7	-0.8	-0.8	-0.7	-2.1	-0.9
Change in arrears	0.1	0.0	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	5.4	3.3	3.3	1.9	3.0	2.3	0.9
<i>Memorandum items:</i>							
Nominal GDP	2,458.3	2,775.7	3,281.5	3,274.2	3,832.4	4,369.4	4,903.3
Primary budget balance	-3.8	-1.5	-2.2	-2.2	-1.8	-1.4	-0.9
Stock of domestic debt, net (end of period)	21.8	22.5	22.4	21.0	20.9	20.7	19.3
Total public debt, net of deposits	44.8	45.9	44.7	44.6	42.9	41.7	39.8

Sources: Kenyan authorities and IMF staff estimates and projections.

Fiscal year runs from July to June.

¹ Coverage increased in FY 2010/11 to incorporate tuitions and fees to universities and hospitals, and associated expenditure.² Includes estimated expenditures associated with the implementation of the new constitution.³ Includes planned sovereign bonds and proceeds from syndicated loan.

Table 3. Kenya: Monetary Survey

	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13
(In billions of Kenyan shillings, unless otherwise indicated)											
Central Bank of Kenya (CBK)											
Net foreign assets	252.4	258.7	282.8	292.0	258.7	271.8	317.2	321.6	326.0	330.4	335.3
(in millions of US dollars) ¹	3,175	3,105	3,040	2,926	3,041	3,281	3,829	3,882	3,935	3,987	4,047
Net domestic assets	-29.8	-49.3	-62.3	-55.9	-3.7	-27.1	-60.0	-45.4	-25.6	-44.2	-40.5
Net domestic credit	13.2	4.9	17.7	50.0	51.9	28.4	-4.4	10.1	30.0	11.4	15.0
Government (net)	-3.7	-1.5	-7.1	49.6	51.9	29.3	-7.0	19.0	29.0	29.0	-7.0
Commercial banks (net)	13.9	3.3	19.9	0.4	0.0	-3.4	0.1	-11.4	-1.5	-20.1	19.5
Other items (net)	-42.9	-54.2	-80.0	-105.8	-55.6	-55.6	-55.6	-55.6	-55.6	-55.6	-55.6
Reserve money	222.6	209.4	220.4	236.2	255.0	244.7	257.3	276.2	300.4	286.2	294.8
Currency outside banks	122.9	114.2	119.0	123.7	137.0	127.4	134.7	141.0	164.6	143.0	151.4
Bank reserves	99.7	95.2	101.5	112.4	118.0	117.3	122.5	135.2	135.8	143.2	143.4
Banks											
Net foreign assets	17.4	27.5	-0.8	18.1	36.5	29.8	37.1	37.9	42.0	44.4	47.7
(in millions of US dollars)	216.5	329.6	-9.0	181.1	429.3	359.2	448.3	457.7	507.0	536.4	575.7
Reserves	99.7	95.2	101.5	112.4	118.0	117.3	122.5	135.2	135.8	143.2	143.4
Credit to CBK	-13.9	-3.3	-19.9	-0.4	0.0	3.4	-0.1	11.4	1.5	20.1	-19.5
Net domestic assets	1,033.3	1,081.1	1,170.2	1,219.6	1,209.3	1,263.1	1,316.8	1,444.0	1,457.1	1,517.9	1,555.6
Net domestic credit	1,189.1	1,259.6	1,346.4	1,427.0	1,444.7	1,498.5	1,552.2	1,679.4	1,692.5	1,753.3	1,791.0
Government (net)	281.5	291.2	284.9	250.9	256.8	265.3	294.1	312.0	294.7	309.7	324.6
Other public sector	22.2	17.0	21.7	32.8	30.8	32.8	34.8	38.8	42.8	46.8	50.8
Private sector	885.4	951.3	1,039.7	1,143.2	1,157.1	1,200.4	1,223.3	1,328.6	1,355.0	1,396.9	1,415.7
Other items (net)	-155.8	-178.5	-176.2	-207.3	-235.4	-235.4	-235.4	-235.4	-235.4	-235.4	-235.4
Total deposits	1,136.6	1,200.4	1,251.0	1,349.7	1,363.8	1,413.5	1,476.4	1,628.4	1,636.5	1,725.7	1,727.2
Monetary survey											
Net foreign assets	269.8	286.1	281.9	310.1	295.2	301.6	354.4	359.5	368.0	374.8	383.0
(in millions of US dollars)	3,391.4	3,435.0	3,031.0	3,107.0	3,470.2	3,640.4	4,277.3	4,339.6	4,441.7	4,523.9	4,623.2
Net domestic assets	1,001.8	1,038.6	1,098.8	1,174.1	1,218.9	1,267.7	1,284.7	1,448.4	1,448.8	1,541.1	1,534.5
Net domestic credit	1,188.4	1,261.2	1,344.2	1,482.0	1,505.1	1,530.3	1,547.7	1,700.9	1,724.0	1,784.8	1,786.5
Government (net)	277.8	289.7	277.8	300.5	308.7	294.6	287.1	331.0	323.7	338.7	317.6
Other public sector	22.2	17.0	21.7	32.8	30.8	32.8	34.8	38.8	42.8	46.8	50.8
Private	888.4	954.5	1,044.7	1,148.7	1,162.7	1,202.9	1,225.8	1,331.1	1,357.5	1,399.4	1,418.2
Other items (net)	-222.7	-222.7	-245.4	-307.9	-286.2	-262.6	-263.0	-252.5	-275.2	-243.7	-252.1
M1	577.2	603.4	620.1	627.7	622.7	645.4	674.1	743.5	747.2	788.0	788.6
Money and quasi-money (M2)	1,099.2	1,145.0	1,183.9	1,232.8	1,254.0	1,299.6	1,357.4	1,497.2	1,504.6	1,586.7	1,588.0
M2 plus resident foreign currency deposits (M3)	1,271.6	1,324.7	1,380.7	1,484.2	1,514.2	1,569.3	1,639.1	1,807.9	1,816.8	1,915.9	1,917.5
M3 plus nonbank holdings of government debt (L)	1,569.6	1,637.4	1,720.6	1,819.9	1,876.1	1,944.5	2,031.0	2,240.1	2,251.2	2,373.9	2,375.9
Memorandum items (Annual percent change unless otherwise specified)											
M1	30.5	29.7	21.2	16.9	7.9	7.0	8.7	18.5	20.0	22.1	17.0
M2	22.4	19.4	14.5	14.3	14.1	13.5	14.7	21.4	20.0	22.1	17.0
M3	21.6	19.6	15.2	19.3	19.1	18.5	18.7	21.8	20.0	22.1	17.0
Deposits	21.4	19.8	15.1	20.2	20.0	17.8	18.0	20.7	20.0	22.1	17.0
Reserve money	22.4	18.0	4.8	12.5	14.5	16.9	16.7	16.9	17.8	16.9	14.6
Currency outside banks	21.9	18.5	17.4	18.2	11.4	11.5	13.3	14.0	20.1	12.2	12.4
Net domestic credit	24.3	24.0	23.7	30.1	26.7	21.3	15.1	14.8	14.5	16.6	15.4
Government (net)	35.5	17.4	0.0	8.0	11.1	1.7	3.4	10.1	4.9	14.9	10.6
Private	20.3	25.7	30.7	36.3	30.9	26.0	17.3	15.9	16.7	16.3	15.7
Net domestic assets of the banking sector	24.9	23.7	19.6	21.6	21.7	22.1	16.9	23.4	18.9	21.6	19.4
NDA growth (as percent of the base period M3)	15.6	14.7	12.5	13.7	13.8	14.0	10.8	15.1	12.3	14.1	12.3
Multiplier (Average M3/RM)	5.9	5.9	6.1	6.1	6.2	6.2	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	2.5	2.5	2.5	2.4	2.3

Source: Kenyan authorities and IMF staff estimates and projections

¹ For historical data, at implicit CBK exchange rate

Table 4. Kenya: Balance of Payments

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
	Revised Program					
	(In millions of US dollars, unless otherwise indicated)					
Current account	-1,691.1	-3,062.9	-4,313.6	-4,120.4	-4,095.8	-3,893.7
Excluding official transfers	-1,691.1	-3,041.9	-4,294.3	-4,101.1	-4,076.6	-3,874.4
Exports, f.o.b.	4,920.4	5,538.5	5,712.0	5,764.8	6,188.4	6,507.3
Coffee	194.2	212.8	213.4	183.2	200.9	182.2
Tea	1,127.2	1,108.4	1,160.6	1,041.6	1,030.6	1,075.7
Horticulture	714.8	732.0	648.5	686.0	718.5	733.8
Imports, f.o.b.	-10,564.5	-12,738.1	-14,216.3	-14,578.8	-15,440.6	-16,130.2
Oil	-2,635.6	-3,299.2	-4,463.4	-4,767.9	-4,783.2	-4,779.5
Other Private	-7,827.6	-9,277.0	-9,525.2	-9,606.5	-10,446.4	-11,133.1
of which: special: maize & sugar	-360.9	-198.9	-268.8	-219.9	-220.4	-222.9
Balance on goods	-5,644.1	-7,199.7	-8,504.3	-8,814.1	-9,252.2	-9,622.9
Balance on services	1,584.8	1,606.5	1,494.4	1,663.3	1,816.1	1,956.9
Credit	3,418.8	3,636.0	3,714.8	3,925.7	4,181.7	4,445.8
of which: foreign travel credit ¹	732.0	889.5	900.8	943.9	987.2	1,033.1
Debit	-1,834.0	-2,029.6	-2,220.5	-2,262.4	-2,365.6	-2,488.9
Balance on goods and services	-4,059.3	-5,593.2	-7,009.9	-7,150.7	-7,436.1	-7,666.0
Income (net)	-68.0	46.4	-66.5	-125.7	-165.4	-129.1
Credit	211.5	275.3	206.6	147.7	141.7	200.6
Debit	-279.5	-229.0	-273.2	-273.4	-307.0	-329.7
of which: official interest payments	-71.1	-60.8	-92.3	-120.9	-148.6	-164.1
Other	-208.3	-168.2	-180.9	-152.5	-158.5	-165.6
Current transfers (net)	2,436.2	2,483.9	2,762.9	3,156.1	3,505.6	3,901.4
Private (net)	2,457.9	2,505.0	2,782.2	3,175.4	3,524.9	3,920.7
of which: remittances	1,006.1	1,187.3	1,387.6	1,481.8	1,583.7	1,694.1
Official (net)	-21.7	-21.1	-19.3	-19.3	-19.3	-19.3
Capital and financial account	2,262.1	3,363.8	4,968.0	4,356.6	4,547.9	4,727.4
Capital account (incl. capital transfers)	735.5	209.7	563.0	569.7	752.0	622.8
Financial account²	1,526.6	3,154.1	4,405.0	3,786.9	3,795.9	4,104.6
Net FDI	578.4	694.0	776.1	826.5	930.6	1,052.3
In Kenya	604.5	759.2	803.6	877.1	984.2	1,107.0
Abroad	-26.1	-65.2	-27.5	-50.5	-53.6	-54.7
Net Portfolio investment	-19.2	-11.7	-12.1	-12.0	-13.4	-12.7
Liabilities	4.0	13.2	13.0	12.8	13.7	15.0
Assets	-23.2	-24.9	-25.2	-24.8	-27.1	-27.7
Net other investment	1,334.8	1,941.5	2,945.5	2,972.4	2,878.7	3,065.0
Official, medium and long term	616.5	316.7	550.5	1,334.2	1,279.4	549.8
Inflows	850.1	547.4	821.6	1,656.5	1,688.6	1,662.0
Project loans	501.6	547.4	821.6	1,040.9	1,380.8	1,208.2
Commercial and Defense loans ³	0.0	0.0	0.0	615.6	307.8	453.8
Monetary Authorities' long-term liabilities (SDR allocations)	348.5	0.0	0.0	0.0	0.0	0.0
Outflows	-233.6	-230.8	-271.2	-322.3	-409.2	-1,112.3
Private, medium and long term	-41.8	-49.7	64.9	327.7	290.5	74.1
Energy financing	61.1	57.2	53.3	57.4	62.1	67.3
Kenya Airways	-48.2	-76.3	54.7	307.1	263.6	41.8
Other	-54.8	-30.5	-43.1	-36.8	-35.1	-35.0
Short-term capital	760.2	1,674.5	2,330.1	1,310.5	1,308.8	2,441.1
of which: commercial banks	442.7	465.5	-457.2	-127.4	-112.4	-120.7
Errors and omissions	-367.4	530.3	695.5	0.0	0.0	0.0
Overall balance	571.0	300.9	654.4	236.3	452.0	833.7
Financing items	-571.0	-300.9	-654.4	-236.3	-452.0	-833.7
Reserve assets (gross)	-579.6	-321.9	-944.2	-420.4	-512.6	-771.0
Use of Fund credit and loans to the Fund (net)	-22.1	78.8	284.1	178.1	54.5	-68.7
Disbursements	0.0	103.3	318.7	220.8	110.4	0.0
Repayments	-22.1	-24.4	-34.7	-42.7	-55.9	-68.7
Rescheduling /debt swap	6.1	5.7	5.7	6.0	6.0	6.0
Memorandum items:						
Gross official reserves (end of period)	3,798.6	4,120.5	5,064.7	5,485.0	5,997.6	6,768.6
(in months of following year's imports of goods and services)	3.1	3.0	3.6	3.7	3.9	4.1
Current account balance (excluding official transfers, percent of GDP)	-5.3	-9.3	-11.4	-8.9	-7.7	-6.5
Import volume growth, goods and services (percent)	10.0	4.3	-2.2	0.6	9.6	6.9
Import value growth, goods and services (percent)	2.7	19.1	11.3	2.5	5.7	4.6
Export volume growth, goods and services (percent)	2.3	-3.7	-2.3	8.8	9.8	8.4
Export value growth, goods and services (percent)	9.8	10.0	2.8	2.8	7.0	5.6
Change in the terms of trade (goods and services, percent) ⁴	14.9	0.6	-8.0	-7.2	1.0	-0.2

Sources: Kenyan authorities and IMF staff estimates and projections.

¹ The foreign travel credit comprise two components, recorded tourism inflows and an estimate of additional under-reported tourism receipts.² Historical figures include errors and omissions.³ 2012 includes the \$600 million syndicated loan.⁴ Base year: 2000.

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

	Dec-07	Dec-08	Dec-09	Jun-10	Dec-10	Jun-11	Sep-11	Dec-11	Jan-12
	(Percent)								
Capital adequacy									
Regulatory capital to risk-weighted assets	18.0	18.9	19.5	19.6	20.8	19.0	18.1	19.4	20.8
Regulatory tier 1 capital to risk-weighted assets	16.8	16.9	17.2	17.5	18.7	16.9	16.0	17.3	18.7
Total capital to total assets	12.0	12.6	12.7	14.0	13.2	12.8	12.4	13.2	14.1
Asset quality									
Non performing loans to total gross loans	10.6	9.0	7.9	7.4	6.2	5.4	4.9	4.4	4.5
Non performing loans net of provisions to capital	12.8	11.3	12.6	10.0	6.4	5.8	5.0	3.5	2.7
Earning assets to total assets	79.4	88.6	85.0	85.1	88.8	89.5	88.5	87.8	87.9
Earning and profitability									
Return on assets (ROA)	3.0	2.8	2.9	3.5	3.7	3.3	3.1	3.3	4.0
Return on equity (ROE)	27.5	25.2	24.8	31.4	30.7	30.8	30.2	32.2	34.9
Interest margin to gross income	34.6	34.9	35.6	33.2	34.7	40.9	40.5	38.6	33.8
Non interest expenses to gross income	50.6	51.7	50.8	47.1	48.2	48.2	47.7	44.6	35.0
Liquidity									
Liquid assets to total assets	37.5	36.4	35.9	39.7	38.4	34.9	33.8	33.3	32.7
Liquid assets to short-term liabilities	40.0	37.0	39.8	45.1	44.5	38.9	37.3	37.0	37.7
liquid assets to total deposits	47.4	46.4	46.3	50.4	51.0	46.3	44.9	43.8	43.1
Total loans to total deposits	71.3	73.3	72.4	68.0	72.5	76.6	78.1	77.4	77.5
Sensitivity to market risk									
Net open position in foreign exchange to capital	...	5.6	4.9	4.9	4.3	4.6	6.4	3.3	3.4
Interest bearing assets to interest bearing liabilities	100.5	113.0	113.2	111.6	117.8	117.9	117.4	115.4	116.0
FX currency denominated assets to total assets	8.7	9.7	8.1	10.1	10.6	12.4	13.5	11.8	11.7
FX currency denominated liabilities to total liabilities	16.3	20.2	18.1	16.3	17.1	18.2	20.6	21.5	22.1
Spread between lending and deposit rate	7.5	7.8	8.7	9.4	9.3	8.8	8.4	8.4	10.1

Source: Central Bank of Kenya.

Table 6. Kenya: Performance Criteria for the Third Review under the 2011–14 ECF Arrangement

(In billions of Kenyan shillings; unless otherwise indicated)

	2011			2012								2013		
	Performance Criteria	Actual	met/ not met	Indicative Targets		Performance Criteria		Indicative Targets		Performance Criteria		Indicative Targets	Performance Criteria	
				End-March		End-June		End-Sept		End-Dec.		End-March	End-June	
	Dec.	Dec.		Second Review	Third Review	Second Review	Third Review	Second Review	Third Review	Second Review	Third Review	New Target	New Target	
Quantitative performance criteria														
Fiscal targets														
Primary budget balance of the central government (=deficit, floor) ^{1,2}	-10.0	-9.8	met	-32.0	-32.0	0.0	-10.0	5.0	0.0	15.0	0.0		-5	0
Monetary targets ^{3,4,6}														
Stock of central bank net international reserves (floor, in millions of US\$) ⁵	3,125	3,294	met	3,125	3,520	3,170	4,070	3,200	4,115	3,325	4,160		4210	4260
Stock of net domestic assets of the central bank (ceiling)	-40.0	-52.8	met	-40	-30	-35	-55	-55	-45	-25	-25		-40	-40
Public debt targets														
Contracting or guaranteeing of medium- and long-term nonconcessional by the central government (ceiling; millions of US\$) ^{7,8}	700	84.6	met	700	700	700	1300	700	1,500	700	1,500		1,500	1,500
New central government and central government guaranteed external payment arrears (ceiling, millions of US\$) ⁹	0.00	0.00	met	0	0	0	0	0	0	0	0		0	0
Indicative targets														
Priority Social Expenditures of the central government (floor) ²	13.5	14.0	met	22.5	22.5	26.1	26.1	12.1	12.1	15.0	15.0		21.2	28.3

¹ The primary budget balance of the central government is defined as overall balance including grants, minus concessional project loans, plus interest payments.² Targets for end-September 2012 and end-December 2012, March 2013 and end-June 2013 are cumulative flow from July 1, 2012 (beginning of the 2012/13 fiscal year).³ For program monitoring, the daily average for the month when testing dates are due.⁴ 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.⁵ Excludes encumbered reserves.⁶ First review targets at September 1, 2010 exchange rates. Second review targets at April 29, 2011 exchange rate. Third review targets at February 29, 2012 exchange rates.⁷ Cumulative flow of contracted debt, from January 1, 2011.⁸ The targets on the ceiling of non-concessional external debt combine nonconcessional project loans, syndicated loan and sovereign bond.⁹ Continuous.

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

Date of Availability	Conditions for Fund Disbursement	Original ECF disbursement		ECF augmentation		Total disbursement	
		Millions of SDRs	Percent of quota ¹	Millions of SDRs	Percent of quota	Millions of SDRs	Percent of quota
January 31, 2011	Board approval of the arrangement	65.136	24.00	-	-	65.14	24.00
June 29, 2011	Observance of the end-March 2011 performance criteria and structural benchmarks, and completion of first review	43.424	16.00	-	-	43.42	16.00
December 15, 2011	Observance of the end-June 2011 performance criteria and structural benchmarks, and completion of second review	43.424	16.00	48.852	18.00	92.276	34.00
April 17, 2012	Observance of the end-December 2011 performance criteria and structural benchmarks, and completion of third review	43.424	16.00	28.497	10.50	71.921	26.50
October 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.

APPENDIX. LETTER OF INTENT

Nairobi, Kenya

March 29, 2012

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

Dear Mrs. Lagarde:

1. Kenya's economy shows signs of stabilizing following recent pressures stemming from external shocks and strong domestic demand. The Shilling has recovered following a rapid depreciation in the third quarter of 2011, and inflation has declined since November 2011. The severe drought in the Horn of Africa and the combination of high international food and oil prices contributed to a marked widening of the current account deficit. Most sectors of the economy continued to expand in 2011, but the drought affected negatively agricultural production and hydro-energy generation.
2. Performance under the economic program supported by an arrangement under the Extended Credit Facility of the IMF has remained favorable. We have met all the performance criteria and indicative targets for end-December 2011. Our efforts have lowered the fiscal deficit by more than envisaged under the program; we have also accumulated international reserves beyond the program target levels. In addition, a tight monetary policy stance has contributed to containing domestic demand and lowering inflationary expectations. On the structural front, Parliament is now considering the Public Financial Management bill, while the new VAT bill has been approved by the Cabinet and will be published and tabled in Parliament shortly.
3. This Letter of Intent describes policies we intend to implement for the remainder of 2011/12 and in 2012/13. Policies in the near term will aim at further reducing inflationary pressures, preserving the strong fiscal position, and reducing the current account deficit. We stay firmly committed to our reform program aimed at achieving higher and sustainable growth in a more equitable environment.

I. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

4. Kenya's economy slowed somewhat in 2011, following robust GDP growth in 2010. The drought in the Horn of Africa placed constraints on agricultural production and energy generation. Imports of staple food items and oil products for thermal power generation combined with persistently high international prices boosted the country's import bill. As export growth remained modest, the external position came under increasing pressure, contributing to a wider than expected current account deficit.

5. Following a sharp increase in inflationary pressures in the second half of 2011, the resolute tightening of monetary policy since October has started producing results. After peaking in November, headline inflation has declined for three consecutive months and the depreciation of the Kenyan shilling has been largely reversed. Inflationary expectations have improved and we now expect lower inflation over the coming months.

6. Economic prospects remain favorable, as the impact of the drought on agricultural production and energy generation abates. Combined with fiscal consolidation efforts, the slowdown in credit to the private sector will reduce domestic demand and contribute to bringing the current account deficit under control. The outlook for foreign direct investment is improving, notably as a result of regional trade integration efforts. Unlike in previous elections episodes, FDI flows are unlikely to be affected significantly, owing to the political reform emanating from the implementation of the new Constitution and the improved security situation.

II. THE ECONOMIC PROGRAM FOR 2012/13

A. Fiscal Policy

7. We remain committed to gradual fiscal consolidation while still pursuing our long-term development objectives as set out in Vision 2030. In 2011/12, despite revenue shortfalls, we maintain our program target by limiting non-priority outlays, while protecting pro-poor expenditures. These shortfalls reflected temporary factors such as the elimination of the withholding regime on VAT, the reduction in the stock of outstanding refund claims, the reduction of excise taxes on fuel products, and the removal of import duties on wheat and maize.

8. Our budgetary proposal for 2012/13 remains consistent with the program objectives. The primary budget deficit will narrow, supported by stronger performance on the revenue side as the impact of temporary measures abates. In addition, the expected approval of our new VAT law should further contribute to increased efficiency, improving the business environment, and revenue mobilization. In the event of revenue shortfalls we still remain committed to the program targets. Expenditure policy will continue to be geared toward reprioritizing current expenditure in order to provide space for development expenditures, social spending, and the implementation of the constitution. Regarding the security intervention in Somalia, the recent decision to integrate Kenyan troops within the UN contingent, will help minimize their impact on the budget.

9. We are pressing forward with ambitious structural reforms in the fiscal area. A comprehensive public financial management bill covering all levels of government is under consideration by the National Assembly. This bill constitutes a milestone for the establishment of sound financial management, in the context of fiscal decentralization, and will help to implement one of the main pillars of our new Constitution. It also provides for the creation of a Treasury Single Account at both the national and county levels, which will enhance transparency in public finances and strengthen cash management. In addition, we have prepared a new VAT draft law that removes the existing exemptions and the zero rates on domestically consumed goods. As a result the new bill will not only improve revenue collection but also simplify tax administration. Following the introduction of the new VAT bill, tax reform will focus on excise tax regime and then on the design and the administration of the income tax.

10. Looking forward, we have already started to prepare the reform of our civil servants' pension scheme to allow for a gradual transition from defined benefits to defined contributions. Moreover, comprehensive work has started on the constitutionally-mandated review of salaries and remuneration scales for civil servants. Our Integrated Financial Management Information System is being rolled out across all levels of government, and twenty-four out of forty-eight spending agencies will use it in the preparation and execution of the 2012/13 budget.

11. We will remain committed to our Medium Term Debt Strategy that ensures sustainability of our public debt dynamics. We have contracted an external syndicated loan to substitute for the shortfall in domestic borrowing. Looking forward, external borrowing will be carefully prioritized to encourage concessional borrowing and identify those projects that maximize Kenya's economic and

social potential. We now plan to issue a sovereign bond in 2013/14 while remaining within the ceiling.

B. Monetary Policy

12. CBK will maintain its tight stance until expectations of low inflation take hold with the aim of achieving annual inflation of single digits before the end of the year. Particular attention will need to be paid to potential risks stemming from adverse weather conditions and oil supply disruptions to ensure that recent gains on the inflation front are not reversed. We will continue to enhance the effectiveness of our new framework for monetary operations that has contributed to clarifying monetary policy signals, enhancing liquidity management, and reducing volatility in the interbank market.

13. We will continue to accumulate international reserves as scheduled for the remainder of 2011/12. As the level of international reserves at end-December 2011 exceeded projections, this will allow us to build a buffer to cope with additional external shocks. We remain fully committed to our floating exchange rate regime. CBK will intervene in the foreign exchange market to achieve our revised NIR target, and to smooth out only temporary excessive exchange rate volatility.

C. Financial Policy

14. We remain committed to the twin objectives of promoting financial inclusion and strengthening financial stability. In particular, banking supervision will focus on emerging credit risk and monitoring of banks with higher exposure to sectors more sensitive to interest rate increases, notably personal loans and real estate. The CBK will closely monitor provisioning practices in small banks and adopt timely corrective action measures if these banks face difficulties. In addition, we remain committed to allow market forces to determine interest rates so as to further strengthen our recent progress in financial inclusion and expanded credit access. We are convinced that reducing inflation expectations, promoting competition within the financial sector and improving information sharing of credit risk will help lower commercial lending rates.

15. We will make further progress in deepening our financial sector to transform it into a regional hub for financial services. The demutualization of the Stock Exchange, for which we will soon publish the regulations in the Kenya Gazette, 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. In order to promote better conditions for trade and price discovery in the cereals market we will further our efforts to establish a Commodities Exchange, once a warehousing infrastructure has been established.

16. We have initiated work on amending our Central Bank Act in line with requirements under the Constitution and plan to submit revisions to the law to the National Assembly. We will intensify our efforts to combat money laundering and terrorism finance in line with the action plan agreed with the Financial Action Task Force. Following the appointment of the Anti-Money Laundering (AML) Board in September 2011, we plan to make the Financial Reporting Centre operational and to revise the AML/CFT Guidelines for financial institutions registered with the Central Bank to reflect the requirements of our AML Act.

III. PROGRAM ISSUES

17. Safeguards assessment. The September 2011 Safeguard Assessment has been updated as required in cases of augmentation under the ECF arrangement. We are in the process of implementing the recommendations of the assessment.

18. Program monitoring. Our program will be monitored using the definitions, data sources, and frequency of monitoring set out in the accompanying revised TMU. The government will make available to Fund staff all data appropriately reconciled and on a timely basis, as specified in the TMU. Table 1 shows the quantitative performance criteria to be used in monitoring performance in the remainder of 2011/12 and in 2012/13. Structural benchmarks, with corresponding dates, are identified in Table 2. Fiscal performance criteria will cover the budgetary central government, but we are prepared to expand coverage to include the budget of national government and county governments as early as possible with fiscal decentralization. The fourth review under the ECF arrangement, assessing end-June 2012 performance criteria is expected to be completed by October 15, 2012, the fifth review will be completed by April 15, 2013, based on end-December 2012 performance criteria, and the sixth review will be completed by October 15, 2013, based on end-June 2013 performance criteria.

19. Given our strong record on program implementation, we request completion of the third review of the ECF-supported program approved on January 31, 2011 and augmented on December 9, 2011, and the associated disbursement of SDR 71.921 million. We reiterate that our program is on

track with regard to all quantitative performance criteria and the indicative target for end-December 2011. The structural benchmarks were also met. We request modification of the performance criteria for end-June and end-December 2012, and establishment of end-June 2013 performance criteria for net international reserves and net domestic assets, as well as for the primary budget of the central government to reflect changes in underlying economic circumstances and outlook.

20. We will maintain a close policy dialogue with the Fund and stand ready to take additional measures, as appropriate to ensure the achievement of the government's economic and social objectives under the ECF-supported program.

21. The government believes that the policies set forth herein are adequate to achieve the objectives of its program, but it will take any further measures that may become appropriate for this purpose. Kenya will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained herein, in accordance with the Fund's policies on such consultation.

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

Sincerely yours,

/s/

Robinson N. Githae
Minister for Finance

/s/

Njuguna Ndung'u
Governor
Central Bank of Kenya

Attachment: Updated Technical Memorandum of Understanding

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

(In billions of Kenyan shillings; unless otherwise indicated)

	2011		me/ not met	2012								2013	
	Performance Criteria	Actual		Indicative Targets		Performance Criteria		Indicative Targets		Performance Criteria		Indicative Targets	Performance Criteria
				End-March		End-June		End-Sept		End-Dec.		End-March	End-June
	Dec.	Dec.		Second Review	Third Review	Second Review	Third Review	Second Review	Third Review	Second Review	Third Review	New Target	New Target
Quantitative performance criteria													
Fiscal targets													
Primary budget balance of the central government (=-deficit, floor) ^{1,2}	-10.0	-9.8	met	-32.0	-32.0	0.0	-10.0	5.0	0.0	15.0	0.0	-5	0
Monetary targets ^{3,4,6}													
Stock of central bank net international reserves (floor, in millions of US\$) ⁵	3,125	3,294	met	3,125	3,520	3,170	4,070	3,200	4,115	3,325	4,160	4210	4260
Stock of net domestic assets of the central bank (ceiling)	-40.0	-52.8	met	-40	-30	-35	-55	-55	-45	-25	-25	-40	-40
Public debt targets													
Contracting or guaranteeing of medium- and long-term nonconcessional by the central government (ceiling; millions of US\$) ^{7,8}	700	84.6	met	700	700	700	1300	700	1,500	700	1,500	1,500	1,500
New central government and central government guaranteed external payment arrears (ceiling, millions of US\$) ⁹	0.00	0.00	met	0	0	0	0	0	0	0	0	0	0
Indicative targets													
Priority Social Expenditures of the central government (floor) ²	13.5	14.0	met	22.5	22.5	26.1	26.1	12.1	12.1	15.0	15.0	21.2	28.3

¹ The primary budget balance of the central government is defined as overall balance including grants, minus concessional project loans, plus interest payments.

² Targets for end-September 2012 and end-December 2012, March 2013 and end-June 2013 are cumulative flow from July 1, 2012 (beginning of the 2012/13 fiscal year).

³ For program monitoring, the daily average for the month when testing dates are due.

⁴ 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.

⁵ Excludes encumbered reserves.

⁶ First review targets at September 1, 2010 exchange rates. Second review targets at April 29, 2011 exchange rate. Third review targets at February 29, 2012 exchange rates.

⁷ Cumulative flow of contracted debt, from January 1, 2011.

⁸ The targets on the ceiling of non-concessional external debt combine nonconcessional project loans, syndicated loan and sovereign bond.

⁹ Continuous.

Appendix Table 2. Kenya: Structural Benchmarks for the ECF Arrangement

Item	Measure	Time Frame	Status
	<p>Tax measures</p> <p>Submit Value Added Tax (VAT) legislation to help improve administration and compliance.</p> <p><i>Macro criticality: The VAT reform will allow for higher mobilization of revenue which will reduce the fiscal imbalance.</i></p>	Second Review	Approved in Cabinet. Expected to be sent to the National Assembly after recess.
	<p>Expenditure control</p> <p>Submit Public Finance Management legislation to the Commission of Implementation of the Constitution, to help accelerate reforms in public financial management.</p> <p><i>Macro criticality: PFM management legislation is crucial for increasing both spending efficiency and improving the fiscal management.</i></p>	Third Review	Completed
	<p>Adopt a Single Treasury Account to strengthen cash management and improve resource management.</p> <p><i>Macro criticality: Single Treasury Account (STA) adoption will improve both liquidity management and expenditure control.</i></p>	Fourth Review	In Progress
	<p>Banking supervision</p> <p>Amend the Banking Act to reinforce prompt corrective action by the banking supervision authority.</p> <p><i>Macro criticality: Reinforcing the banking supervision authority is crucial to reducing the risk of macroeconomic instability.</i></p>	First Review	Completed on December 24, 2010 (2010 Finance Act)
	<p>Capital markets</p> <p>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.</p> <p><i>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.</i></p>	First Review	Completed in January 2011 (guidelines were introduced as Attorney General ruled that a new Law was not needed)

Attachment. Updated Technical Memorandum of Understanding

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

I. QUANTITATIVE PERFORMANCE CRITERIA AND BENCHMARKS

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

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

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

- priority social spending of the 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 and June 30, 2013 test date, the central government primary balance including grants excluding external concessional loans will be measured cumulative from July 1, 2012.

The above items are defined as follows:

- **Net domestic financing** of the central government is defined as the sum of:
 - net domestic bank financing;
 - net domestic nonbank financing;
 - change in the stock of domestic arrears of the central government; and
 - proceeds from privatization.
- **Net external financing excluding external concessional project loans** is defined as the sum of:
 - disbursements of **external nonconcessional project loans**, including securitization;
 - disbursements of **budget support loans**;
 - principal repayments on all **external loans**;
 - net proceeds from issuance of external debt;
 - any exceptional financing (including rescheduled principal and interest);
 - net changes in the stock of short-term external debt; and
 - any change in external arrears including interest payments.
- **External concessional project loans** of the central government are defined as **external project loans** contracted by the central government, which are considered concessional according to

the definition in paragraph 11. All other **external project loans** are deemed **nonconcessional external project loans**.

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

III. PERFORMANCE CRITERION ON THE NET INTERNATIONAL RESERVES (NIR) 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 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 specified in Table 1, plus medium- and long-term liabilities (i.e., liabilities with a maturity of one year or more) of the CBK, including those arising from the August 28, 2009

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

SDR General allocation and the September 9, 2009 SDR Special allocation; minus the value in shillings of encumbered reserves converted at the accounting exchange rate specified in Table 1.

- NDA is composed of:
 - net CBK credit to the central government;
 - outstanding net credit to domestic banks by the CBK (including overdrafts); and
 - other items net.
 - Reserve money is defined as the sum of:
 - currency in circulation; and
 - 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) encompasses commercial loans, including the proceeds of syndicated loans and eventual proceeds from the issuance of a sovereign bond, and non-concessional project financing.

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

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.

TMU Table 1. Kenya: Program Exchange Rates

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

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

TMU Table 2. Kenya: Summary of Data to Be Reported

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

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

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



Press Release No. 12/139
FOR IMMEDIATE RELEASE
April 17, 2012

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Third Review Under the Extended Credit Facility for Kenya and Approved US\$ 110.9 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) has completed the third review under a three-year arrangement under the Extended Credit Facility (ECF) for Kenya.¹ The completion of the review enables the disbursement of SDR 71.921 million (about US\$ 110.9 million), which will bring the total disbursement under the arrangement to SDR 272.757 million (about US\$420.7 million). The Executive Board's decision was taken on a lapse of time basis.²

Kenya's economic reform program has started to yield results, as the authorities have taken decisive measures to address inflationary and external balance pressures. As a result, inflation is abating, the shilling has strengthened, international reserves are on the rise, the debt-to-GDP ratio is declining, and the government securities market is functioning more smoothly. More importantly, economic growth has held up in 2011, decelerating only slightly from 2010, despite the severe drought in the Horn of Africa and the higher food and fuel prices.

Performance under the program was favorable through end-2011. The fiscal outcome was in line with the program, thanks to strict expenditure control. International reserves exceeded the target,

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

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

monetary policy remained appropriately tight, and government spending to protect the poor was above the program threshold. The authorities also made good progress with their structural reform efforts in the areas of public financial management and tax reform. Pension reform and the reform of the pay for civil servants have recently advanced.

Looking forward, stronger growth is expected in 2012 as the effects of the external shocks abate. Monetary policy will aim to achieve low and stable inflation, and the Central Bank of Kenya (CBK) will continue accumulating foreign reserves in order to build a buffer to cope with future external shocks. Fiscal consolidation will continue and non-priority outlays will be limited to create space for infrastructure spending and for implementing fiscal decentralization as envisaged by the new Constitution. The new VAT law will help revenue mobilization. Policies for the financial sector will focus on banking supervision, close monitoring of credit risk, and moving forward with opening up the stock exchange.

The uncertain global environment outlook—in particular the European sovereign-debt crisis and the risk for further increases in oil prices—could affect Kenya by dampening growth and widening the deficit of the external current account. Thus, policies should continue to aim at ensuring that domestic demand grows in line with supply to reduce the external imbalance and keep inflationary pressures in check.

The three-year SDR 325.68 million (about US\$ 502.4 million) ECF arrangement with Kenya was approved by the IMF's Executive Board on January 31, 2011 (see [Press Release No. 11/22](#)). The Executive Board subsequently approved augmentation of financing under the ECF arrangement to SDR 488.52 million (about US\$ 753.6 million) on December 9, 2011 (see [Press Release No. 11/457](#)).