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[Kenya](#) and the IMF

Kenya: Letter of Intent

Press Release:

[IMF Executive Board](#)

[Approves US\\$209](#)

[Million Disbursement](#)

[to Kenya Under the](#)

[Exogenous Shocks](#)

[Facility](#)

May 29, 2009

May 15, 2009

[Country's Policy](#)

[Intentions Documents](#)

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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

Nairobi, May 15, 2009

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. Strauss-Kahn:

In response to bold economic and structural reforms implemented by the Government over the Economic Recovery Strategy (ERS) period, 2003–07, the Kenyan economy staged a remarkable recovery with real GDP growth reaching 7 percent in 2007, up from 0.5 percent in 2002. This growth rate, which compared well with those achieved by most reforming countries in sub-Saharan Africa, had a positive impact on the welfare of Kenyans, with per capita income rising from about US\$ 350 in 2002 to over US\$ 700 by 2007.

However, in 2008, the economy suffered major shocks that threatened to reverse the gains we had achieved over the ERS period. Post-election violence in early 2008 impacted negatively on key sectors of our economy such as tourism, manufacturing, transport and agriculture, resulting in a year-on-year decline in real GDP of 1 percent in the first quarter of 2008. While the economy showed signs of quick recovery during the subsequent quarter, these hopes were diminished as the country was buffeted by record high fuel and fertilizer prices. These shocks were compounded by the failure of the short rains in October-November 2008, resulting in a sharp decline in domestic food supplies, particularly, maize—a key staple food for our population. Consequently, an estimated 10 million Kenyans have become food insecure and millions are at risk of starvation. The government and the private sector need to import about one million tons of maize and other cereals between February and August 2009. At the same time, the economy began to feel the adverse effects of the global financial crisis which has slowed recovery of our tourism sector and reduced remittances and private capital inflows.

Impact of the shocks

These shocks have put severe pressure on our fiscal position, the balance of payments and the exchange rate. The international reserves of the Central Bank of Kenya (CBK) have fallen to below 3 months of import cover from about 4 months a year ago and are expected to remain under pressure in 2009.

The global financial crisis has made it difficult to issue a planned sovereign bond in the international capital market to finance our development expenditures. This, together with

diminished prospects for privatization receipts and lower revenues arising from a weaker economy, has given rise to a substantial financing shortfall for the 2008/9 budget.

Recession in advanced countries is likely to restrain, if not reduce, demand for Kenya's exports, including tea, horticulture and coffee in 2009 and, if protracted, in the medium-term. Moreover, tourism earnings, remittances and private capital inflows are expected to decline. These developments will, notwithstanding the decline in oil and fertilizer prices, put further pressure on our external balance of payments, exchange rate and official foreign exchange reserves in 2008/9.

These shocks are threatening to derail our economic recovery and pose substantial challenges for our macroeconomic policy management. Inflationary pressure associated with food shortages remains high and is not expected to dissipate at least until the long rains are received to boost food supplies after August. Thus, increased importation of maize will further erode our official foreign exchange reserves and put pressure on the exchange rate at a time when our prospects for exports earnings, remittances, and capital inflows are being threatened by the negative impact of the global financial crisis

While we are yet to feel the full impact of the global financial crisis—especially its second round effects on the real economy, Kenya is likely to face a more difficult time in 2009/10 with low economic growth, increased unemployment and continued high prices for maize if rains become inadequate. We are thus faced with the task of finding solutions to sustain the economy and protect the livelihood of the poor.

Policies to address the shocks

Given our commitment to maintaining macro-economic stability, reigning in inflation and sustaining growth crucial for poverty reduction, we had to take immediate action to mitigate the impact of the shocks arising from drought, higher world prices of food, fuel and fertilizer, and the global financial crisis. We have taken concerted fiscal, monetary and administrative/structural measures and will be implementing additional measures in the coming year:

- The Government has withdrawn the generalized maize subsidy scheme introduced in November 2008 in response to rising maize prices and partially liberalized the maize market in Kenya. Because of design flaws, the scheme led to diversion of maize from the National Cereal and Produce Board (NCPB) to unintended purposes. Going forward, a new well-targeted food subsidy program that avoids price distortions and minimizes opportunities for abuse will be developed by December 2009. As the new scheme will not need the support of an export ban, we intend to eliminate the ban on maize exports imposed in October 2008 by end-December 2009.

Effective February 2009, the government removed the duty and VAT on maize imports for a period of six months to allow the private sector to import maize at lower cost to

bridge the food deficit. The Government will reassess the food situation with a view of granting an extension of duty-free importation of maize, if the situation dictates so.

- On the fiscal front, the government is taking action to protect critical expenditures and boost economic activity while ensuring medium-term debt sustainability. Because of the revenue shortfall, the postponement of the planned sovereign bond issuance, and additional expenditures for drought relief, a financing gap for the financial year ending June 2009 has emerged. The government will close the gap by rationalizing expenditures, cutting non-priority expenditures and increasing domestic borrowing. The increased borrowing is necessary to maintain expenditures on key infrastructure projects and poverty reduction, as well as to support economic activity in the face of the adverse impact of the global financial crisis. Despite the higher domestic financing, the overall fiscal deficit (including grants) for 2008/09 is about 5 percent of GDP based on the current implementation rate for foreign financed projects—smaller than budgeted but moderately larger than in 2007/08. We recognize the downside risk of a larger-than-projected revenue shortfall. Should this risk materialize, we would take further actions such as reprioritizing expenditures to keep within the current target for net domestic borrowing. For 2009/10, we will continue to stimulate the economy. To this end, we plan to borrow from domestic sources about Ksh 109 billion (4.2 percent of GDP), which we believe can be accommodated by the domestic financial market. Despite these temporary increases in domestic borrowing, we remain committed to reducing the debt-to-GDP ratio in the medium term.
- In the monetary area, to ease the liquidity situation, the CBK has cut its policy rate—the Central Bank Rate (CBR)—by a total of 75 percentage point since December and lowered banks' reserve requirement ratio from 6 percent to 5 percent. Going forward, the revised monetary program for 2008/9 is expected to reign in inflation, while providing sufficient liquidity to support economic activity and allowing for a gradual rebuilding of international reserves.
- In view of the challenges in gauging monetary policy under the current methodology of measuring the consumer price index, the Kenya National Bureau of Statistics began in February 2009 to undertake a Point of Sale Survey (PSS) based on an updated consumer basket. These price data are needed to determine the price reference period for the new CPI, and to finalize CPI rebasing and revision exercise. We expect to review and audit the implementation of the new series; and thereafter to launch a new CPI with a revised compilation methodology by end-May 2009.
- To address the increased risks to the financial sector, the CBK is intensifying its oversight to ensure that banks are making adequate and timely provision for bad and doubtful loans, and taking an increasingly proactive approach to surveillance and enforcement. The government will bring the Banking Bill before Parliament before the end of the next Parliamentary session—enacting this bill would strengthen the hand of the CBK by authorizing consolidated supervision and prompt corrective action, which will be crucial if asset quality deteriorates.

- Regarding the external sector, as the balance of payments starts improving in 2009/10, the central bank will pursue a strategy of gradually rebuilding the official foreign exchange reserves consistent with the reserve money path that will reduce inflation to 5 percent by June 2010. We will maintain a managed-float exchange rate regime, which has served Kenya well in terms responding to external shocks. The CBK will continue to limit its interventions in the foreign exchange market only to smoothing excessive short-term volatilities. In view of the importance of closely monitoring the transactions in the balance of payments as the impact of the global financial crisis unfolds, the KNBS is committed to undertaking a foreign capital flow survey by October 2009 to track foreign direct investment and other capital flows. Already preparatory work including identification of sampling frame and trainings has been done.
- We are committed to zero tolerance of corruption. In this regard, the Government will continue to advance governance reforms within the context of updated Governance Action Plan (GAP). Recent corruption allegations related to the sale of maize from the National Cereal and Produce Board (NCPB) to middlemen are being investigated by the Kenya Anti-Corruption Commission (KACC). In the meantime, the Government has instituted changes in the management of NCPB and launched forensic audit of NCPB operations that will inform further actions. With regard to mismanagement of the distribution of fuel associated with the State-owned Kenya Pipeline Corporation (KPC) and private petroleum dealers, the Government has taken swift corrective actions. It replaced the management at KPC and changed the procedures for allocation of storage space to oil suppliers at the Kipevu storage facility, and the KACC has launched an investigation.
- We will continue to pursue structural reforms to improve our long-term growth potential. Our priority will be given to the enactment of the Public Financial Management Bill and establishing its enabling regulations; improving treasury cash management (including making operational the treasury single account); strengthening debt management; improving fiscal reporting (including increasing the functionality of IFMIS); and furthering procurement reforms.

The Government stands ready to implement other policy measures should the shocks turn out to be worse than expected.

Request for Fund assistance under ESF

The Government has declared the food situation a national disaster. The WFP has completed a comprehensive assessment of the food situation and the interventions required. So far, we have received support from China of US\$3 million and we expect other development partners, including the World Bank and the AfDB, to channel their support through the WFP mechanism to help mitigate the food problem. The NCPB is expected to import 3 million bags of maize under a commodity credit guarantee scheme provided by the United States Department of Agriculture. A number of other donors are providing support

through existing portfolio with the aim of improving domestic agricultural productivity in a sustainable manner.

Despite these anticipated increases in donor support, the challenges outlined earlier require additional urgent assistance, particularly with regard to bolstering our international reserves. We therefore request that the IMF allow the Kenyan government the maximum access of 50 percent of quota through the Rapid-Access Component of the Exogenous Shocks Facility (ESF) to address these challenges. Further, we will continue to engage with the Fund on policy advice and have no intention of introducing new exchange and trade restriction. Similarly, we will maintain full pass-through of world prices for petroleum products. We expect to update the Financial Sector Assessment Program (FSAP) following our earlier request. We also request an update of the safeguard assessment for the Central Bank of Kenya.

The Government of Kenya authorizes the IMF to make this letter and the IMF staff report available to the public, including through the IMF internet website.

Sincerely yours,

/s/

Uhuru M. Kenyatta
Deputy Prime Minister and
Minister for Finance

/s/

Njuguna Ndung'u
Governor
Central Bank of Kenya