International Monetary Fund

Kenya and the IMF

Press Release:
IMF Executive Board Approves Three-Year, US$508.7 Million Arrangement Under Extended Credit Facility for Kenya
January 31, 2011

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Kenya: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

January 17, 2011

The following item is a Letter of Intent of the government of Kenya, which describes the policies that Kenya intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Kenya, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

Letter of Intent

January 17, 2011

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
700 19th Street NW
Washington, DC 20431 USA

Dear Mr. Strauss-Kahn:

Following shocks associated with the post-election violence of 2008, consecutive droughts, and the impact of the global economic downturn in 2009, Kenya's economy is recovering steadily. Economic prospects have been boosted by the promulgation of our new constitution on August 27, which will both help to address the long-standing social and political problems that have held back our growth potential and stimulate renewed interest from foreign investors.

For 2010 and beyond, the main goal of our policies is to bring Kenya back to the growth trajectory set in the medium-term plan of Vision 2030. Key priorities include investing in infrastructure and the energy sector to deal with the challenges of climate change, spending on implementation of the new constitution, and ensuring adequate allocations to the social sectors. At the same time, we intend to strike a balance between devoting resources for these priorities and gradual fiscal adjustment to ensure long-term debt sustainability. Monetary policy will aim at meeting the medium-term inflation target, maintaining the floating exchange rate regime, and gradually building up foreign exchange reserves to meet our import coverage targets. Structural reforms for the near and medium-term will focus on strengthening the public financial management framework, modernizing and simplifying the tax system, increasing access to financial services while ensuring adequate supervision, and enhancing the business environment.

The main features of the government's economic reform program are described in the attached Memorandum of Economic and Financial Policies (MEFP), which lays out the economic objectives and policies of the Government of Kenya for the 2010/11–2013/14 period. These objectives and policies are consistent with the aspirations of Kenya's Vision 2030. Based on our balance of payments needs and the policies described in the MEFP, we request that the Executive Board approve a three-year Fund arrangement under the Extended Credit Facility (ECF) in the amount of SDR 325.68 million in total for the period January 2011–January 2014, and the first disbursement of SDR 65.14 million.

The government believes that the policies set out in this letter are adequate to achieve the objectives of its program, but it will take any further measures that may become appropriate for this purpose. The government will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultations. The Government of Kenya will provide such information as the Fund may request in connection with progress in implementing its economic and financial policies.

We have no objection to publication of the staff report for the request of the ECF arrangement, this letter of intent, and the attached memorandum of economic and financial policies and technical memorandum of understanding.

Sincerely yours,

/s/

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

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

Attachment 1. Memorandum of Economic and Financial Policies for 2011–13 under the Three-Year Program of the Extended Credit Facility Arrangement

I. Background

1. **Kenya stands at a critical juncture in its post-independence history.** The new constitution approved in August 2010 has raised expectations in the country that a permanent solution to long-standing social and political challenges may be achievable. The new legal framework envisaged in the constitution will allow for strong institutions to provide checks and balances on the government, judiciary reform, the devolution of resources to the regions, land-ownership reform, and improvements in the public expenditure framework. The successful implementation of the new constitution will enhance the chances of achieving Kenya's Vision 2030 aspirations of substantial improvements in the economic, social and political fronts.

2. **The economic gains achieved since 2003 were disrupted in 2008/09, but recovery is underway.** Our economy staged a strong recovery during 2003–07, in response to bold economic and structural reforms. Real GDP growth reached 7 percent by 2007 before suffering major setbacks as a result of the post-election violence in early 2008, a severe drought, high international commodity prices, and spillover effects of the global financial crisis. These shocks threatened to reverse the gains we had achieved in terms of expanding employment opportunities for our people and fighting poverty. A concerted effort by the government, including easing of macroeconomic policies, has begun to bear fruit with recovery now underway. However, our per capita GDP has not increased sufficiently to make a dent on poverty and reduce unemployment, and long-standing energy and infrastructure gaps remain. Despite improved macroeconomic policy management, strong growth needs bolder measures to address governance-related weaknesses, deep-seated political differences and an unfavorable business environment.

3. **The government is committed to achieve a higher and sustainable growth of the economy in a more equitable environment, with increased employment opportunities.** Our first Medium-Term Plan (MTP) of Vision 2030 (Poverty Reduction Strategy Paper—PRSP) aims at raising real GDP growth to 10 percent. Achieving this growth will enable us to direct more resources to pro-poor sectors including education and health to achieve social development and reduce poverty. With agriculture the mainstay of the economy, we plan to improve productivity in agriculture by reducing the cost of farm inputs, improving farm prices, expanding irrigation to new areas, increasing water access, and preserving the environment. Public investment in construction and upgrading of the road, railroad network, ports, and information and communication technology will be complemented by private sector investment under the Public Private Partnership (PPP) framework. In addition, to meet the power needs for the expanding economy, the National Electricity Supply Master Plan will identify new generation and supply sources with the goal of tripling the national electricity

supply of dependable energy to 3,000 megawatts by 2018, with emphasis on the development of alternative power sources, especially geothermal power.

II. Recent Economic Developments

4. **Recent data indicate that Kenya's economy is bouncing back from the major shocks in 2008/2009.** Real GDP growth reached 5 percent in the first half of 2010 reflecting in part the lagged effects of last year's fiscal and monetary stimulus, as well as favorable weather conditions that supported a rebound in agriculture growth. The government's renewed efforts to upgrade infrastructure together with lower interest rates supported a strong expansion in construction activity. By June 2010, credit growth had picked up, with an increasing share going to personal loans helped by rapid modernization of financial services that has seen increased financial inclusion. Inflation has remained well below the 5 percent target, helped by ample food supply and low telecommunication rates driven down by intense competition in a vibrant mobile telephony market.

5. **Low reserves and increasing public debt entail vulnerabilities.** Despite Fund support under the ESF and the 2009 SDR allocation, international reserves have remained below target as capital inflows remain subdued relative to other developing economies. Increased tea exports, tourism receipts and remittances helped improve the external current account, but the risk of adverse exogenous shocks remains high. Notwithstanding strong public investment that will support future growth, public debt in net present value (NPV) terms now lies at the 40 percent debt-to-GDP (or over 45 percent of GDP in nominal terms) ceiling set in our medium-term debt-management framework, which is consistent with the debt sustainability threshold for a country like Kenya—a medium performer according to the World Bank 's Country Policy and Institutional Assessment (CPIA) Index. Our debt strategy aims at maintaining a sustainable level of debt, diversifying sources of financing with emphasis on concessional external financing and shifting the composition of domestic debt towards long term maturities to minimize both cost and risk. However, pressing needs for large investment in infrastructure—especially in the energy sector—and the cost of implementing the constitution, will keep the fiscal deficit at around 7½ percent of GDP for a second consecutive year in 2010/11. While recognizing these increased demands, we will ensure that our public debt including contingent liabilities remains within sustainable path over the medium term.

III. Program Objectives and Macroeconomic Policies

6. **The 2011–13 Economic Program under the three-year ECF will help to protect Kenya's external position, while preserving stability and supporting the conditions for sustainable growth**. The program will aim at addressing balance-of-payments financing needs arising from the impact on domestic demand of the government's investment plan, especially into geothermal energy; providing a reserve cushion to help address adverse

external shocks; and maintaining macroeconomic stability in the implementation of the decentralization process envisaged in the new constitution.

7. **Our policies outlined in the 2010 Medium-Term Budget Strategy Paper and updated in the 2011 Budget Outlook Paper aim at consolidating the economic recovery and put our economy back onto a high and sustainable growth path.** Over the program period, we expect real GDP growth to rise close to 7 percent, with an increased reliance on domestic private savings and investment consistent with a decline in the external current account deficit to about 5 percent of GDP. To this end, we will up-scale investment in the key priority social and economic sectors as well as in critical physical infrastructure such as roads, rail, power generation, and ports. This will be complemented by deepening structural reforms in the area of governance, public financial management; public services, business regulation, and the financial sector, with support from the World Bank and other development partners. These efforts will help reduce the cost of doing business and thus enhance Kenya's competitiveness as well as private sector investment and growth.

A. Fiscal Policy

8. ***Policy objective:*** Fiscal policy will continue to support economic activity while allowing for implementation of the new constitution within a context of sustainable public financing. As such, we are committed to gradually reduce the overall fiscal deficit to about 5 percent of GDP over the medium term. This will help to bring down the debt-to-GDP ratio to a sustainable level and contribute to reducing the external imbalance. Fiscal measures will seek a reduction of the primary budget deficit to about 2 percent of GDP in 2012/13 ***(performance criterion)*** from 3.8 percent projected for 2010/11. The government will maintain the fiscal revenue-to-GDP ratio at around 25 percent and keep budgetary expenditures consistent with medium-term priorities while providing sufficient room for implementation of the new constitution.

9. ***Implementation of the new constitution:*** We plan to provide sufficient resources to implement the new constitution to meet the timeline provided in the transitional arrangement. Constitution-related expenditures include drafting of new laws; review of existing legislation to conform with the provisions of the new constitution; stakeholder participation and civic education; winding up and setting up new offices; capacity building for counties; construction and/or rehabilitation of county assemblies, National Assembly and Senate; and, establishment of the new judicial system. While final costing is not yet completed at this stage, we have set aside Ksh 4 billion in this current fiscal year and Ksh 9.5 billion for the next year for this purpose. As detailed costing of these expenditures will become clear in the course of the program, we plan to update the fiscal targets to ensure smooth implementation of this national objective, in the context of program reviews. Updating of the targets will take into account available support from development partners while ensuring continued public finance sustainability.

10. ***Revenue measures:*** We plan to appoint a Tax Reform Commission (TRC) that will be in charge of simplifying our tax code in line with best practices, in order to help improve tax compliance, minimize delays, and raise revenue. Key measures we plan to implement include rationalizing existing tax incentives, expanding the income tax base and removing tax exemptions as envisaged in the constitution. In addition, we will improve the infrastructure for enhanced collection of property taxes to strengthen the revenue base of the new counties within the devolved system. We have requested technical assistance from the Fund in support of these reform efforts.

11. We will modernize our VAT legislation to help improve administration and compliance ***(structural benchmark).*** VAT reform will include accompanying policies to reinforce its effectiveness, with measures to rationalize VAT expenditures and exemptions as well as measures to improve efficiency of VAT filing, VAT refund processing, and VAT withholding. We will continue to rely on assistance from the World Bank and the Fund in these areas.

12. ***Revenue administration measures:*** We will continue with efforts to increase automation of KRA processes to help combat tax evasion and to support customs reform. This will include more intensive use of cameras and digital video clips to accompany verification reports and making further progress in rolling out the Electronic Cargo Tracking System. To further enhance governance, we will continue our policies to reduce face-to-face interaction with KRA officials and to shift from paper to electronic based applications.

13. ***Expenditure measures:*** We intend to maintain a policy of rationalizing recurrent expenditure including restraining growth in wage payments to free resources towards development expenditure. Over the medium term, we will continue to protect pro-poor wage expenditure in health and education sectors while limiting new recruitment in the public service to sustainable levels. Given the need to implement the new constitution, we will ensure that adequate resources are set aside for this purpose. We will also ensure that development expenditure remains supportive of critical infrastructure that will help reduce the cost of doing business and crowd in private sector investment in areas identified in the Vision 2030's first MTP.

14. Expenditure control will be enhanced with the implementation of a new public finance management (PFM) legislation. In line with constitutional implementation process, a draft PFM Bill will be submitted to the Commission for the Implementation of the Constitution by December 2011 ***(structural benchmark)*** for consideration and submission to parliament. The new PFM legislation will help to accelerate reforms in public financial management under a coordinated strategy to revitalize Public Finance Management Reforms, as well as facilitate adoption of a Single Treasury Account by June 2012 to strengthen cash management system and improve resource management ***(structural benchmark)***. To enhance effectiveness of the Public Procurement Oversight Authority, we will review the procurement legislation and enhance its capacity. In addition, we will implement the Integrated Financial

Management Information System (IFMIS) across government Ministries and Departments. The IFMIS will ensure effective budgetary management at all stages, including budget preparation, treasury management, budgetary control, fiscal reporting and preparation of annual accounts. The IFMIS will be eventually rolled out to the county governments. Meanwhile, we will deepen implementation of Performance Based Budgeting that will help improve control and accountability.

15. ***Poverty and social impact:*** We will continue pursuing the poverty reduction objectives and MDGs. Public investment is still needed to achieve the MDGs, but because fiscal space remains limited, strong donor assistance will be needed to raise and sustain high public investment levels. Nevertheless, we will continue to protect priority social expenditures to ensure progress in achieving social objectives as elaborated in the social pillar of our Vision 2030 MTP ***(indicative target)***. We will also ensure efficient utilization of existing resource allocations to these critical social sectors while we undertake additional measures to boost benefits to mitigate the poverty impact of food insecurity problems to vulnerable members of our society. Over the medium term, we plan to rationalize and expand existing social protection programs, while at the same time ensure adequate spending on education and health.

16. ***Financing policy:*** With gradual fiscal consolidation, we expect the share of domestic financing to decline from 70 percent of financing the current fiscal year to about 60 percent next year. The composition for subsequent years will depend on the timing of the issuance of a sovereign bond. External financing will come mainly from concessional external sources, including about US$2 billion in project loans in the next two fiscal years, mainly from the World Bank (WB) and the African Development Bank (AfDB). The WB is expected to provide budget support of US$100 million through a Development Policy Loan In the absence of concessional financing, the government will maintain nonconcessional financing including guarantees at below US$700 million in the remainder of fiscal year 2010/11 and US$700 million in the year 2011/12 ***(performance criterion).*** The nonconcessional financing including the sovereign bond proceeds will be limited to investment projects that demonstrate revenue streams and of high social returns. While we plan to issue a sovereign bond in 2012/13, we will monitor developments in the international capital markets with a view to issue the bond early to take advantage of the favorable interest rates, market conditions permitting. As before, we will continue with our policy of not incurring external arrears ***(performance criterion)***.

17. ***Contingent liabilities management:*** Following issuance of the government's Public Procurement and Disposal regulations in March 2009, the government is committed to adopt a PPP policy that seeks to address any gaps in the legal and regulatory framework that could impede successful implementation of the PPP agenda, and provide for a clear and mandatory regulatory framework to guide PPP investments. As the government embraces the PPP framework, we will introduce administrative arrangements and processes that help guide the selection and implementation of projects. We will scrutinize PPP projects carefully to

preserve fiscal discipline and safeguard the interest of tax payers. All guarantees provided under the PPP agenda, together with all other contingent liabilities will be integrated into the debt management process.

B. Monetary Policy

18. ***Policy objective:*** The CBK will keep the 5 percent inflation target and maintain a floating exchange rate regime. For that purpose, the CBK will pursue a prudent money supply growth and embark on a gradual accumulation of international reserves that will lift the import coverage to over four months of following year's imports of goods and services by the end of the program period ***(performance criterion)***, consistent with the CBK statutory obligation. Monetary policy will focus on its medium-term inflation target, with net domestic assets as an intermediate target ***(performance criterion).*** To that effect, the CBK will monitor the appropriate monetary aggregates to ensure consistency with market developments to pre-empt any inflationary pressures, and enhance coordination of monetary and fiscal policy to minimize the liquidity impact of government financial transactions as well as respond timely to external shocks.

19. ***Monetary policy framework:*** The government will set up a strategy to move away from monetary targeting towards an appropriate monetary policy framework that will take into account the expected continuation of a reduction of velocity of circulation and the rise in the money multiplier explained by deeper financial intermediation and increased modernization of the financial system. With inflation targeting a viable option, the CBK will continue to refine the required infrastructure for its successful adoption. As a step towards this goal and with a view to strengthening central bank accountability in the conduct of monetary policy, the Minister of Finance will continue to convey to the CBK the inflation objective for the fiscal year after the budget presentation to parliament. The CBK will report on deviations of 2 percent or more from the stated inflation target. In line with the new constitution, the CBK Act will be refined to enhance its operational mandate within an improved framework of transparency and accountability, while preserving its operational autonomy.

C. Financial Policy

20. ***Policy objective:*** We will step up the efforts to strengthen the financial infrastructure to adapt to the new challenges associated with the modernization of the banking system, including cross-border operations and mobile banking. Measures conducive to that goal are the following:

- Upgrade the crisis management frameworks to deal with the challenges of cross-border banking activities, including implementation of consolidated supervision.

- Reinforce prompt corrective action by the banking supervision authority, by amending the Banking Act by March 2011 ***(structural benchmark)***.

- Give powers to the Deposit Protection Fund Board to hold and sell unrealizable securities after winding up an institution.

- Strengthen risk-based supervision including adopting a time-bound program to put in place an assessment of conglomeration risk of relevant local groups.

- Expand supervisory procedures to ensure full monitoring of financial business driven by bank agents under the newly introduced bank agency model and through the use of mobile banking.

- Modify the CBK Act to allow the central bank to share or disclose information obtained from surveillance of authorized foreign exchange bureaus for criminal investigations.

- Introduce legislation by March 2011 to allow the demutualization of the Nairobi Stock Exchange, in an effort to strengthen capital markets ***(structural benchmark)***.

- Enforce compliance of Retirement Benefit Authority (RBA) rules on National Social Security Fund (NSSF), in particular the appointment of external fund managers and external custodians.

- Fully implement the Crime and Anti-Money Laundering Act of 2009, including introducing necessary by-laws and regulations.

21. ***Financial access:*** Financial access to the population has improved, with a share of 40 percent of people with access to formal financial services in 2009, up from 26 percent in 2006. Innovative financial products and services are expanding financial access, helped by the use of mobile-based technology and widespread use of mobile phones (one cell phone per adult). According to World Bank estimates, about ¾ of the population already transfer cash equivalent to 20 percent of GDP annually, and the number of mobile-based deposit accounts products is growing rapidly. The recent introduction of a Credit Reference Bureau and the agency banking model are helping reaching previously unbanked segments of the population by mitigating credit risk and reducing transaction costs. Following approval of the Microfinance Act in 2008, the CBK has licensed three deposit-taking microfinance institutions (MFIs), and many other institutions have started the licensing process. We are considering the following measures to support the drive towards higher credit access:

- Facilitate the increase in information coverage by the newly introduced Credit Reference Bureau.

- Amend the Microfinance Act to facilitate the use of third party agents by Deposit-Taking Microfinance Institutions.

- Complete the regulatory and supervisory frameworks for Savings and Credit Cooperatives (SACCOs) to help improve consumers' confidence.

- Implement currency centers out of Nairobi to reduce cash-in-transit costs to banks' branches.

22. More fundamental reforms are needed to ensure adequate access to productive credit to small and medium-sized enterprises. Some elements of the constitutional reform would favor broadening access to credit, such as the envisaged decentralization and judiciary reform. Recently introduced regulation and supervision of specialized institutions such as MFIs and SACCOs are necessary steps to help strengthen their financial soundness. These institutions have potentially large financial outreach that could favor lower transaction costs in lending to micro-enterprises, in particular in the rural area where about 250 deposit-taking SACCOs already constitute an important source of credit for rural households. Many of these institutions experience the same difficulties as other financial institutions in trying to expand lending to the productive sector, namely a lengthy and costly collateralization, complex and uncertain loan recovery processes in the event of default, inefficient registry, and weak legal basis for the use of alternative risk mitigators. In adapting Kenya's institutional framework to the new constitution, reform in the following areas will be assessed:

- Unify the framework for the use of immovable property as collateral, including land, and eliminating restrictions to free contracting. Create a streamlined and transparent system for the treatment of noncorporate movable assets as collateral.

- Significantly simplify the regime for stamp duties charged at different stages of collateralization and execution of collateral.

- Create a unique registry for encumbrances within the Register General, and establish a simplified registration process. In amending the Company's Act, remove limits to the type of security interests that a company can register, and give the same preference to creditors charging fixed and floating rates (the latter normally preferred for lending to some agriculture activities).

- Reform the legal framework and tax treatment of alternative risk mitigators such as hire purchases, invoice discounting and factoring, and warehouse receipts. Over time, local governments may promote the use of these alternative risk mitigators by financially sound SACCOs.

IV. Safeguards and Statistics Issues

23. The government remains committed to protecting the financial soundness of the CBK, and to adhering to the principles of good governance and best practices, including those encapsulated in the IMF's safeguards policy. A safeguards assessment of the CBK was conducted in September 2009, which found that the CBK had made notable progress in

strengthening its safeguards. The bank is committed to implementing measures to address the remaining vulnerabilities, further strengthen the CBK's operations, and minimize the possibility of misreporting and misuse of Fund resources.

24. On statistical issues, the government plans to release a revised set of national accounts data in 2012. The government is also taking steps to improve the monitoring of fiscal data, in particular, the preparation, on a regular basis, of summary statistics on domestic arrears and pending bills. Moreover, the government intends to develop a framework for systematically monitoring productivity changes in the economy, and to produce, on a regular basis, trade data. Kenya participates in the General Data Dissemination System (GDDS) project for Anglophone Africa.

V. PROGRAM MONITORING FOR 2011/12

25. ***Technical memorandum of understanding (TMU).*** The program will be monitored using the definitions, data sources, and frequency of monitoring set out in the accompanying TMU. The government will make available to Fund staff all data appropriately reconciled and on a timely basis, as specified in the TMU.

26. ***Performance criteria and structural benchmarks.*** Annex 1 shows the quantitative performance criteria to be used in monitoring performance in *2011.* Structural benchmarks, with corresponding dates, are identified in Annex 2.

27. ***Program review.*** The first review under the ECF arrangement, assessing end-March 2011 performance criteria, will be completed by July 15 2011. This review will focus on maintaining fiscal discipline while keeping expenditure in favor of social and economic spending as a priority. The second review under the ECF arrangement, assessing end-June performance criteria, is expected to be completed by October 15, 2011. The third review under the ECF arrangement assessing end-December performance criteria, is expected to be completed by April 15, 2012.

28. ***Coverage.*** Fiscal performance criteria will cover the central government, but the authorities' will prepare to expand coverage to include the general government as early as possible, in anticipation of fiscal decentralization.

Annex 1. Kenya: Proposed Performance Criteria

(In billions of Kenyan shillings; unless otherwise indicated)

	2010	2011		
	Projection End-Dec.	Performance Criteria End-March	Performance Criteria End-June	Performance Criteria End-Dec.
Quantitative performance criteria				
Fiscal targets				
Primary budget balance of the central government (-=deficit, floor) 1/ 2/ 3/	-20.7	-55.0	-25.0	-50.0
Monetary targets 4/ 5/				
Stock of central bank net international reserves (floor, in millions of US$) 6/	3,505	3,450	3,480	3,695
Stock of net domestic assets of the central bank (ceiling)	-45.0	-40.0	-40.0	-25.0
Public debt targets				
Contracting or guaranteeing of medium- and long-term nonconcessional external debt by the central government (ceiling; millions of US$) 7/ 8/	…	450	700	700
New central government and central government guaranteed external payment arrears (ceiling, millions of US$) 9/	0	0	0	0
Indicative targets				
Priority Social Expenditures of the central government(floor) 10/ 3/	5.9	17.6	24.8	7.0

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

Annex 2. Kenya. Structural Benchmarks under the Extended Credit Facility Arrangement

Measure	Proposed Time Frame
Tax measures	
Submit VAT legislation to help improve administration and compliance.	Second Review
<u>*Macro criticality*</u>*: The VAT reform will allow for higher mobilization of revenue that will reduce the fiscal imbalance.*	
Expenditure control	
Submit PFM legislation to the Commission for the Implementation of the Constitution, to help accelerate reforms in public financial management.	Third Review
<u>*Macro criticality*</u>*: PFM management legislation is crucial for increasing both spending efficiency and improving fiscal management.*	
Adopt a Single Treasury Account to strengthen cash management and improve resource management.	Fourth Review
<u>*Macro criticality*</u>*: Single Treasury Account adoption will improve both liquidity management and expenditure control.*	
Banking supervision	
Amend the Banking Act to reinforce prompt corrective action by the banking supervision authority.	First Review
<u>*Macro criticality*</u>*: Reinforcing the banking supervision authority is crucial to reducing the risk of macroeconomic instability.*	
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.	First Review
<u>*Macro criticality*</u>*: Demutualization of the Nairobi Stock Exchange is essential for the development of deeper financial markets that will enhance financial stability.*	

Attachment 2. 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 March 31, 2011, June 30, 2011 and December 31, 2011 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 (**ceiling**); and
- medium- and long-term external public debt arrears (**continuous ceiling**).

3. The program sets indicative targets for March 31, 2011; June 30, 2011; and December 31, 2011 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 October 1, 2010 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, 2011 test

date, the central government primary balance including grants will be measured cumulative from July 1, 2011.

1. 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) and external commercial debt exceed the programmed amounts, the target for NIR will be adjusted upward by the difference.

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

7. **NIR are monitored in U.S. dollars,** and, for program monitoring purposes, assets and liabilities in currencies other than the U.S. dollar shall be converted into dollar equivalent values, using the exchange rates as specified in Table 1, and net international reserves will be computed as the daily average for the month when the testing date is due.

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

8. **Net domestic assets** are defined as reserve money minus NIR converted in shillings at the accounting exchange rate of 81 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 81 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.

2. 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 lessor 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 contracted or guaranteed by the central government is measured as a cumulative flow of nonconcessional external debt contracted or guaranteed by the central government. The ceiling on non concessional external borrowing will exclude the proceeds of the issuance of a sovereign bond up to a maximum amount of US$500 million. Medium- and long-term debt refers to debt with maturity of one year or longer.

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

14. 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.

15. 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 December 31, 2010.

VII. Indicative Target on Priority Social Spending

16. 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

17. 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 Extended Credit Facility

(Rates as of September 1, 2010)

Currency	Kenyan Shillings Per Curreny Unit	Dollars Per Curreny Unit
Australian dollar	72.88	0.9000
Canadian dollar	77.14	0.9526
Chinese yuan	11.89	0.1468
Danish krone	13.92	0.1719
Euro	103.65	1.2800
Japanese yen	0.96	0.0118
Norwegian krone	13.05	0.1612
Pound sterling	124.65	1.5394
Swedish krone	10.99	0.1358
SDR	122.65	1.5147
U.S. dollar	81.00	1.0000

Table 2. Kenya: External Budget Support to the Central Government 2010–11 1/

(In millions of U.S. dollars)

	2010	2011		
	End-December	End-March	End-June	End-December
External Budget Grants	0.0	0.0	0.0	0.0
External Budget Concessional Loans	0.0	0.0	0.0	100.0
External Budget Commercial Loans	0.0	0.0	0.0	0.0
Total External Budgetary Support	0.0	0.0	0.0	100.0

Source: Kenyan authorities data.

1/ For end-December, 2010, end-March 2011 and end-June 2011, the programmed amounts are cumulative from July 1, 2010. For end-December 2011, the programmed amounts are cumulative from July 1, 2011.

Table 3. Summary of Data to Be Reported

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

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