ACRONYMS

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

Executive Summary

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

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

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

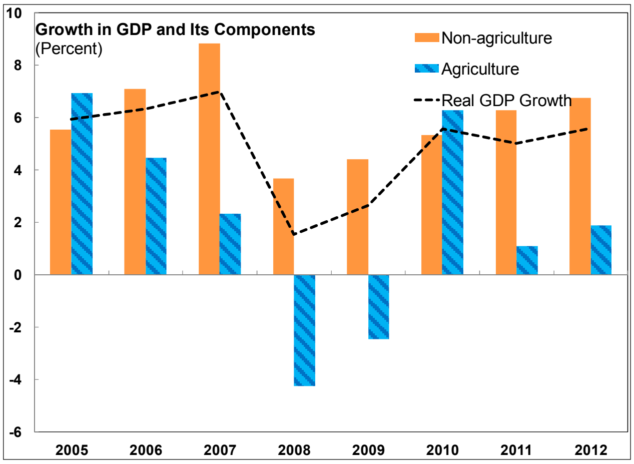
Fundamental reforms under the program are under way. The Public Finance Management (PFM) Law is ready for submission to the Commission on the Implementation of the Constitution. The new VAT law will contribute significantly to increasing revenue mobilization and minimize administrative costs. Financial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

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

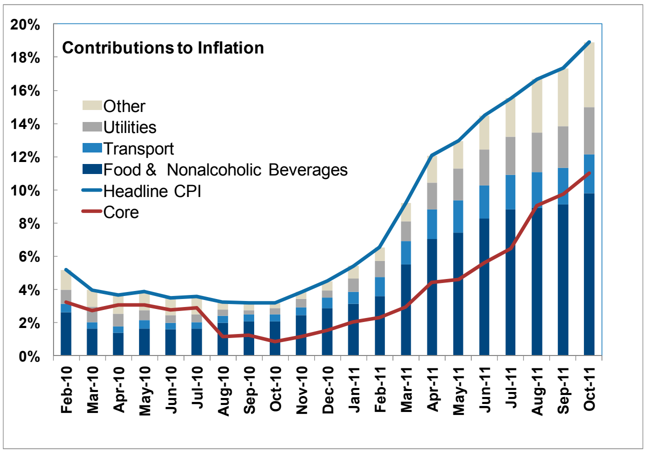
I. Macroeconomic Developments and Program Implementation

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

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



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

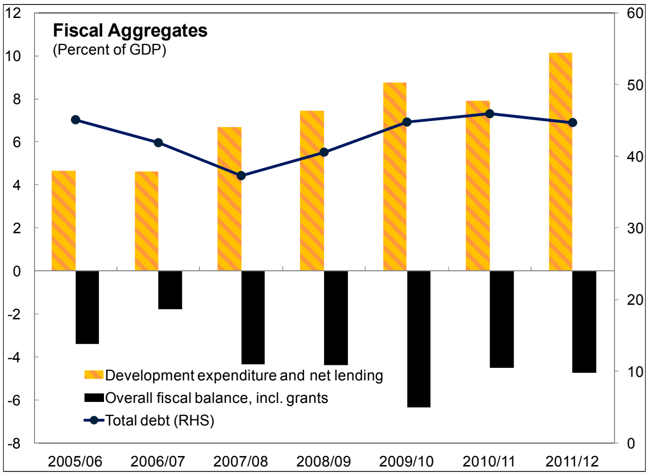


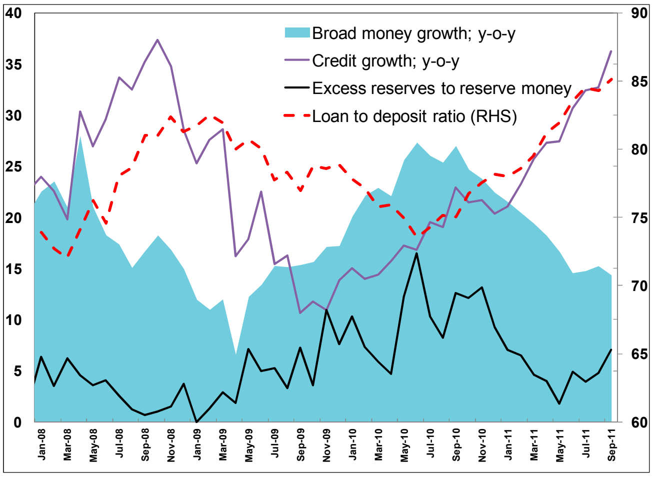
[1] Core inflation is defined as inflation excluding food and energy from the consumer basket.

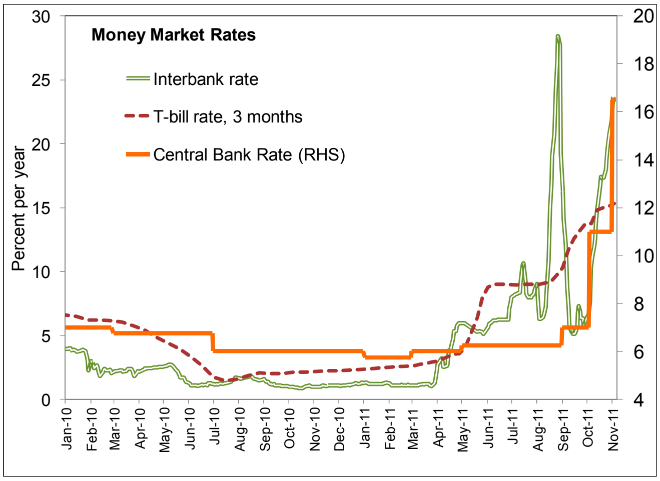
- **Fiscal policy has moved toward consolidation.** The primary deficit declined from 3.8 percent of GDP in FY 2009/10 to 1.5 percent of GDP in FY 2010/11 because of delays in domestically-financed investment, restraint in current spending, and strong tax revenue performance. The FY 2010/11 primary balance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

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

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

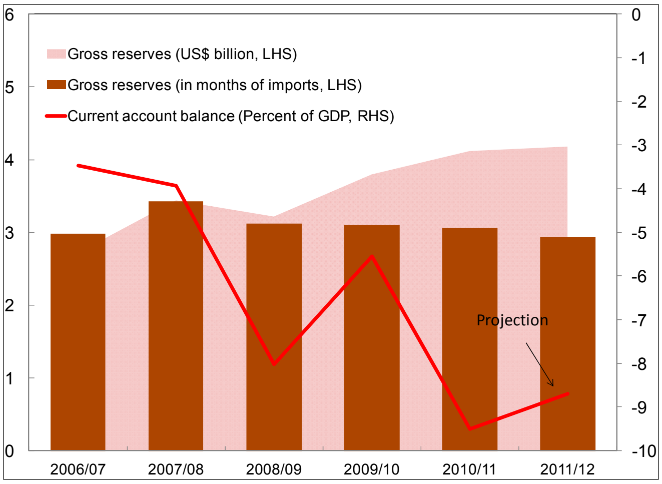




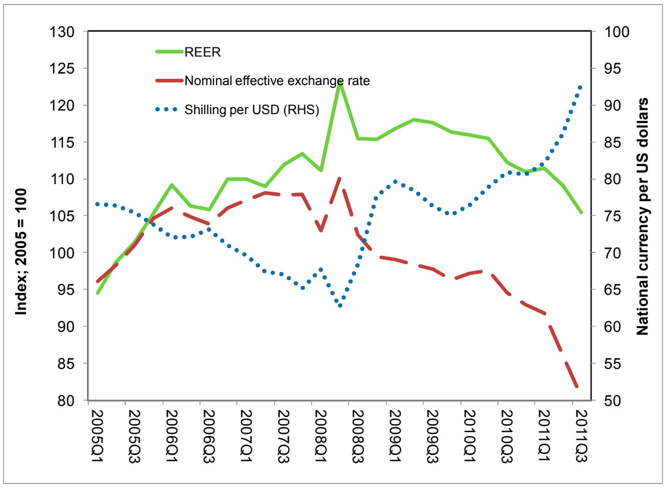


[2] September 2011 NDA stood at negative Ksh 26 billion compared to the ceiling target of negative Ksh 45 billion. September 2011 NIR stood at USD 3,436 million, compared to the floor target of USD 3,600 million. The fiscal indicative targets for September 2011 were all met.

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



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



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

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

II. THE ISSUES

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

A. Heightened External Vulnerabilities

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

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

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

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

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

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

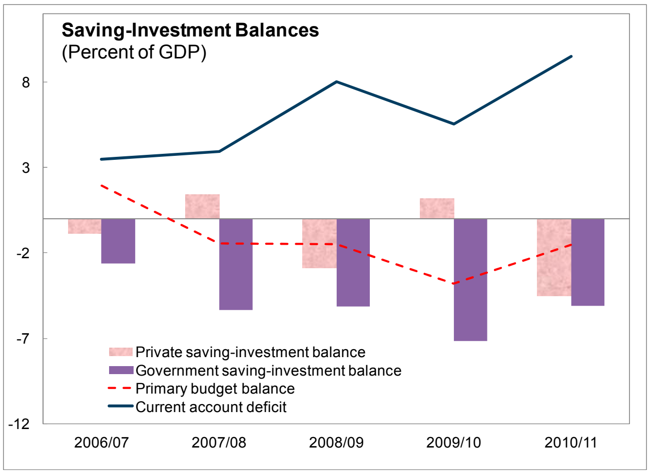
Indicators of the Estimated Near-Term Impact of the Drought

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

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

B. Monetary Policy and Macro-financial Imbalances

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



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

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

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

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

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

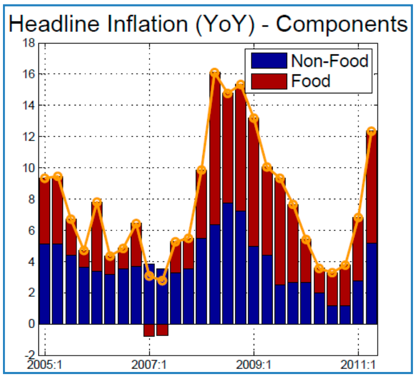
8. **The authorities emphasized that rapid private sector credit growth has been driven by demands reflecting a welcome dynamism in economic activity, but they agreed that easy monetary conditions have more recently played a key role** (Box 3). Demand for investment financing and working capital has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

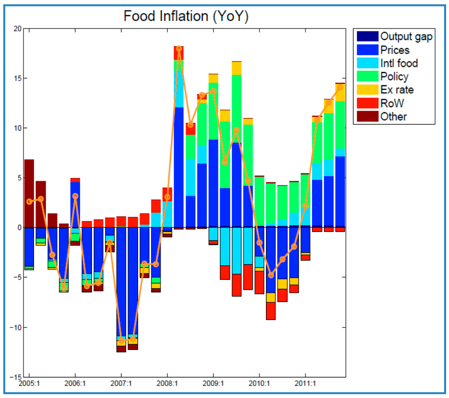
9. **The acceleration of credit growth has heightened credit and liquidity risk**. Half of total bank loans are concentrated in personal, real estate and trade loans, sectors more sensitive to a possible deterioration of the quality of the loan portfolio arising from high interest rates or a slowdown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

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

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

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

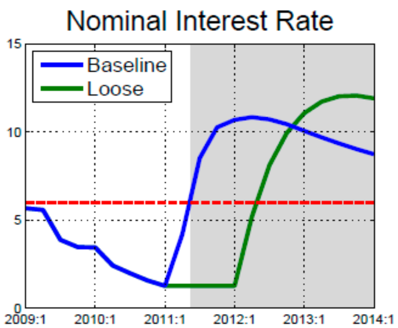


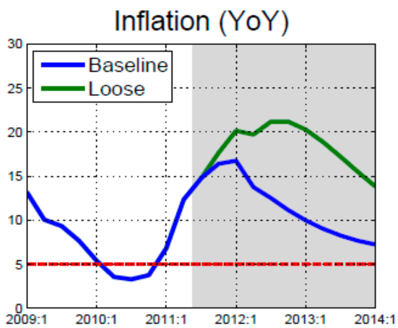


We apply the model to decompose historical data into trends and shocks. The main findings are as follows:[2/]

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

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



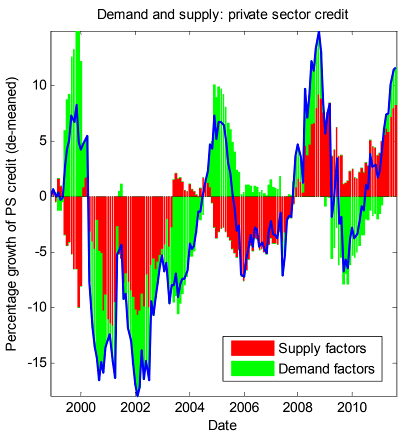


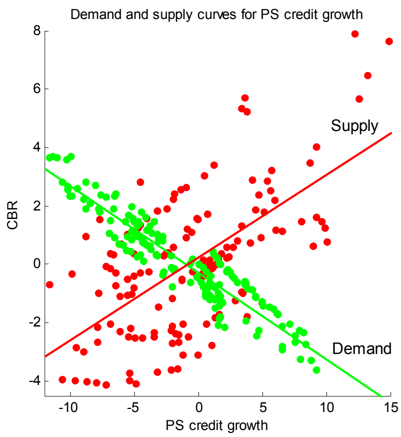
[1/] The model is work in progress by IMF staff from the African Department (AFR) and the Research Department (RES), with the collaboration of OG Research.

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

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

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





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

III. Policy Adjustment and the ECF-supported Economic Program

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

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

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

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

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

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

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

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

A. Reining in Inflation

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

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

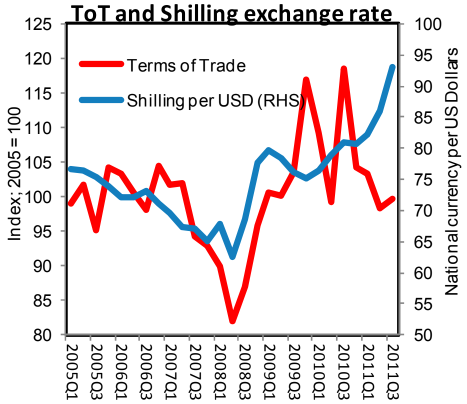
13. **Looking forward, monetary policy would seek to ease inflationary expectations and bring down inflation to the upper bound of the inflation target by end-2012.** Credit growth is expected to decelerate to 20 percent by June 2012. The government intends to borrow from the CBK only on a temporary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

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

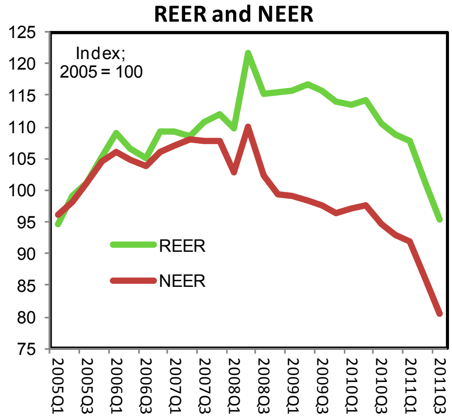
15. **The government indicated its commitment to maintaining free prices and avoiding price controls.** Parliament has approved a law giving the ministry of finance the power to declare some goods essential and cap their prices, but the government indicated that it will refrain from using these powers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

Figure 1. Kenya: External Stability and Sustainability Analysis

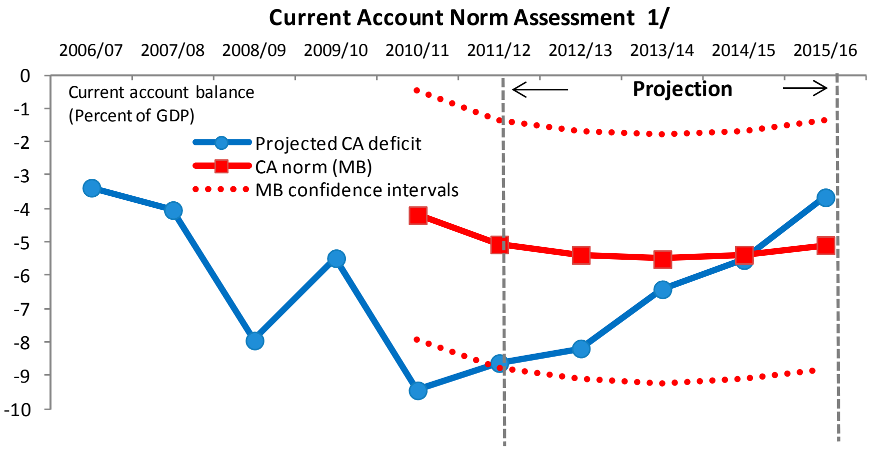
Terms of trade deterioration has placed renewed pressures on the Kenyan shilling exchange rate...



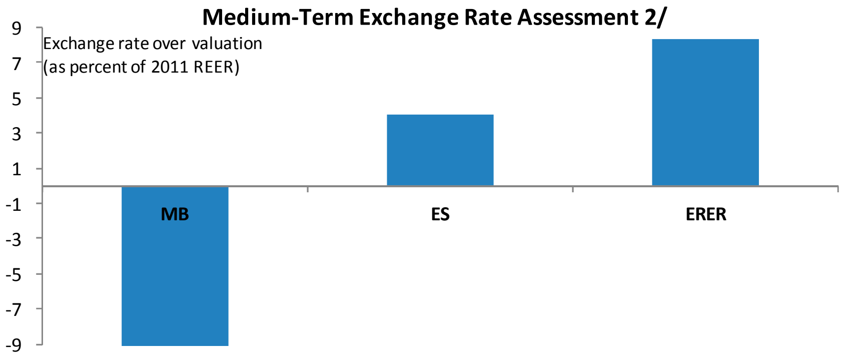
...while the NEER and REER have depreciated consistent with the deterioration of the external current account.



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



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



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

B. Consolidating the Fiscal Position

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

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

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

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

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

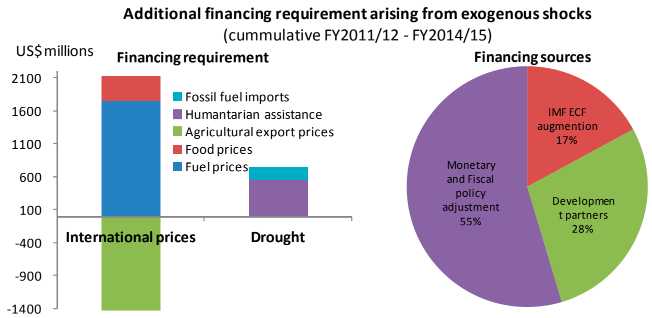
21. **The authorities emphasized that their commitment to sound expenditure management would ensure an orderly transition towards fiscal decentralization.** The proposed new PFM law defines the extent and the modalities of the decentralization process that

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

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

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

C. Mitigating External Shocks



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

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

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

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

D. Monitoring Financial Risks and Deepening Financial Reform

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

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

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

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

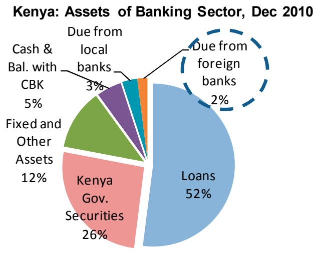
28. **The National Social Security Fund** (NSSF) **is undertaking significant reform.** A new framework for social security policy will redefine pension schemes, including by transforming the NSSF from a provident fund into a social insurance pension scheme. A new management has radically improved the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

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

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

Box 4. Cross Border Linkages in the Kenyan Banking Sector

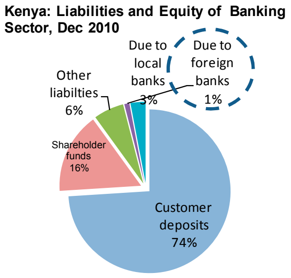
- Cross border linkages have become a prominent feature of the Kenyan banking sector. Foreign and regional banks hold 40 percent of the banking sector's assets. In recent years, six locally-owned Kenyan banks, some of systemic importance, have expanded into neighboring East African Community (EAC) countries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



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

- However some risks may emerge:

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



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

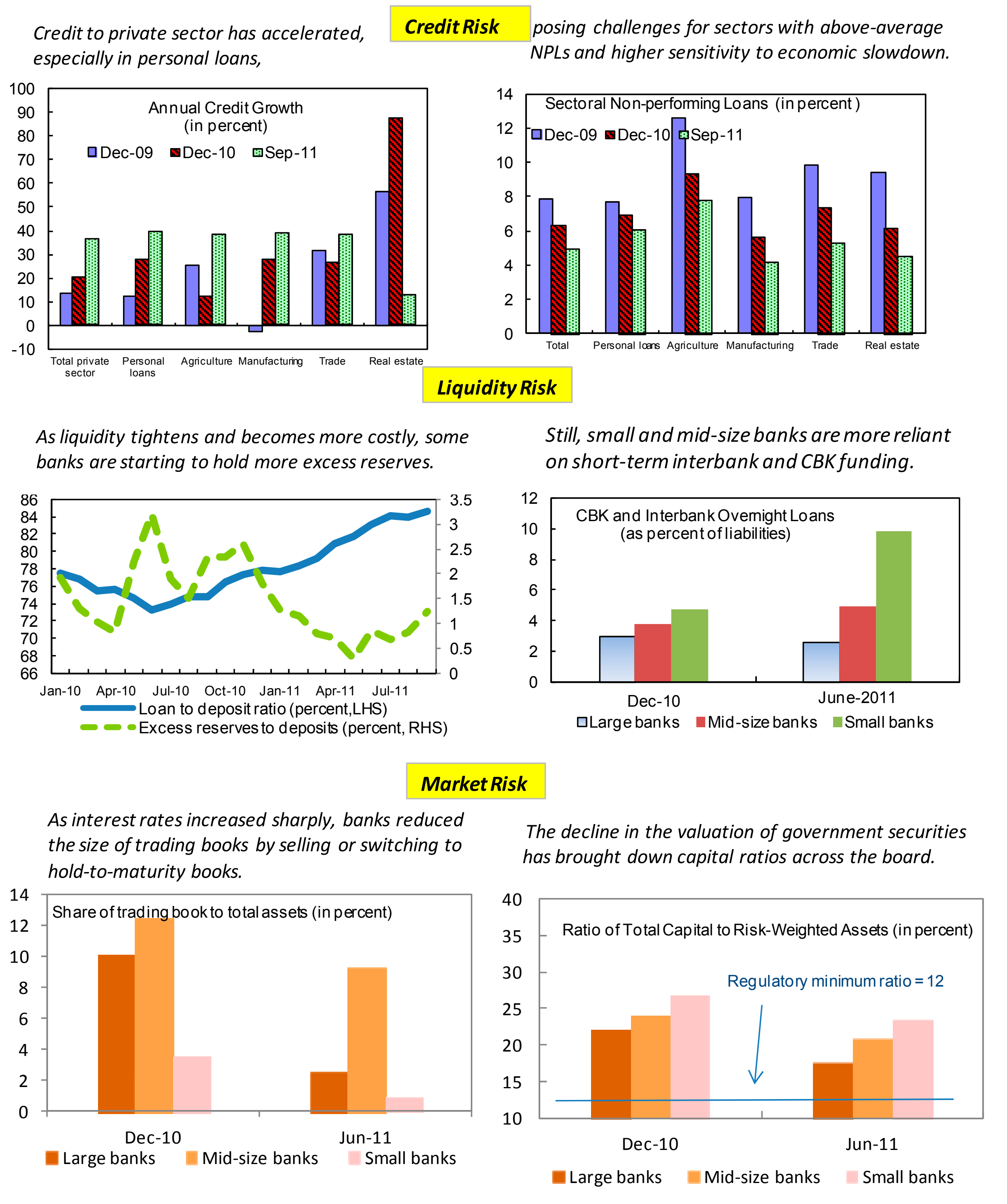
- The authorities are involved in several joint initiatives with supervisors from other EAC countries and several other countries in the region to enhance joint supervision. The key supervisory priorities are: (i) mapping relationships among local groups including banks, (ii) requiring disclosure and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

Topography of the Kenyan Banking Sector

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

Source: June 2011 balance sheets and staff calculations.

Figure 2. Kenya: Financial Risks, 2011



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

IV. Program Issues

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

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

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

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

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

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

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

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

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

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

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

V. Staff Appraisal

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Sources: Kenyan authoritie and IMF staff estimates and projections.

1/ Fiscal year is from July 1st through June 30th.
2/ The consumer price index series was revised in November 2009 based on a new methodology.
3/ Actual as of September 30, 2011.
4/ Revenue plus program grants minus recurrent expenditure.

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

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

Sources: Kenyan authorities and IMF staff estimates and projections.

1/ Fiscal year runs from July to June.

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

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

4/ Includes planned sovereign bonds.

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

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

Sources: Kenyan authorities and IMF staff estimates and projections.

1/ Fiscal year runs from July to June.

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

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

4/ Includes planned sovereign bonds.

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

(In billions of Kenyan shillings, unless otherwise indicated)

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

Source: Kenyan authorities and IMF staff estimates and projections

1/ For historical data, at implicit CBK exchange rate

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

(In millions of US dollars, unless otherwise indicated)

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

Sources: Kenyan authorities and IMF staff estimates and projections.

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

2/ Historical figures include errors and omissions.

3/ Base year: 2000.

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

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

Source: Central Bank of Kenya.

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

(In billions of Kenyan shillings; unless otherwise indicated)

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

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

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

		Original ECF disbursement		Proposed ECF augmentation		Total disbursement	
Date of Availability	Conditions for Fund 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 15, 2012	Observance of the end-December 2011 performance criteria and structural benchmarks, and completion of third review	43.424	16.00	28.497	10.50	71.921	26.50
October 15, 2012	Observance of the end-June 2012 performance criteria and structural benchmarks, and completion of fourth review	43.424	16.00	28.497	10.50	71.921	26.50
April 15, 2013	Observance of the end-December 2012 performance criteria and structural benchmarks, and completion of fifth review	43.424	16.00	28.497	10.50	71.921	26.50
October 15, 2013	Observance of the end-June 2013 performance criteria and structural benchmark, and completion of the sixth review	43.424	16.00	28.497	10.50	71.921	26.50
Total		**325.680**	**120.00**	**162.840**	**60.00**	**488.520**	**180.00**

1/ Kenya's quota is SDR 271.4 million.

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

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

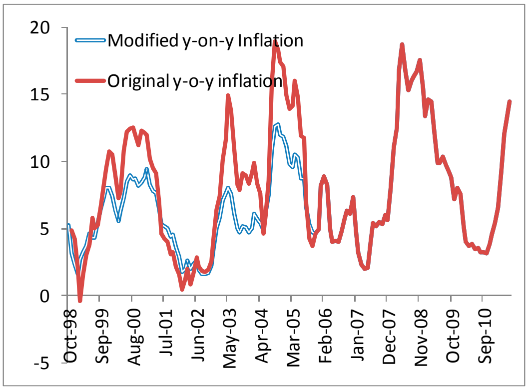
Sources: Fund staff estimates and projections.

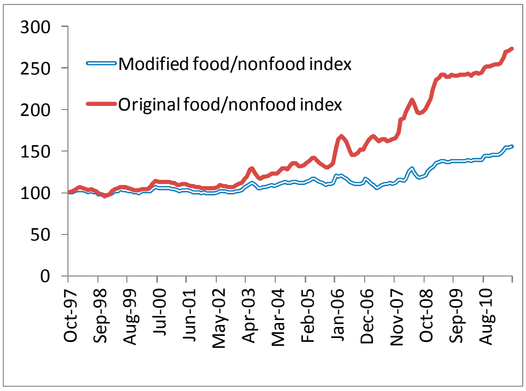
1/ Assumes access of 180 percent of quota during 2011–13 w ith 30 percent of the proposed augmentation of 60 percent of quota to be disbursed in December 2011, w hile the remaining 4 disbursements w ill be phased in equally. Outstanding credit at Sept-2011 stands at SDR 377 million, equivalent to 135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

2/ Total debt service includes repayments to the IMF.

APPENDIX I. Constructing a Consistent CPI Time Series for Kenya

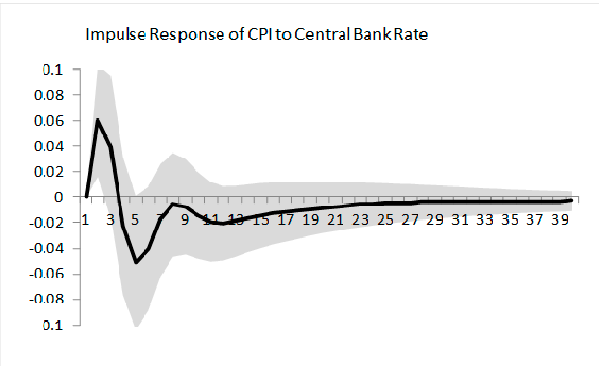
We calculate a modified CPI time series to address inconsistencies in the historical CPI as a result of several changes in the CPI basket and calculation methodology. The new CPI methodology and basket, which came to use in February 2009, has been applied by KNBS to recalculate the CPI index going back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

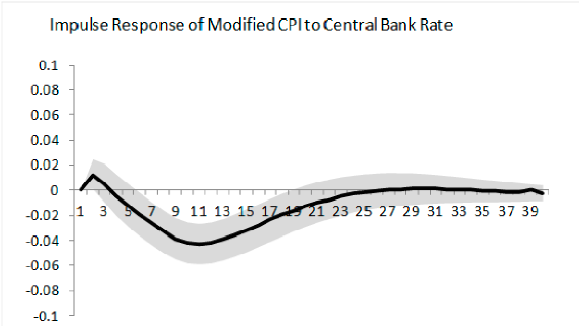




To provide a roughly consistent CPI time series, we apply simple regressions to measure the upward bias for different ranges of food inflation, in periods where CPI data using old and new methodologies were available. By comparing the two overlapped series, we are able to calculate a modified food CPI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

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





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

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

APPENDIX II. LETTER OF INTENT

Nairobi, Kenya
November 18, 2011

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

Dear Ms. Lagarde:

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

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

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

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

policies contained in this Letter of Intent and its attachments, in accordance with the Fund's policies on such consultation.

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

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

Sincerely yours,

/s/

Uhuru M. Kenyatta
Deputy Prime Minister and
Minister for Finance

/s/

Njuguna Ndung'u
Governor
Central Bank of Kenya

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

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

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

I. Background

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

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

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

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

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

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

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

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

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

II. The Economic Program for 2011/12

A. Monetary Policy

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

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

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

B. Fiscal Policy

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

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

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

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

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

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

C. Financial Sector Policy

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

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

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

III. Program Issues

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

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

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

(In billions of Kenyan shillings; unless otherwise indicated)

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

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

Table 2. Kenya: Structural Benchmarks for the ECF Arrangement

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

Attachment II. Updated Technical Memorandum of Understanding

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

I. Quantitative Performance Criteria and Benchmarks

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

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

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

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

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

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

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

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

The above items are defined as follows:

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

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

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

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

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

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

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

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

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

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

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

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

- **Gross official international reserves** exclude:

  - ➢ the reserve position in the IMF;
  - ➢ pledged, swapped, or any encumbered reserve assets, including but not limited to reserve assets used as collateral or guarantees for third-party external liabilities;
  - ➢ deposits with Crown agents; and
  - ➢ precious metals other than gold, assets in nonconvertible currencies and illiquid foreign assets.

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

  - ➢ the total outstanding liabilities of the CBK to the IMF except those arising from the August 28, 2009 SDR general allocation and the September 9, 2009 SDR special allocation;
  - ➢ convertible currency liabilities of the CBK to nonresidents with an original maturity of up to and including one year;
  - ➢ commitments to sell foreign exchange arising from derivatives (such as futures, forwards, swaps, and options).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

VII. Indicative Target on Priority Social Spending

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

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

VIII. Coverage

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

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

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