INTERNATIONAL MONETARY FUND

IMF Country Report No. 17/25

KENYA

January 2017

FIRST REVIEWS UNDER THE TWENTY-FOUR MONTH STAND-BY ARRANGEMENT AND THE ARRANGEMENT UNDER THE STANDBY CREDIT FACILITY AND REQUESTS FOR WAIVERS OF APPLICABILITY, REPHASING OF DISBURSEMENTS, AND MODIFICATION OF PERFORMANCE CRITERION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR KENYA

In the context of the First Review Under the Twenty-Four Month Stand-By Arrangement and the Arrangement Under the Standby Credit Facility, the following documents have been released and are included in this package:

- A **Press Release** including a statement by the Chair of the Executive Board.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on January 25, 2017, following discussions that ended November 3, 2016, with the officials of Kenya on economic developments and policies underpinning the IMF arrangement under the Stand-By Arrangement. Based on information available at the time of these discussions, the staff report was completed on December 23, 2016.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the International Development Association (IDA).
- A **Staff Supplement** updating information on recent developments.
- A **Statement by the Executive Director** for Kenya.

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

Letter of Intent sent to the IMF by the authorities of Kenya*
Memorandum of Economic and Financial Policies by the authorities of Kenya*
Technical Memorandum of Understanding*
*Also included in Staff Report

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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January 25, 2017

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IMF Executive Board Completes First Review Under the Stand-By Arrangement and Standby Credit Facility Arrangement for Kenya

On January 25, 2017, the Executive Board of the International Monetary Fund (IMF) completed the first review of Kenya's performance under the program supported by the Stand-By Arrangement (SBA) and an Arrangement under the Standby Credit Facility (SCF). The 24-month SBA/SCF with a combined total access of SDR 1.06 billion (about US$1.5 billion) was approved by the IMF's Executive Board on March 14, 2016 (see Press Release No. 16/110)

The Kenyan authorities have indicated that they will continue to treat both arrangements as precautionary, and do not intend to draw on the SBA and SCF arrangements unless exogenous shocks lead to an actual balance of payments need.

Following the Executive Board discussion on Kenya, Mr. Tao Zhang, Deputy Managing Director and Acting Chair, said:

"Kenya's economy has continued to perform well. Real GDP growth increased in 2016, inflation remains within the target range, and the current account deficit has narrowed.

The macroeconomic outlook is overall positive, including robust growth and reduced external imbalances. However, interest rate controls are likely to reduce access to credit, weighing on growth. They also complicate monetary policy and adversely affect banking sector profitability, especially for small banks. Although the adverse effects of the controls are manageable in the near term, if maintained, they could potentially pose a risk to financial stability. Therefore, it is essential to remove these controls, while taking steps to prevent predatory lending and increase competition and transparency of the banking sector.

The envisaged fiscal consolidation that targets a 3.7 percent of GDP deficit by 2018/19 is critical to maintain a low risk of debt distress while preserving fiscal space for development priorities. Continued public financial management reforms, aimed at upgrading the efficiency of public spending and expenditure control, are key to strengthening fiscal policies and institutions.

Establishing a formal interest rate corridor remains a priority for strengthening the monetary policy framework. While adoption of such a corridor has been delayed given the uncertainties created by interest rate controls, it will be important to conduct liquidity operations to realign interbank rates to the policy rate as economic conditions permit.

The authorities are taking actions to strengthen financial stability and to enforce reporting requirements. These include steps to implement the action plan on banking regulation and supervision to enhance capacity to monitor credit and liquidity risks and limit insider lending.

Continued improvements in macroeconomic statistics and acceleration of governance reforms will be essential to reinforcing efficiency, transparency, and accountability".

INTERNATIONAL MONETARY FUND

KENYA

December 23, 2016

FIRST REVIEWS UNDER THE TWENTY-FOUR MONTH STAND-BY ARRANGEMENT AND THE ARRANGEMENT UNDER THE STANDBY CREDIT FACILITY AND REQUESTS FOR WAIVERS OF APPLICABILITY, REPHASING OF DISBURSEMENTS, AND MODIFICATION OF PERFORMANCE CRITERION

EXECUTIVE SUMMARY

Precautionary program: The Executive Board approved on March 14, 2016 a 24-month Stand-By Arrangement (SBA) and an arrangement under the Standby Credit Facility (SCF), with combined access of SDR 1.063888 billion (196 percent of quota). The first tranche of SDR 542.8 million (100 percent of quota) was made available upon approval of the arrangements, and a further SDR 56.994 million (10.5 percent of quota) will become available upon completion of the first reviews. The authorities intend to continue treating both arrangements as precautionary, and to draw only if exogenous shocks lead to an actual balance of payment need.

Performance under the program: Macroeconomic developments have been broadly in line with the program, including strong growth and lower current account deficits. On fiscal policy, revenue shortfalls in 2015/16 were more than offset by under-execution of public investment. However, there have been delays in meeting structural benchmarks, and the recent adoption of interest rate controls has complicated achieving the objective to modernize the monetary policy framework. Even so, the program remains broadly on track. All continuous and end-June 2016 quantitative performance criteria were met.

Program modalities: The staff report proposes a revision in the macroeconomic framework to reflect recent developments, a modification of the performance criterion on the primary fiscal balance for end-December 2016 in line with a higher budget deficit for 2016/17, and a rephasing of the availability of disbursements under the program. Debt sustainability analysis continues to show a low risk of debt distress, although vulnerabilities have increased.

Policies: Staff and the authorities agree on the need for a growth-friendly fiscal adjustment, further steps towards a modern forward-looking monetary policy framework, and improved financial sector supervision and regulation. These would safeguard public debt sustainability, enhance the effectiveness of monetary policy, and reduce vulnerabilities in the financial sector.

Staff views: The authorities' economic program, supported by the precautionary SBA and SCF arrangements, continues to target a significant reduction in vulnerabilities, paving the way for an eventual exit from Fund arrangements. On this basis, staff recommends completion of the first reviews and supports the authorities' requests for waivers of applicability for SBA for end-December 2016 performance criteria, rephasing of disbursements, and modification of performance criterion.

Approved By
Roger Nord (AFR) and Vitaliy Kramarenko (SPR)

Discussions were held in Nairobi during October 19-November 3, 2016 and continued in subsequent weeks. The staff team comprised B. Clements (head), E. Alper, N. Hobdari, and M. Saito (all AFR); S. Mbaye (FAD), R. Moya (MCM), and P. Sharma (SPR). R. Morales (Resident Representative) participated in the discussions. T. Sitimawina from the Executive Director's office joined the mission. The mission met with Cabinet Secretary to the Treasury Rotich, CBK Governor Njoroge, as well as other senior government officials, members of parliament, members of the CBK Monetary Policy Committee, and representatives of the private sector.

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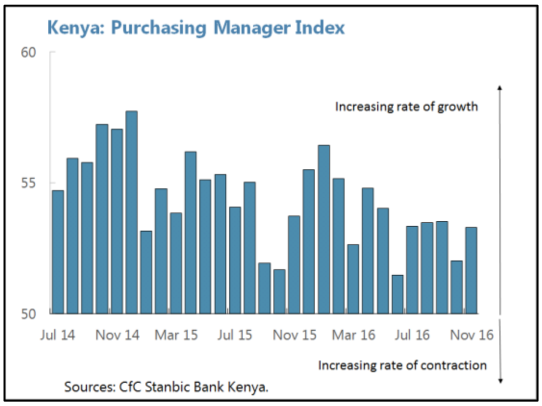
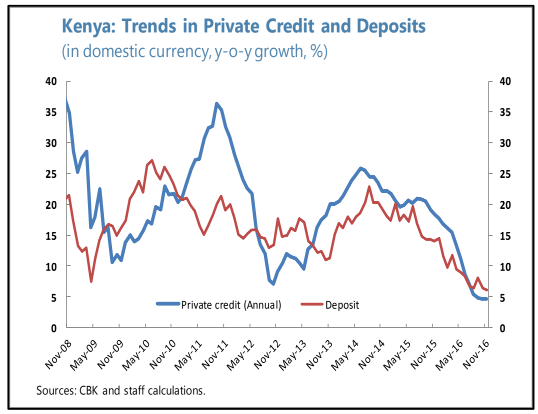
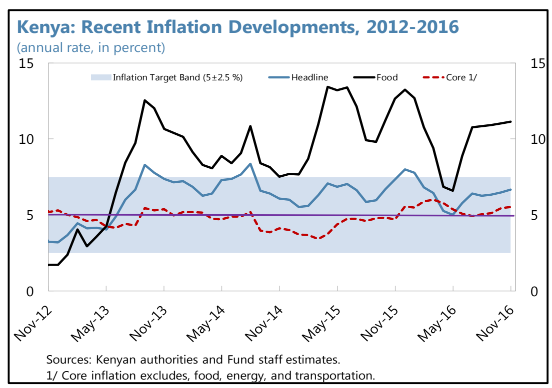
DEVELOPMENTS UNDER THE PROGRAM

1. Real GDP growth has been in line with program projections through the first half of 2016. Real GDP growth reached 5.6 percent in 2015 (Table 1), and accelerated further (to 6.1 percent) in 2016H1. The main drivers were the continued strong expansion in the construction and electricity sectors, favorable weather conditions, and a recovery in tourism. Short-term leading indicators suggest economic growth will remain robust in 2016 (Figure 1), although the deceleration of credit growth—consistent with regional trends—suggests some slowing in the future (Figure 2).

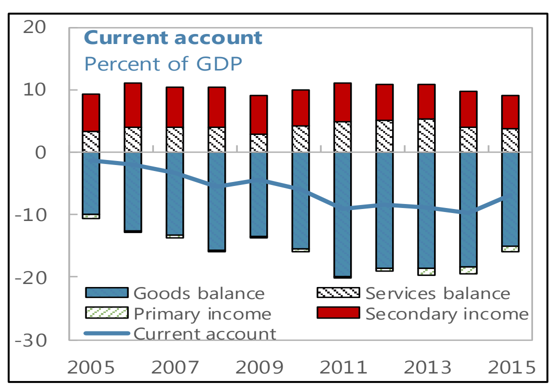




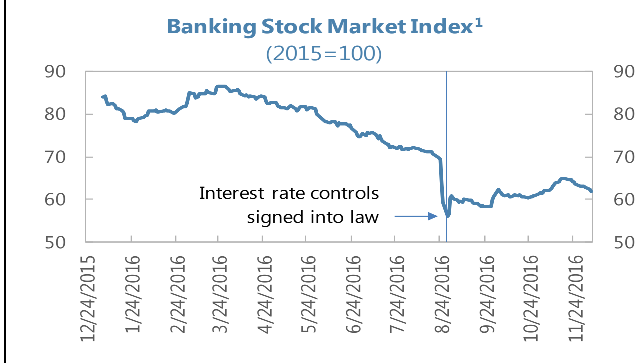
2. Inflation remains within the authorities' target range (5±2.5 percent). Headline inflation, after falling to a multi-year low of 5 percent in May 2016, has been trending up in recent months, reflecting mainly a renewed spike in food prices, and stood at 6.7 percent in November 2016. The Central Bank of Kenya (CBK) cut the policy rate (CBR) by 100 basis points in May, and another 50 basis points in September (Figure 2), citing mild inflationary pressures and concerns about the slowdown in private sector credit growth.



3. The current account deficit has narrowed and reserve coverage has improved (Table 4). The current account deficit fell by 3 percentage points of GDP to 6.8 percent in 2015, primarily due to lower oil prices and investment-related imports that more than offset weaker exports (Figure 3). The current account deficit has continued to narrow in 2016, with the 12-month current account deficit falling to 5.2 percent of GDP in September (compared to a projected 8 percent for the year as a whole under the program). The CBK has accumulated reserves, which as of end-November stood at 5.3 months of prospective imports.



4. A new law introducing interest rate controls became effective in September 2016. The law puts a ceiling on lending rates by banks and financial institutions at 4 percentage points above the CBR, coupled with a floor on term-deposit rates equal to 70 percent of the CBR. With the CBR currently at 10 percent, this implies a floor of 7 percent on term deposit rates and a ceiling of 14 percent on loan rates, which could affect over half of the banking sector's deposits and loans. Since the signing of the law, stock prices of Kenya's biggest banks have fallen and a number of banks have announced cost-cutting measures, including layoffs, closure of branches, and cancellation of expansion plans. Both the National Treasury and the CBK had publically voiced their opposition to the law before it was implemented in Parliament.



Sources: Bloomberg.

[1] Calculated as weighted average of 11 banks trading prices based on the share of gross loans.

PROGRAM PERFORMANCE

5. Program implementation has been mixed:

- **Quantitative targets.** All continuous and end-June quantitative performance criteria (PCs) were met (MEFP Table 1). All end-March and end-June 2016 indicative targets have been met with the exception of the end-June social spending target, which was missed by a small margin because of delays in disbursement of donor commitments on the social cash transfers. All end-September 2016 quantitative indicative targets have been met. The authorities are seeking a rephasing of disbursements, modification of the end-December PC on the primary budget balance of the national government in line with the revised annual program targets, and waivers of applicability for the end-December PCs on the primary budget balance, stock of central bank net international reserves, national government external payment arrears, and the monetary policy consultation clause, for which data are not yet available. Staff expects these PCs to have been met.

- **Monetary policy consultation clause.** Headline inflation has remained within the authorities' target range since February 2016 and is expected to remain within the range in the near term.

- **Structural reforms.** Progress on structural reforms has been slower than envisaged, reflecting capacity issues and the need for additional technical assistance. None of the structural benchmarks were met at the envisaged completion date, although two were completed with a delay--notably the adoption of an action plan by the CBK to strengthen the regulatory framework for banks, and the establishment of a tracking system for government pending bills. In addition, partially consolidated financial statements for all entities in the public sector were made publicly available. There was significant progress toward the integration of personnel payments into the Integrated Financial Management Information System (IFMIS), the issuance of

Cabinet guidelines on the management of public investment projects, and the completion of a study on tax expenditures. Benchmarks that have not been met are proposed to be re-phased and updated (with the exception of establishing an interbank interest rate corridor, ¶16) and will be monitored under the course of the program (MEFP Tables 2 and 3).

POLICY DISCUSSIONS

A. Revised Macroeconomic Framework and Risks

6. Recent developments warrant a revision to the macroeconomic framework, including a downward revision of growth and an improved balance of payments position (Tables 1–5).

- **GDP growth.** Staff expects that the interest rate controls will reduce economic growth. Staff and the authorities discussed the international experience with lending rate controls, which suggests that they reduce access to credit, especially for unsecured lending and for small and medium-sized enterprises (SMEs), which in turn reduces GDP growth. While there is considerable uncertainty regarding the timing and magnitude of the expected adverse impact of the interest rate caps, there was agreement to base the program on a lower GDP growth (text table), with the impact declining over time under the assumption that lenders gradually adjust their fees and borrowers shift to micro-financing affiliates that are not covered by the new law.

- **Inflation.** Core inflation is expected to decline in coming months, in part reflecting the diminished impact of the base effects of excise rate hikes in December 2015. At the same time, higher global fuel prices will put pressure on domestic fuel prices. On balance, headline inflation will be slightly above the original program projections for 2017.

- **Balance of payments.** The current account deficit is projected to decrease further in the medium term, primarily due to a faster recovery of tourism and goods exports, as well as lower oil and investment-related imports. The projected pick-up in export growth is underpinned mainly by gains in competitiveness due to reforms to the business environment (¶21), ongoing regional integration supported by infrastructure investment, and stronger global growth. International reserves are projected to be slightly above levels in the original program.

Kenya: Revised Macroeconomic Outlook

	2014	2015		2016		2017		2018	
	Act.	Prog	Act.	Prog.	Proj.	Prog.	Proj.	Prog.	Proj.
Real GDP growth (percent)	5.3	5.6	5.6	6.0	6.0	6.1	5.3	6.5	5.8
CPI inflation, average (percent)	6.9	6.6	6.6	6.6	6.3	5.7	6.3	5.1	5.2
CPI inflation, eop (percent)	6.0	8.0	8.0	5.8	6.0	5.5	5.9	5.0	5.0
Current account balance (percent of GDP)	-9.8	-8.2	-6.8	-8.0	-5.5	-6.7	-5.7	-6.6	-5.6
Gross international reserves (in billions of US$)	7.9	7.5	7.5	7.8	7.8	8.3	8.5	9.0	9.4
Gross international reserves (months of imports)	5.3	4.5	5.1	4.5	4.8	4.5	4.8	4.4	4.9
Total public debt (gross, percent of GDP)	48.6	51.2	51.2	53.1	54.4	54.4	54.7	54.0	54.4

Sources: Kenyan authorities and IMF staff estimates and projections.

7. These macroeconomic projections are subject to larger risks than envisaged in the original program, mainly reflecting the interest rate controls. There is higher uncertainty around the baseline because of the interest rate controls; their effects on growth will depend on how they are implemented (including any mitigating measures) and the speed of adjustment by borrowers and lenders to the new environment (¶25). Other risks include: (i) on the upside, a faster-than-projected recovery of tourist arrivals; and (ii) on the downside, a potential increase in the volatility of global capital flows and new security incidents. If interest rate controls were abolished, the growth path would be largely similar to the original program.

B. Fiscal Policy: Staying the Course of Adjustment to Preserve Sustainability

8. The 2015/16 deficit outturn was lower than anticipated (Table 2 and Figure 3). Total revenues fell 1 percent of GDP short of the program target, reflecting shortfalls in personal income taxes, lower import volumes, and lower reported profits in the financial sector. However, the revenue shortfall was more than offset by an under-execution of investment spending, including both on domestically-financed investment (by 0.5 percent of GDP) and the foreign-financed Standard Gauge Railway (SGR) project (1 percent of GDP). Current spending was broadly in line with program projections, as higher domestic interest and pension payments were offset by the under-execution of other spending, including wages. The overall cash deficit was 7.5 percent of GDP in 2015/16, compared to 8 percent under the program. The financing plan was broadly consistent with the program. In line with the smaller deficit, net public debt was also lower than in the program.

9. Fiscal developments in the first quarter of FY2016/17 were characterized by a marked improvement in revenue collection. Receipts of domestic VAT and excise revenues were particularly high, reflecting improvements in revenue administration from the i-Tax and excise goods management systems, new excise tax measures, and the re-introduction of VAT withholding. Spending execution, on the other hand, was characteristically slow, resulting in a small cash deficit of 0.8 percent of GDP at end-September 2016.

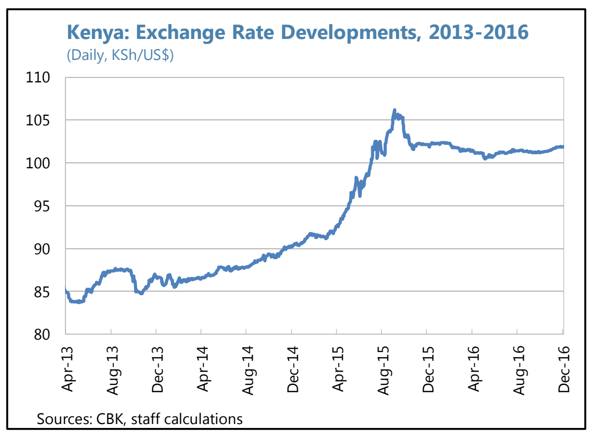
10. The authorities are committed to reducing the deficit to 6.9 percent of GDP in 2016/17 (Table 2, MEFP ¶11). Despite improvements in collection during the first quarter of 2016/17, revenues and grants are expected to be 0.3 percent of GDP lower than anticipated in the program, due to the carried-over shortfall from 2015/16. In addition, interest payments and other current spending—mainly one-off, election-related spending—are higher than in the program. To ensure a reduction of the deficit to 6.9 percent of GDP, the authorities have committed to adjust lower-priority spending to fit the revised revenue envelope. In addition, the authorities have initiated reforms, expected to be implemented by January 2017 to significantly broaden the tax base (MEFP ¶12). The higher deficit (by 0.4 percent of GDP) relative to the original program is justified in light of the lower-than-expected deficit and net public debt outturn in 2015/16, and one-off election related spending.

11. The authorities and staff agreed to preserve a fiscal deficit path consistent with the original program, targeting an overall deficit of 3.7 percent of GDP by 2018/19 (MEFP ¶12)**.** Such a path would ensure a progressive convergence towards the East African Monetary Union deficit ceiling of 3 percent of GDP by 2020/21, consistent with the envisaged fiscal reforms. In addition, the authorities are targeting a medium-term debt anchor of 45 percent of GDP in PV terms, while allowing for a high level of growth-enhancing public investment. This will require further revenue mobilization efforts, combined with a rationalization of low-priority spending, including in wages and other discretionary recurrent spending. The authorities have committed to close monitoring of revenue developments in the remainder of 2016/17 and, if necessary, will take additional measures—including in the 2017/18 budget—to ensure that the envisaged increase in tax revenues in 2017/18 (0.4 percent of GDP) is achieved (MEFP ¶13).

12. The authorities are moving ahead in strengthening public financial management reforms (MEFP ¶14). These reforms aim at improving the efficiency of government spending and strengthening expenditure control to mitigate fiscal risks. They include steps to strengthen the selection and monitoring of investment projects and making further progress in consolidating financial statements for the general government. In addition, the authorities have established a monitoring system for the government's pending bills in IFMIS and are also moving towards establishing a Treasury Single Account by introducing a centralized payment system in mid-2017. In additions Kenya's IFMIS will be made more comprehensive by incorporating personnel and debt payments. As an intermediate step, the authorities are automating the release of funds from the exchequer account for the Ministry and Development Agencies (MEFP Table 3).

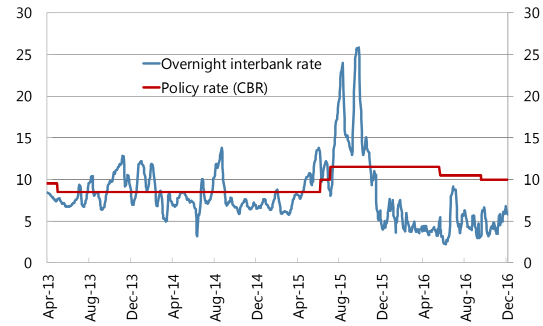
C. Monetary Policy and Exchange Rate Issues: Maintaining Stability

13. The CBK accumulated international reserves and kept inflation within the target range in the context of a mostly benign external environment in 2016. The exchange rate has remained stable, with the shilling ranging between 100.5–102.5 against the US dollar during 2016 (text figure). Despite recent exchange rate pressures, also reflecting the recent US interest rate hike, international reserves increased by about US$ 300 million in 2016 as Kenya benefited from an improved current account and relatively strong capital inflows (Figure 4). The stability of the exchange rate also contributed to headline inflation remaining within authorities' target range from February 2016 and the CBK lowered the policy rate to 10 percent during the year (¶2).



14. Unsterilized foreign exchange interventions and continued financial stability concerns have complicated the monetary policy framework. Interbank interest rates have deviated significantly from the CBR during 2016 (text figure), reducing the effectiveness of the CBR as a tool for monetary policy. The significant spread of the interbank rate from the CBR[1] (over 600 basis points on average in 2016) mainly reflected the CBK's unsterilized interventions in the foreign exchange market, as well as liquidity provision by the CBK to smaller banks that experienced liquidity shortfalls and were cut off from the interbank market (see ¶18). At the same time, large banks have begun to hold more liquidity, with the liquidity to asset ratio increasing from 27.8 percent at end-2015 to 34.3 percent at end-September).

Kenya: Policy Rate and Interbank Rate, 2013-2016
(in percent)



Sources: CBK.

15. The recent adoption of interest rate controls further constrains Kenya's interest-rate based monetary policy framework (Box 1). Under the interest rate controls, the ceiling for lending rates is automatically linked to the CBR. A reduction in the CBR thus reduces the maximum rate that banks can charge on their loans, which could lead banks to further ration out some high-risk and/or high-cost borrowers, including not only SMEs but also those needing longer-maturity loans. Monetary loosening through a cut in the CBR may be less effective than before in easing credit conditions for the economy. Thus, the scope for adjustments in the CBR is restricted under the interest rate controls. Interest rate controls could also lead to higher dollarization (as FX loans and deposits are exempt from this legislation), weakening the monetary transmission mechanism and increasing exchange rate risks.

[1] The CBR serves as a floor for lending by the CBK to banks to inject liquidity through reverse repo operations, and as a ceiling for withdrawing liquidity by the CBK from the market through repo operations.

Box 1. The Potential Impact of Interest Rate Controls in Kenya

The Kenyan Parliament introduced a new law on interest rate controls that became effective in September 2016, with the aim of reducing the cost of borrowing and increasing the return on savings. International experience, however, shows that such controls are ineffective and can have significant unintended consequences. These would ultimately lead to lower economic growth and undermine efforts to reduce poverty. In addition, linking deposit and lending rates to the policy rate limits the central bank's capacity to maintain price stability and support sustainable economic growth. The objectives of the law could be achieved, instead, by increased competition and transparency in the banking sector.

Potential adverse impacts of the law include the following:

Reduced access to finance for small borrowers

Instead of facilitating affordable lending, ceilings on lending rates often lead to lower financial access for the poor and underprivileged. Caps on lending rates lead to a reallocation of lending from small borrowers towards the government and large private borrowers (e.g., corporates), as they tend to be cheaper to administer. This behavior has been observed in many countries, including in Bolivia, Colombia, the Dominican Republic, Ecuador, Haiti, Nicaragua, Peru, Poland, WAEMU countries, and Zambia, among others. In Kenya, these effects are likely to be even stronger because the lending rate ceiling is much lower than in other countries with interest rate controls.

Increase in costly informal lending and indebtedness

As access to bank credit is curtailed, small borrowers with little or no collateral may be forced to turn to informal lenders. These often charge much higher rates and are not subject to regulation. Hence, ceilings are likely to be ineffective in reducing costs for borrowers. On the contrary, they are likely to lead borrowers to shift more debt into short-term revolving credit instruments, such as credit cards, and increase the indebtedness of low-income borrowers. An increase in such informal lending following the imposition of lending rate caps has been observed in several countries.

Reduced transparency

Financial institutions may try to compensate—partially or totally—for the impact of interest rate ceilings with non-interest charges and fees. Even if they succeed in offsetting the impact on lending rates, transparency may be significantly affected. In fact, it is not unusual that low-income borrowers face an increase in the cost of borrowing through additional fees and commissions as experienced in Armenia, Nicaragua, South Africa, and Zambia. The increased reliance by banks on non-interest charges and fees makes it difficult for borrowers to accurately access the total cost of borrowing and make informed decisions.

Reduced competition and innovation

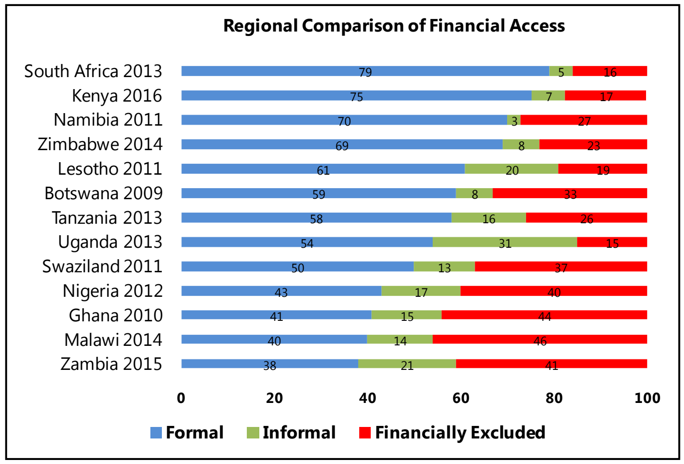
SMEs often rely on small banks for their loans. Interest controls are likely to hit these small banks harder, which often have to pay higher deposit rates than bigger banks. Interest controls limit the capacity of small banks to pass on these higher costs of deposits to their borrowers. Meanwhile, larger banks may close their branches that become unprofitable after the controls. Both factors will reduce competition and the provision of banking services to the population, as experienced in Italy in the 1970s.

Box 1. The Potential Impact of Interest Rate Controls in Kenya (Continued)

The quality of bank services could also decline following the imposition of interest controls. To deal with a squeeze in their profitability, banks may discourage access to financial services by limiting access to interest-earning deposits, discontinuing hybrid checking/saving accounts, and/or introducing new penalties for early withdrawals. This can reduce the range of financial services available for low-income households, even in countries where interest rate controls are predominantly not binding as in France and Germany.

Adverse effects on financial inclusion

The adverse effects of the law could reverse some of the significant gains in financial inclusion observed in Kenya since interest rates were liberalized in the mid-1990s. For example, access to credit by SMEs increased from 25.6 percent in 2006 to 33.4 percent in 2013, according to World Bank Enterprise Surveys. The development of mobile banking has also helped to increase financial inclusion through banks (by 27 percentage points in the past 10 years), by reducing transaction costs and allowing financial institutions to attract new customers. A reversal in this trend would adversely affect a large segment of the economy. This, in turn, would translate into a less dynamic economy, with an impact on employment generation and growth.



Reduced monetary policy effectiveness

Linking deposit and lending rates to the CBR reduces monetary policy effectiveness. For example, suppose the CBK were to loosen its monetary policy stance to encourage credit growth through a cut in the policy rate. The consequence of this would be a decline in the interest rate ceiling, which would make it less profitable for banks to lend to small, high-cost borrowers. This would discourage banks from lending to these customers, offsetting the impact of the rate cut. Even more fundamentally, interest rate controls reduce the signaling effect and thus the relevance of the CBR.

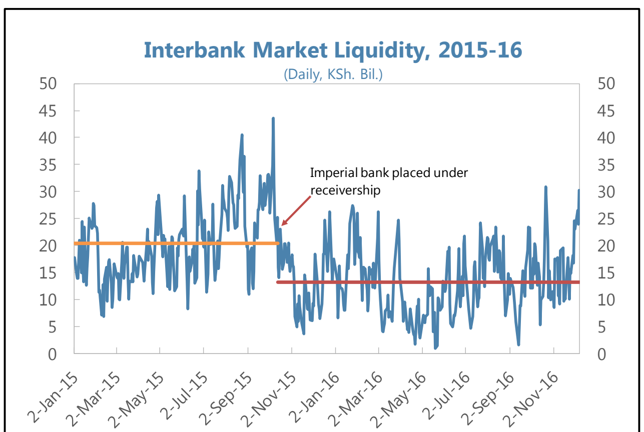
17. The authorities expressed commitment to strengthen the monetary policy framework, although establishing an interest rate corridor was not seen as feasible at this stage. The disconnect between the CBR and interbank rates reduces the signaling effect and thus relevance of the CBR, creating challenges for the CBK to communicate its monetary policy stance. The CBK reiterated its commitment to align the interbank rates with the CBR to further modernize the monetary policy framework. However, they argued that the implementation of a formal interest rate corridor in the context of interest rate controls would be undesirable since it would restrict movements in the overnight interbank rate, constraining the CBK's capacity to react to changes in economic conditions and meet its inflation objective. Nonetheless they are committed to realign interbank rates to the CBR as economic conditions permit (MEFP ¶16). Staff concurs that establishing the formal interest rate corridor would be inappropriate while interest rate controls remain in place. At the same time, staff underlined the importance of establishing a formal corridor as a way to strengthen the monetary policy framework over the medium term, and welcomed other measures currently underway to strengthen the monetary policy framework (MEFP ¶16).

18. The current accommodative stance of monetary policy stance is broadly appropriate in light of the benign inflation and weaker growth outlook. While real interbank interest rates are close to zero, inflation is expected to remain contained and growth is projected to be below potential in 2016 and 2017. An accommodative monetary policy stance, as gauged by overnight interbank rates, remains appropriate, and depreciation pressures, should they occur, should not be resisted. If growth and inflation surprise on the upside, however, or if global monetary conditions tighten more than expected, the CBK should stand ready to tighten monetary policy.

D. Financial Sector: Mitigating Financial Stability Risks

19. The banking sector remains adequately capitalized but credit quality has deteriorated, especially for a number of small banks. The latest financial soundness indicators (end-September) suggest that the banking system remains well-capitalized while maintaining adequate levels of liquidity. At the same time, non-performing loans (NPLs) have increased in recent months and reached 8.8 percent of total gross loans in September. Provisions, currently close to 50 percent of NPLs, have declined since early 2016 (Table 5), with significant differences across banks. Six relatively small banks, accounting for 6.7 percent of the banking system, have NPL ratios of more than 20 percent (based on bank disclosure reports for 2016Q3). The CBK recently adopted an action plan to strengthen banking supervision, including on AML/CFT, as well as legal and regulatory framework for banks (MEFP ¶19-20). The authorities continue to enhance their financial crisis preparedness with the consolidation of the Kenya Deposit Insurance Corporation (KDIC), but a sufficient level of staffing is needed to ensure its capacity for timely action.

20. The interbank market has become highly segmented, with adverse effects on liquidity management. Two banks were put in receivership in the second half of 2015, and a mid-sized bank was put in receivership in April 2016. The latter bank (3.3 percent of total bank assets) was intervened because of serious liquidity deficiencies after audit reports found evidence of insider lending in excess of prudential limits. Since then, risk aversion in the banking sector has increased, and daily transactions on the interbank market have fallen by about a third. The market has become highly segmented, with large banks with high levels of liquidity reluctant to provide liquidity to smaller banks. This has also been reflected in wide differences in interbank lending rates for large and small banks. Volumes on the horizontal repo (overnight collateralized) market also remain low. The CBK has promptly reacted to these events, putting in place the necessary liquidity facilities to minimize the effects on financial stability.



Sources: CBK, staff calculations.

21. The interest rate controls pose challenges to bank profitability and are expected to hamper credit growth. Before the implementation of the law, over half of the commercial bank loans had rates above the current ceiling and deposits with rates below the floor (¶4). The implementation of the new law will have an adverse effect on banks' net interest income. Staff and the authorities agreed that in the short run, the banking system had sufficient capital buffers to weather the effects of the interest rate controls on capital adequacy. At the same time, there was concurrence that the caps would, over the medium term, adversely impact asset quality as banks would lose their capacity to price risks adequately, potentially posing a risk to financial stability. The authorities are monitoring developments closely and are committed to taking steps as needed to ensure financial stability. Staff and the authorities agreed that the objectives of the law could be achieved, instead, by increased competition and transparency in the banking sector. These are consistent with the CBK's action plans to reduce borrowing costs for households and businesses (MEFP ¶21). Rapid results from this action plan could alleviate the concerns of Parliament that gave rise to the controls and facilitate their elimination.

E. Supporting The Business Environment and Policy Making Through Structural Reforms and Data Provision and Quality

22. Structural reforms have improved the business climate and underpinned the strengthening of the private sector. Kenya's ranking in the World Bank's Doing Business Report (2016) improved 21 places relative to 2015, one of the top 10 increases across the globe. Ongoing reforms will seek to (i) reduce transportation and trading costs, (ii) strengthen governance in business operations through the introduction of anti-bribery legislation, and (iii) improve procurement procedures and frameworks at the national and county level (MEFP ¶14).

23. The authorities are making progress in improving macroeconomic statistics, especially on the external sector. The Kenya Bureau of National Statistics (KNBS) is conducting a foreign investment survey to collect data for 2014 and 2015 and the first estimate of the annual International Investment Position (IIP) will be published in May 2017.

PROGRAM MODALITIES

24. Staff proposes resetting and updating the structural benchmarks that were not met (MEFP Tables 2–3). Structural benchmarks that were not met are proposed to be reset and updated with a view to provide additional time to provide technical assistance on these by the Fund and the World Bank Group. The authorities have made significant progress in these areas and should be in a position to complete the benchmarks within the rephrased timeline. Staff believes that the structural reforms envisaged in the program remain appropriate.

A. Capacity to Repay the Fund and Risks to the Program

25. Kenya retains a strong capacity to repay the Fund (Table 7). The Debt Sustainability Analysis update (Annex 1) finds that Kenya remains at low risk of debt distress. However, as measured by the standardized stress tests under the DSA framework, the vulnerability to export shocks has increased. Risks are also higher, due to the impact of interest rate controls, Nonetheless, the growth and resilience of exports is expected to increase, supported by stepped-up infrastructure investments, ongoing regional integration and the strong recovery in tourism, the latter reflecting steps taken in recent years to increase security. Together with the envisaged fiscal consolidation over the medium term, this would help maintain Kenya's low risk of debt distress. Obligations to the Fund (assuming full drawings under the precautionary program), measured relative to exports and GDP, remain manageable. Debt sustainability and capacity to repay the Fund is predicated on the planned medium-term fiscal consolidation and ongoing reforms to boost growth.

26. The main downside risks to the program stem from the interest rate controls, external shocks, and a delay in fiscal consolidation. The interest rate controls could reduce growth by more than anticipated under the program baseline. Staff estimates that the maximum adverse effect would be to reduce growth by around 2 percentage points each year in 2017 and 2018; under the baseline, the effects will be to reduce growth by about 1 percentage point a year. Over the near term, the controls do not jeopardize achieving the key objectives of the program on monetary policy and financial stability. If maintained over the long run, however, they could pose large risks to the program. With respect to other risks, external shocks leading to an increase in global financial market volatility would reduce or reverse capital flows to Kenya. Domestically, the upcoming elections could erode program ownership, delay fiscal consolidation plans, and potentially lead to heightened political instability. In addition, strains in relations between the central government and counties could weaken fiscal discipline, and weaker-than-expected improvements in revenue administration could lead to fiscal slippages. On the upside, exploitation of oil and gas resources discovered in 2014 could significantly improve the medium- to long-term external and fiscal position. The program is fully financed for 12-months with good prospects for the remaining period being adequately financed.

27. If downside risks materialize, policy measures may be needed to safeguard macroeconomic stability and debt sustainability. In the event of an external shock, flexibility in the exchange rate, combined with the use of Kenya's ample foreign currency reserves, would help avoid excessive volatility. Some further monetary policy tightening may be needed to prevent second-round effects on inflation. The use of fiscal policy for demand management purposes remains constrained in the near term in light of Kenya's substantial level of public debt.

B. Implementation of Safeguards Recommendation

28. The main recommendations of the safeguards assessment have been completed. A key recommendation of the May 2015 update safeguard update—to reconstitute the CBK Board—was implemented in November 2016. In addition, the CBK has strengthened its internal audit and financial reporting practices, and amended its legal framework in line with staff's suggestions. The only outstanding recommendation relates to the reconstitution of the Audit Committee, which is expected to be implemented shortly.

STAFF APPRAISAL

29. Kenya's economic performance has remained robust, underpinned by solid macroeconomic policies. Supported by higher public infrastructure spending, favorable weather conditions, and a recovery in the tourism sector, real GDP growth has picked up further in the first half of 2016. Inflation remains within the authorities' target range, and the current account deficit has narrowed further. The exchange rate remains stable and international reserve coverage has increased.

30. The impact of interest rate controls is negative, although the adverse effects are manageable in the near term. The recent law on interest rate controls is expected to reduce access to credit, thereby weighing on growth. The controls also weaken the signaling effect of the CBR, complicating the conduct of monetary policy. In addition, the controls adversely affect banking sector profitability through reduced interest margins, especially for small banks. Nonetheless, staff deems that the effects of the controls are manageable in the near term: growth is expected to remain above 5 percent, the CBK has sufficient tools to achieve its inflation objective, and banks have sufficient buffers to absorb the projected reduction in interest margins.

31. Staff urges the immediate removal of interest controls. The authorities could explore other ways to prevent predatory lending practices on consumer loans. Staff supports the envisaged steps by the CBK aimed at increasing competition and the transparency of the banking sector and believes that these would help generate support for the removal of the controls. Rapid implementation of these reforms would help achieve the objectives of the law without the distortions created by the interest rate controls. Staff welcomes the authorities' commitment to closely monitor the impact of the law on credit and bank profitability.

32. Fiscal consolidation over the medium term is key to maintaining macroeconomic stability and public debt sustainability. The 2016/17 budget deficit is slightly higher than under the program to accommodate election-related spending. This spending will be unwound and additional measures will be taken over the next two years to return the deficit to the original program deficit target of 3.7 percent of GDP by 2018/19. Notwithstanding the envisaged adjustment, the authorities' commitment to contain low-priority spending would preserve fiscal space for development priorities, including greater provision of health and education services. Staff welcomes the authorities' commitment to achieve its revenue targets as part of this effort. Staff urges the authorities to resolutely implement their fiscal strategy to maintain public debt sustainability and support inclusive growth.

33. Staff welcomes the authorities' reforms to strengthen fiscal policies and institutions. Despite some delays, the authorities have made significant progress in public financial management reforms. Staff welcomes the envisaged fiscal reforms aimed at upgrading the efficiency of public spending and strengthening expenditure control, which will buttress the credibility of the envisaged consolidation.

34. Establishing an interest rate corridor remains a key priority for strengthening the monetary policy framework. In light of the uncertainties created by interest rate controls, establishing a formal interest rate corridor at this time may be difficult. In this context, staff welcomes the CBK's commitment to conduct liquidity operations to realign the interbank rates to the CBR, as market conditions permit.

35. Staff welcomes the CBK's efforts to strengthen financial stability and to enforce enhanced reporting requirements. The CBK has addressed emerging risks to financial stability risks by resolutely intervening in banks deemed unviable and by providing liquidity to smaller banks that have been cut off from the interbank market. The envisaged steps to implement the action plan on banking regulation and supervision will increase the authorities' capacity to monitor credit and liquidity risks and limit insider lending.

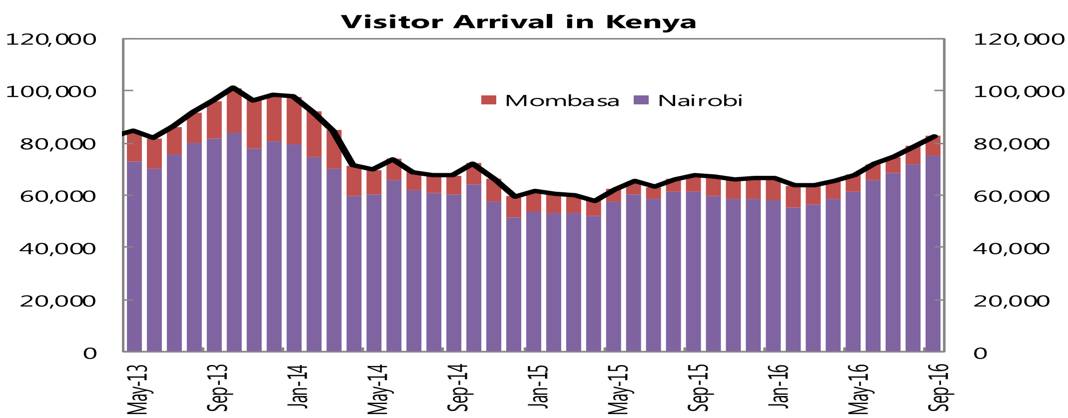
36. Continued improvements in macroeconomic statistics and accelerated implementation of governance reforms are essential to upgrade efficiency, transparency, and accountability. Staff welcomes ongoing reforms to reduce the costs of doing business, introduce anti-bribery legislation, and improve public procurement procedures. The publication of the foreign investment survey data for 2014 and 2015, the first-ever IIP for 2011-16, and quarterly publication of consolidated GFS-compliant general government data are welcome steps to improve external and fiscal sector data.

37. Staff supports completion of the first reviews under the precautionary SBA and SCF arrangements. Economic policies remain strong. Notwithstanding the adverse effects of the recent law on interest rate controls, the authorities' economic program supported by the SBA and SCF arrangements helps maintain a sustainable public debt position, keep inflation within authorities' target range, and strengthen financial sector oversight. On this basis, staff recommends completion of the first reviews under the SBA and SCF arrangements and also supports the authorities' requests for waivers of applicability for SBA for end-December PCs, rephasing of disbursements, and modification of performance criterion.

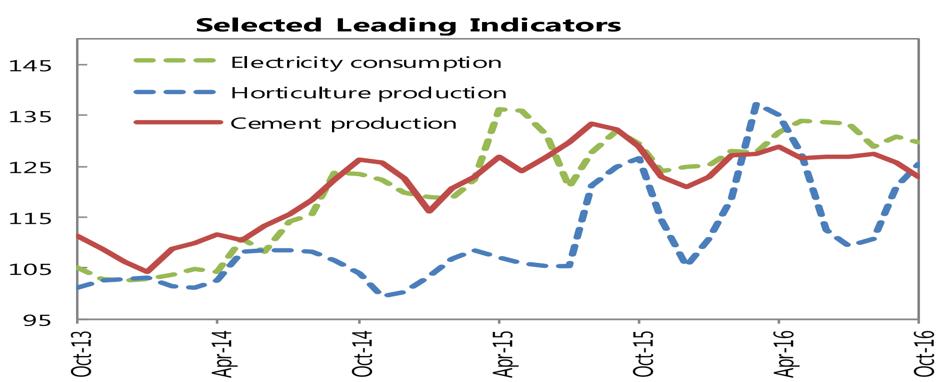
Figure 1. Kenya: Real Sector

Growth has remained robust to date…

…with visitor arrivals starting to recover…

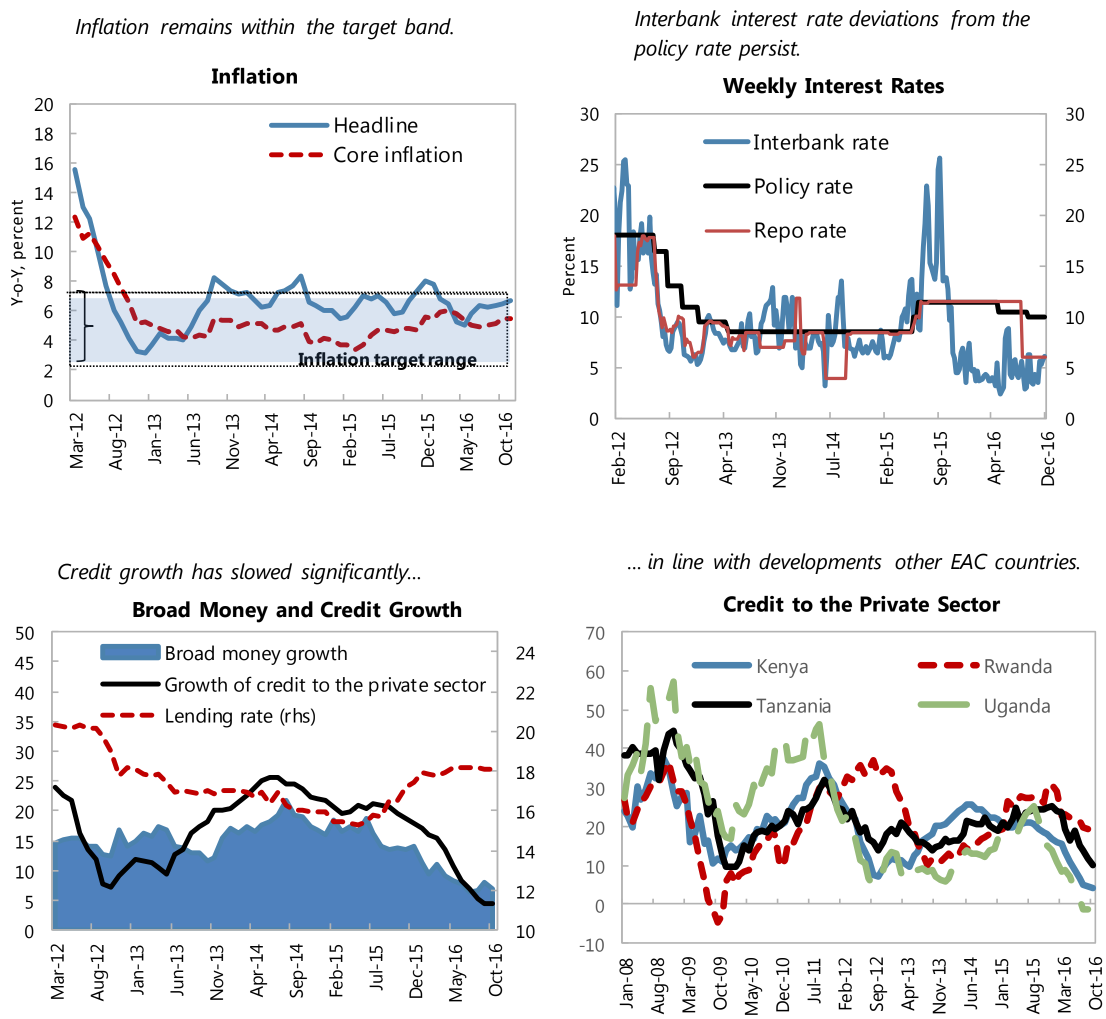


…and high frequency indicators suggesting continued strong momentum.



Source: Kenyan authorities and IMF staff estimates.

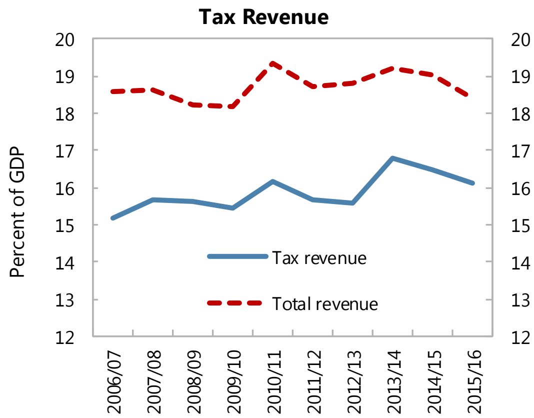
Figure 2. Kenya: Monetary Sector



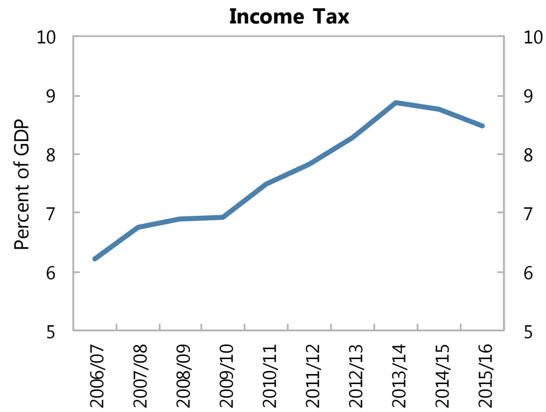
Source: Bloomberg; Kenyan authorities; and IMF staff estimates.

Figure 3. Kenya: Fiscal Operations[1]

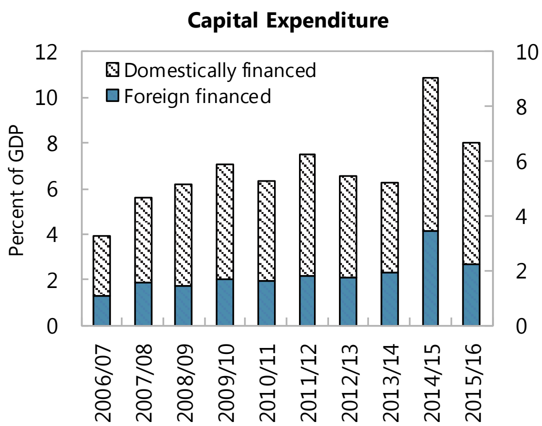
Revenue collection has declined in recent years…



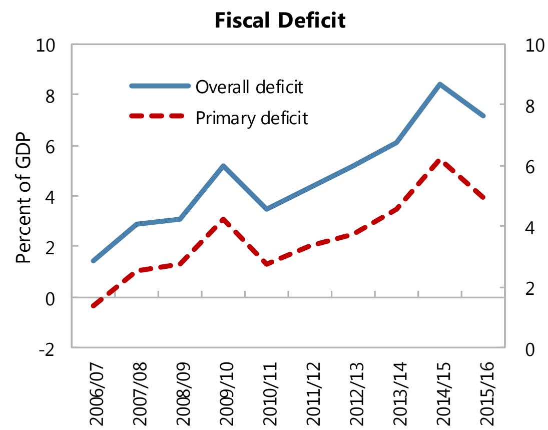
… as reflected in recent challenges in PIT collection.



But reduced capital spending has more than compensated for the revenue decline…



… leading to a lower deficit in 2015/16.

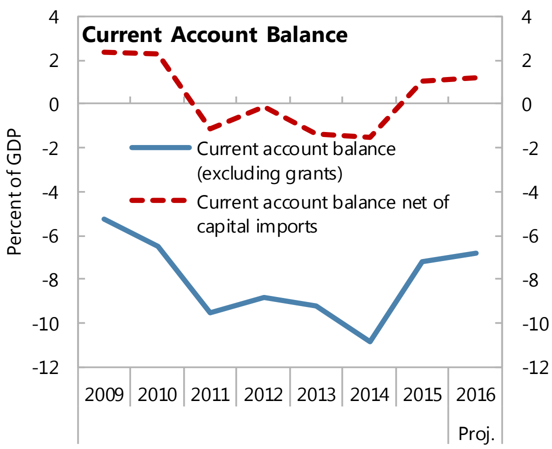


Source: Kenyan authorities and IMF staff estimates.

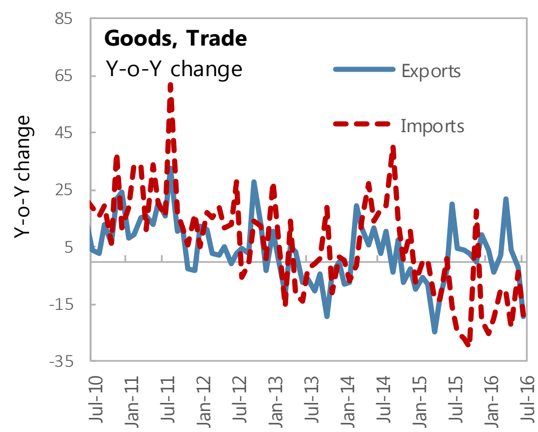
[1] For years 2012/13 and 2013/14, the charts are referring to general government.

Figure 4. Kenya External Sector

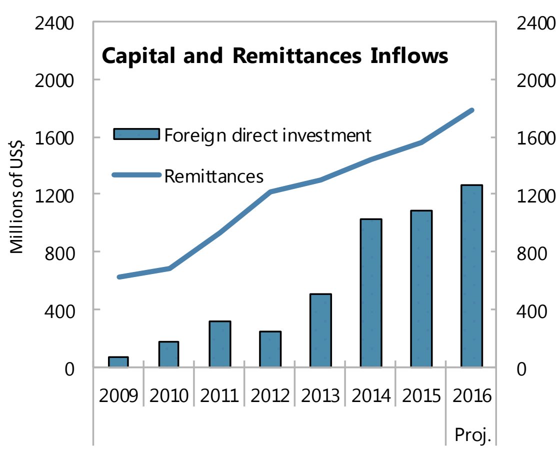
The current account deficit has declined ...



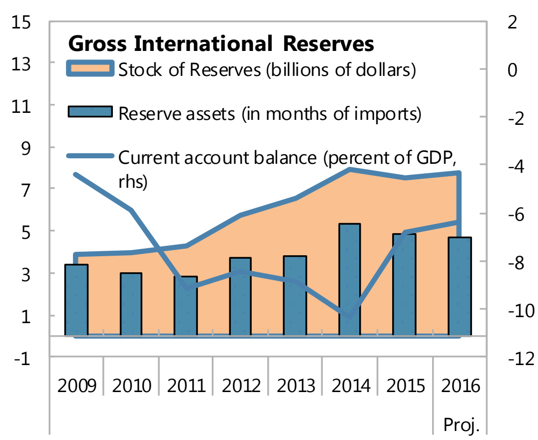
...largely reflecting import compression...



... while remittances and FDI are picking up.



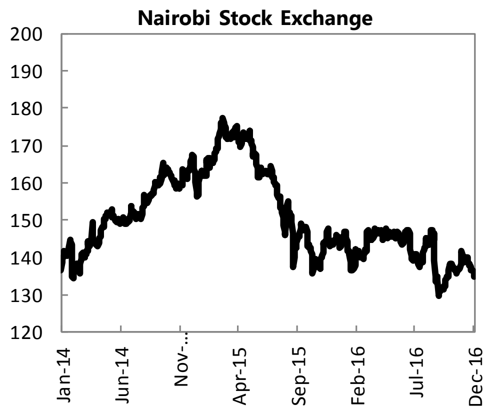
International reserves have remained stable.



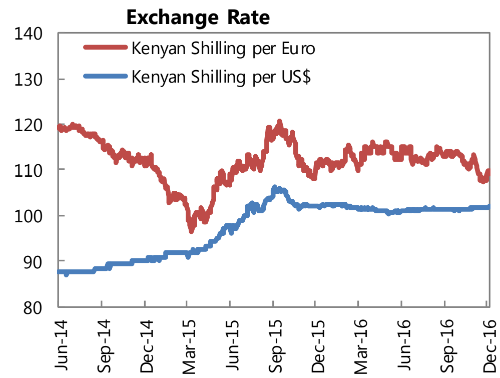
Sources: Kenyan authorities and IMF staff estimates.

Figure 5. Kenya: Financial Developments

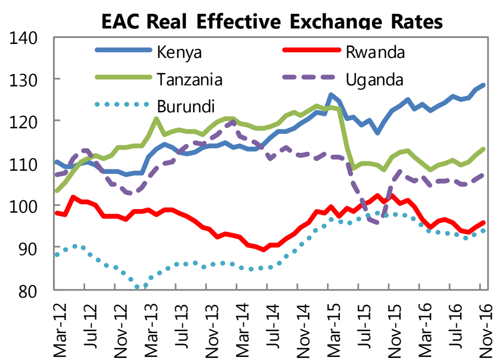
Stock market growth has turned negative.



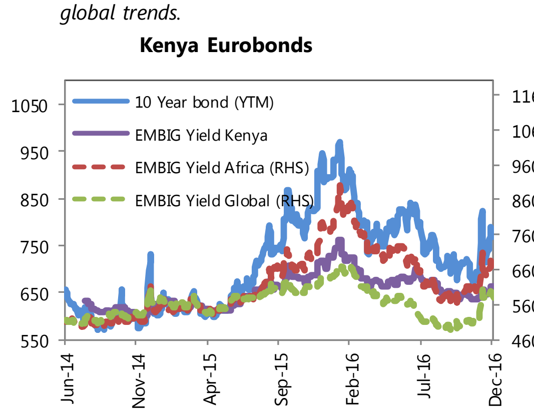
The shilling has stabilized against the U.S.$ since



...and the REER is currently at end-2014



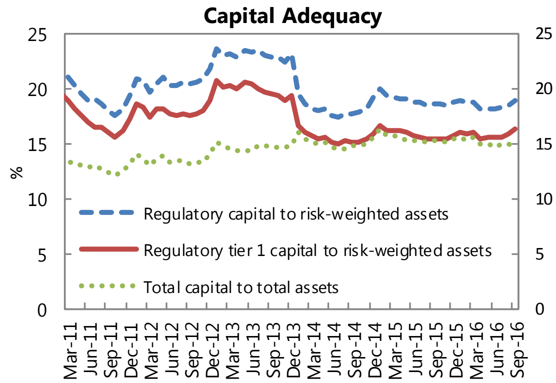
The recent decline in Kenya bond yields is in line with global trends.



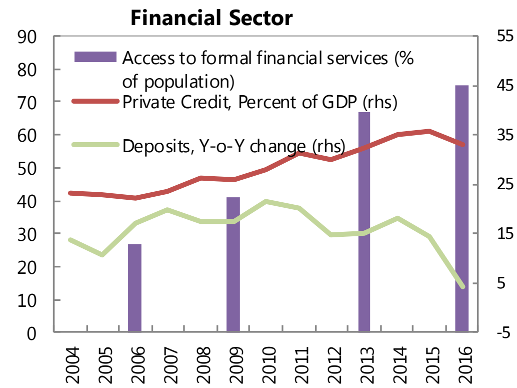
Source: Bloomberg; IMF staff estimates.

Figure 6. Kenya: Financial Sector

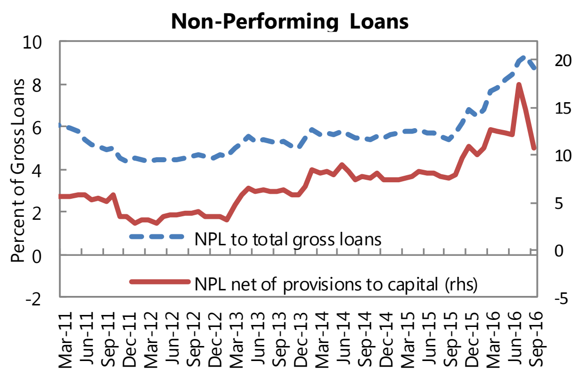
The banking sector is adequately capitalized …



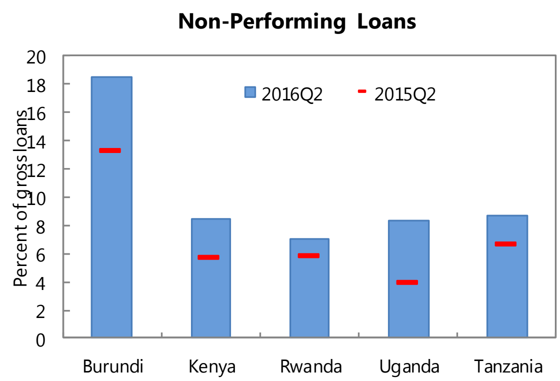
… and financial deepening continues.



NPLs net of provisions are on the rise but declined recently…



…and NPLs are comparatively low.



Source: CBK and IMF staff estimates.

Table 1a. Kenya: Selected Economic Indicators, 2014/15–2019/20

	2014/15	2015/16		2016/17		2017/18	2018/19	2019/20
	Act.	Prog.	Prel.	Prog.	Proj.	Proj.		
	(Annual percentage change, unless otherwise indicated)							
Output, prices, and exchange rate								
Real GDP	5.5	5.8	5.8	6.1	5.6	5.5	6.0	6.3
GDP deflator	8.6	6.8	7.5	6.2	5.9	5.5	5.4	5.4
CPI (period average)	6.6	6.9	6.5	6.0	6.4	5.8	5.0	5.0
CPI (end of period)	7.0	6.3	5.8	5.7	6.5	5.0	5.0	5.0
Core inflation (period average) [2]	4.4	5.8	5.4	5.7	5.0	5.2	5.0	5.0
Exports volume	-2.5	1.9	-1.5	3.1	7.4	7.2	7.6	7.0
Imports volume	3.2	9.3	1.6	4.5	4.1	6.0	7.2	7.3
Exchange rate (Kenyan shilling/US$)	92.7	.	102.1	.	.	.	.	.
Real effective exchange rate (depreciation, -)	6.0	.	1.2	.	.	.	.	.
Money and credit								
Broad money (M3)	18.6	14.6	7.9	14.2	10.5	.	.	.
Reserve money	14.9	13.1	4.9	14.5	10.8	.	.	.
Credit to non-government sector	20.3	15.3	8.6	17.2	6.0	.	.	.
Policy rate	10.0	.	10.5	.	.	.	.	.
M3/GDP (percent)	44.4	45.4	41.8	46.0	40.9	.	.	.
NPLs (percent of total gross loans)	5.7	.	8.4		.	.	.	.
	(Percent of GDP, unless otherwise indicated)							
Central government budget								
Total revenue and grants	19.7	20.4	19.2	20.7	21.0	21.2	21.4	21.4
Tax revenues	16.7	17.3	16.3	17.6	17.0	17.4	17.6	17.6
Non-tax revenues	2.6	2.6	2.5	2.7	3.4	3.2	3.2	3.2
Grants	0.5	0.4	0.4	0.4	0.5	0.6	0.6	0.6
Expenditure	28.5	28.4	27.1	27.4	27.9	27.4	26.1	25.4
Current	19.6	19.7	19.6	19.2	19.9	19.8	19.0	18.5
Capital	8.8	8.6	7.2	8.2	8.0	7.4	7.0	6.8
Unidentified measures	0.0	0.0	0.0	0.3	0.0	0.3	1.0	0.6
Primary balance	-5.5	-5.0	-4.2	-3.4	-3.8	-2.6	-0.5	-0.2
Excluding SGR (phase 1) related spending	-3.4	-3.0	-3.4	-2.0	-2.8	-1.7	-0.5	-0.2
Overall balance	-8.5	-8.0	-7.5	-6.5	-6.9	-5.9	-3.7	-3.4
Excluding SGR (phase 1) related spending	-6.4	-6.1	-6.7	-5.1	-6.0	-5.0	-3.7	-3.4
Excluding grants	-9.0	-8.4	-7.9	-6.9	-7.5	-6.5	-4.3	-4.0
Net domestic borrowing	4.4	3.0	3.3	2.6	4.3	3.0	2.6	1.8
Public debt [3]								
Public gross nominal debt	48.7	52.1	54.1	54.2	52.5	53.3	52.3	51.1
Public net nominal debt	44.5	50.0	47.9	52.2	49.4	51.3	50.4	49.2
of which : external public debt	24.0	28.8	26.6	30.7	26.1	27.3	26.3	25.9
Public gross debt, PV	43.4	47.0	47.5	48.4	48.8	48.8	47.9	46.2
Public net debt, PV	39.1	45.0	41.3	46.4	45.7	46.8	45.9	44.3
Gross domestic debt	24.7	23.3	27.6	23.5	26.4	26.0	26.0	25.2
Investment and saving								
Investment	22.6	23.7	20.5	23.9	20.9	20.8	21.8	21.4
General government	9.8	9.8	8.5	9.7	9.6	9.3	9.0	8.4
Nongovernment	12.8	13.9	12.0	14.2	11.3	11.5	12.8	12.9
Saving	12.9	14.4	15.7	16.5	15.4	15.2	16.2	15.9
General government	1.0	1.9	0.6	2.8	2.1	2.5	4.1	4.1
Nongovernment	11.9	12.5	15.1	13.7	13.3	12.7	12.1	11.8
External sector								
Exports (goods and services)	16.8	18.0	16.4	17.7	17.1	17.6	18.0	18.3
Imports (goods and services)	-31.3	-32.6	-25.1	-30.4	-25.6	-26.1	-26.3	-26.5
Current account balance (including grants)	-9.6	-9.3	-4.8	-7.3	-5.5	-5.6	-5.5	-5.5
Gross international reserves								
In billions of US$	7.2	7.7	8.3	8.0	8.9	9.1	9.5	9.1
In months of next year imports	5.2	4.5	5.4	4.5	5.3	4.9	4.7	4.2
Memorandum items:								
GDP at current market prices								
Billion of Kenyan shillings	5,751	6,444	6,586	7,259	7,435	8,236	9,202	10,303
US$ billion	62.6	63.0	66.3	66.8	72.0	77.9	84.2	91.3
GDP per capita (nominal US$)	1,435	1,404	1,478	1,447	1,562	1,644	1,729	1,825

Sources: Kenyan authorities and IMF staff estimates and projections.

[1] Fiscal years are from July 1 to June 30.

[2] Excluding food and fuel.

[3] Excludes guaranteed debt and other contingent liabilities.

Table 1b. Kenya: Selected Economic Indicators, 2015–20

	2015	2016		2017		2018	2019	2020
	Act.	Prog.	Proj.	Prog.	Proj.	Proj.		
	(Annual percentage change, unless otherwise indicated)							
Output, prices, and exchange rate								
Real GDP	5.6	6.0	6.0	6.1	5.3	5.8	6.2	6.5
GDP deflator	9.1	6.7	6.0	5.8	5.8	5.4	5.5	5.3
CPI (period average)	6.6	6.6	6.3	5.7	6.3	5.2	5.0	5.0
CPI (end of period)	8.0	5.8	6.0	5.5	5.9	5.0	5.0	5.0
Core inflation (period average) [1]	4.4	5.8	5.4	5.7	5.0	5.2	5.0	5.0
Exports volume	-11.1	-0.2	7.8	6.5	7.8	7.8	7.5	7.1
Imports volume	0.0	9.7	3.2	-0.1	4.9	7.1	7.2	7.4
Exchange rate (Kenyan shilling/US$)	97.8	.	.	.	.	.	.	.
Real effective exchange rate (depreciation, -)	4.7	.	.	.	.	.	.	.
Money and credit								
Broad money (M3)	14.1	17.4	4.4	.	14.7	.	.	.
Reserve money	3.4	13.6	4.3	.	12.9	.	.	.
Credit to non-government sector	17.8	16.3	4.0	.	6.7	.	.	.
Policy rate	11.5	.	.	.	.	.	.	.
M3/GDP (percent)	42.7	45.5	39.7	.	40.9	.	.	.
NPLs (percent of total gross loans)	6.8	.	.	.	.	.	.	.
	(Percent of GDP, unless otherwise indicated)							
Central government budget								
Total revenue and grants	19.5	20.5	20.3	20.7	21.1	21.3	21.4	21.4
Tax revenues	16.5	17.4	17.0	17.6	17.2	17.5	17.6	17.6
Non-tax revenues	2.5	2.7	2.9	2.7	3.3	3.2	3.2	3.2
Grants	0.5	0.4	0.5	0.4	0.6	0.6	0.6	0.6
Expenditure	27.8	27.9	27.5	26.9	27.6	26.7	25.7	25.4
Current	19.6	19.5	19.6	19.0	19.9	19.4	18.8	18.5
Capital	8.0	8.4	7.8	7.9	7.7	7.2	6.9	6.8
Unidentified measures	0.0	0.1	0.1	0.5	0.1	0.6	0.8	0.6
Primary balance	-4.9	-4.2	-3.8	-2.7	-3.2	-1.5	-0.3	-0.2
Excluding SGR (phase 1) related spending	-3.4	-2.4	-2.8	-2.1	-2.7	-1.2	-0.2	0.0
Overall balance	-8.0	-7.2	-7.0	-5.7	-6.4	-4.8	-3.5	-3.4
Excluding SGR (phase 1) related spending	-6.5	-5.5	-5.9	-5.2	-5.9	-4.4	-3.3	-3.2
Excluding grants	-8.5	-7.7	-7.4	-6.1	-7.0	-5.4	-4.1	-4.0
Net domestic borrowing	3.9	2.8	3.4	2.6	3.7	2.8	2.2	1.8
Public debt [2]								
Public gross nominal debt	52.4	53.1	54.4	54.4	54.7	54.4	52.9	51.2
Public net nominal debt	47.2	51.1	49.8	52.4	52.1	52.4	51.0	49.3
of which : external public debt	26.4	29.7	27.4	30.8	28.3	28.3	27.2	26.8
Public gross debt, PV	46.3	48.3	48.7	48.5	49.0	48.6	47.1	45.3
Public net debt, PV	41.0	45.7	44.1	46.5	46.4	46.6	45.2	43.5
Gross domestic debt	26.0	23.4	27.0	23.6	26.4	26.1	25.7	24.4
Investment and saving								
Investment	21.0	23.8	21.2	23.8	19.9	21.8	21.6	21.2
General government	9.1	9.8	9.1	9.6	9.5	9.2	8.7	8.2
Nongovernment	11.9	14.1	12.1	14.2	10.4	12.7	12.9	13.0
Saving	14.2	15.8	15.7	17.1	14.2	16.3	16.1	15.7
General government	0.8	2.4	1.4	3.4	2.3	3.4	4.1	4.3
Nongovernment	13.4	13.4	14.3	13.7	11.8	12.9	11.9	11.5
External sector								
Exports (goods and services)	16.5	17.6	15.8	17.8	16.4	17.0	17.3	17.6
Imports (goods and services)	-30.8	-31.0	-24.1	-29.9	-24.5	-25.2	-25.3	-25.5
Current account balance (including grants)	-6.8	-8.0	-5.5	-6.7	-5.7	-5.6	-5.5	-5.5
Gross international reserves								
In billions of US$	7.5	7.8	7.8	8.3	8.5	9.4	9.4	10.0
In months of next year imports	5.1	4.5	4.8	4.5	4.8	4.9	4.5	4.4
Memorandum items:								
GDP at current market prices								
Billion of Kenyan shillings	6,224	6,839	6,993	7,680	7,784	8,673	9,711	10,888
US$ billion	63.6	64.6	68.9	69.0	75.1	80.7	87.7	95.0
GDP per capita (nominal US$)	1,439	1,420	1,516	1,475	1,607	1,681	1,776	1,873

Sources: Kenyan authorities and IMF staff estimates and projections.

[1] Excluding food and fuel.

[2] Excludes guaranteed debt and other contingent liabilities.

Table 2a. Kenya: Central Government Financial Operations, 2014/15–2019/20[1]

	2014/15	2015/16		2016/17		2017/18	2018/19	2019/20
	Act.	Prog.	Prelim.	Prog.	Proj.		Proj.	
	(in billions of Kenyan Shillings, unless otherwise indicated)							
Revenues and grants	**1,133.8**	**1,313.2**	**1,267.5**	**1,499.5**	**1,558.5**	**1,743.1**	**1,971.2**	**2,204.0**
Revenue	**1,106.4**	**1,285.6**	**1,237.9**	**1,469.8**	**1,518.5**	**1,691.6**	**1,914.0**	**2,142.8**
Tax revenue	958.2	1,115.9	1,073.9	1,275.8	1,267.3	1,430.9	1,621.1	1,813.5
Income tax	508.6	585.6	566.0	666.1	659.8	747.3	837.4	937.6
Personal income	279.8	n.a.	312.0	n.a.	361.9	411.8	460.1	515.2
Corporate income	228.8	n.a.	254.0	n.a.	297.9	335.5	377.3	422.4
Import duty (net)	74.0	86.4	79.2	97.2	90.4	102.4	113.2	125.4
Excise duty	115.9	143.6	139.5	171.7	178.4	197.4	228.8	258.7
Value-added tax	259.7	300.3	289.2	341.0	338.7	383.8	441.7	491.8
Domestic	127.9	n.a.	160.4	n.a.	191.2	213.2	248.5	278.2
Imports	131.8	n.a.	128.8	n.a.	147.5	170.6	193.2	213.6
Nontax revenue	148.2	169.8	163.9	194.0	251.2	260.6	292.9	329.3
Investment income	13.5	21.1	19.3	23.8	31.4	17.7	19.7	22.1
Other	59.6	70.1	65.0	79.8	75.9	86.4	97.9	111.3
Ministerial and Departmental Fees (AIA)	56.7	58.5	62.4	65.9	125.0	135.3	151.2	169.3
Railway Levy	18.4	20.0	17.3	24.5	18.9	21.3	24.0	26.6
Grants	**27.4**	**27.6**	**29.6**	**29.7**	**40.1**	**51.5**	**57.2**	**61.2**
Project grants	22.3	19.9	24.1	22.4	32.7	44.9	50.2	56.2
Program grants	3.8	6.4	4.3	6.1	6.4	6.1	6.1	5.0
Expenditure and net lending	**1,640.3**	**1,828.2**	**1,781.9**	**1,991.2**	**2,074.6**	**2,252.9**	**2,402.2**	**2,613.9**
Recurrent expenditure	**1,126.3**	**1,256.6**	**1,291.6**	**1,383.2**	**1,465.9**	**1,621.6**	**1,738.1**	**1,892.7**
Transfer to counties	229.3	264.2	264.0	284.8	284.8	304.2	328.5	354.9
Interest payments	172.9	195.8	215.3	223.5	231.0	273.9	292.5	329.6
Domestic interest	139.6	153.8	172.9	166.9	172.6	204.6	215.2	247.2
Foreign interest due	33.3	42.0	42.5	56.6	58.4	69.3	77.3	82.4
Wages and benefits (civil service)	298.0	333.5	319.3	360.8	344.8	398.8	434.7	456.4
Civil service reform	1.0	1.0	0.0	1.5	1.5	0.0	0.0	0.0
Pensions and Other Consolidated Fund Services	38.2	47.4	53.4	56.1	60.2	76.6	86.4	99.4
Defense and NSIS	93.7	112.5	113.7	117.2	125.2	125.6	129.5	133.9
Other	293.1	302.2	325.8	339.3	418.5	442.5	466.4	518.5
Development and net lending	**508.6**	**558.6**	**479.0**	**596.2**	**597.7**	**618.5**	**650.3**	**706.1**
Domestically financed	266.0	326.9	301.3	349.3	400.8	365.4	412.0	433.8
Foreign financed	240.4	224.5	175.5	244.3	194.7	247.6	232.1	265.3
of which: SGR (phase 1) project	123.5	118.2	52.4	101.6	73.6	72.0	0.0	0.0
Overall balance (cash basis, incl. grants)	**-489.6**	**-515.0**	**-492.1**	**-491.7**	**-516.1**	**-509.8**	**-431.0**	**-409.9**
Adjustments to cash basis	16.9	0.0	22.4	0.0	0.0	0.0	0.0	0.0
Unidentified measures (deficit reducing)	**0.0**	**0.0**	**0.0**	**20.5**	**0.0**	**24.3**	**91.9**	**61.8**
Overall balance including measures (cash basis, incl. grants)	**-489.6**	**-515.0**	**-492.1**	**-471.3**	**-516.1**	**-485.5**	**-339.0**	**-348.1**
Overall balance excluding SGR (phase 1) related expenditure	**-366.1**	**-396.8**	**-439.7**	**-369.6**	**-442.5**	**-413.5**	**-339.0**	**-348.1**
Statistical discrepency	19.1	0.0	-17.5	0.0	0.0	0.0	0.0	0.0
Financing	**470.5**	**515.0**	**474.6**	**471.3**	**516.1**	**485.5**	**339.0**	**348.1**
Net foreign financing	216.5	309.3	269.9	278.3	194.1	238.5	102.0	158.5
Disbursements	296.7	352.3	305.0	330.1	323.1	302.7	251.9	234.7
Project loans	94.7	86.4	99.0	120.4	88.5	130.7	181.9	209.2
Program loans	3.5	8.2	8.6	0.0	7.4	0.0	0.0	0.0
Commercial borrowing [2]	75.0	139.5	145.0	108.1	153.7	100.0	70.0	25.5
Standard Gauge Railway (phase 1) loan from China	123.5	118.2	52.4	101.6	73.6	72.0	0.0	0.0
Repayments due	-80.2	-43.0	-35.1	-51.7	-129.0	-64.2	-149.9	-76.1
Net domestic financing	254.0	205.7	204.6	192.8	321.9	247.1	237.0	189.6
Memorandum items:								
Nominal GDP	5,751.1	6,443.5	6,586.1	7,259.4	7,434.6	8,236.4	9,201.9	10,303.3
Primary balance incl. grants	-316.7	-319.2	-276.7	-247.8	-285.1	-211.6	-46.5	-18.6
Primary balance excluding SGR (phase 1) expenditure (incl. grants)	-193.2	-201.0	-224.4	-146.2	-211.5	-139.6	-46.5	-18.6
Cyclically adjusted Primary balance incl. grants	-318.6	-317.4	-282.9	-246.2	-294.0	-219.9	-57.5	-35.1
Total gross public debt, gross	2,799.8	3,356.8	3,564.3	3,933.4	3,906.8	4,393.2	4,815.5	5,261.5
of which: external debt 3	1,379.4	1,853.6	1,749.2	2,226.2	1,943.2	2,250.7	2,422.2	2,663.8
of which: domestic debt	1,420.4	1,503.2	1,815.1	1,707.2	1,963.6	2,142.5	2,393.3	2,597.7
Total net public debt [4]	2,557.5	3,223.2	3,155.9	3,787.8	3,671.9	4,226.1	4,634.7	5,065.8

Sources: Kenyan authorities and IMF staff estimates and projections.

[1] Fiscal year runs from July to June.

[2] Includes proceeds from (i) syndicated loans and (ii) planned sovereign bonds.

[3] External debt excludes guarantees.

[4] Total net debt in 2013/14 includes proceeds from US$2.0bn Eurobond.

Table 2b. Kenya: Central Government Financial Operations, 2014/15–2019/20[1]

(Percent of GDP)

	2014/15	2015/16		2016/17		2017/18	2018/19	2019/20
	Act.	Prog.	Prelim.	Prog.	Proj.		Proj.	
	(in percent of GDP, unless otherwise indicated)							
Revenues and grants	**19.7**	**20.4**	**19.2**	**20.7**	**21.0**	**21.2**	**21.4**	**21.4**
Revenue	**19.2**	**20.0**	**18.8**	**20.2**	**20.4**	**20.5**	**20.8**	**20.8**
Tax revenue	16.7	17.3	16.3	17.6	17.0	17.4	17.6	17.6
Income tax	8.8	9.1	8.6	9.2	8.9	9.1	9.1	9.1
Personal income	4.9	n.a.	4.7	n.a.	4.9	5.0	5.0	5.0
Corporate income	4.0	n.a.	3.9	n.a.	4.0	4.1	4.1	4.1
Import duty (net)	1.3	1.3	1.2	1.3	1.2	1.2	1.2	1.2
Excise duty	2.0	2.2	2.1	2.4	2.4	2.4	2.5	2.5
Value-added tax	4.5	4.7	4.4	4.7	4.6	4.7	4.8	4.8
Domestic	2.2	n.a.	2.4	n.a.	2.6	2.6	2.7	2.7
Imports	2.3	n.a.	2.0	n.a.	2.0	2.1	2.1	2.1
Nontax revenue	2.6	2.6	2.5	2.7	3.4	3.2	3.2	3.2
Investment income	0.2	0.3	0.3	0.3	0.4	0.2	0.2	0.2
Other	1.0	1.1	1.0	1.1	1.0	1.0	1.1	1.1
Ministerial and Departmental Fees (AIA)	1.0	0.9	0.9	0.9	1.7	1.6	1.6	1.6
Grants	**0.5**	**0.4**	**0.4**	**0.4**	**0.5**	**0.6**	**0.6**	**0.6**
Project grants	0.4	0.3	0.4	0.3	0.4	0.5	0.5	0.5
Program grants	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0
Expenditure and net lending	**28.5**	**28.4**	**27.1**	**27.4**	**27.9**	**27.4**	**26.1**	**25.4**
Recurrent expenditure	**19.6**	**19.5**	**19.6**	**19.1**	**19.7**	**19.7**	**18.9**	**18.4**
Transfer to counties	4.0	4.1	4.0	3.9	3.8	3.7	3.6	3.4
Interest payments	3.0	3.0	3.3	3.1	3.1	3.3	3.2	3.2
Domestic interest	2.4	2.4	2.6	2.3	2.3	2.5	2.3	2.4
Foreign interest due	0.6	0.7	0.6	0.8	0.8	0.8	0.8	0.8
Wages and benefits (civil service)	5.2	5.2	4.8	5.0	4.6	4.8	4.7	4.4
Pensions and Other Consolidated Fund Services	0.7	0.7	0.8	0.8	0.8	0.9	0.9	1.0
Other	5.1	4.7	4.9	4.7	5.6	5.4	5.1	5.0
Development and net lending	**8.8**	**8.7**	**7.3**	**8.2**	**8.0**	**7.5**	**7.1**	**6.9**
Domestically financed	4.6	5.1	4.6	4.8	5.4	4.4	4.5	4.2
Foreign financed	4.2	3.5	2.7	3.4	2.6	3.0	2.5	2.6
of which: SGR (phase 1) project	2.1	1.8	0.8	1.4	1.0	0.9	0.0	0.0
Overall Balance (incl. grants)	**-8.8**	**-8.0**	**-7.8**	**-6.7**	**-6.9**	**-6.2**	**-4.7**	**-4.0**
Adjustments to cash basis	0.3	0.0	0.3	0.0	0.0	0.0	0.0	0.0
Overall balance (cash basis, incl. grants)	**-8.5**	**-8.0**	**-7.5**	**-6.8**	**-6.9**	**-6.2**	**-4.7**	**-4.0**
Unidentified measures (deficit reducing)	**0.0**	**0.0**	**0.0**	**0.3**	**0.0**	**0.3**	**1.0**	**0.6**
Overall balance incl. measures and grants (cash basis)	**-8.5**	**-8.0**	**-7.5**	**-6.5**	**-6.9**	**-5.9**	**-3.7**	**-3.4**
Overall balance incl. measures and excl. SGR (phase 1) related spending	**-6.4**	**-6.2**	**-6.7**	**-5.1**	**-6.0**	**-5.0**	**-3.7**	**-3.4**
Statistical discrepency	0.3	0.0	-0.3	0.0	0.0	0.0	0.0	0.0
Financing	**8.2**	**8.0**	**7.2**	**6.5**	**6.9**	**5.9**	**3.7**	**3.4**
Net foreign financing	3.8	4.8	4.1	3.8	2.6	2.9	1.1	1.5
Disbursements	5.2	5.5	4.6	4.5	4.3	3.7	2.7	2.3
Project loans	1.6	1.3	1.5	1.7	1.2	1.6	2.0	2.0
Program loans	0.1	0.1	0.1	0.0	0.1	0.0	0.0	0.0
Commercial borrowing [2]	1.3	2.2	2.2	1.5	2.1	1.2	0.8	0.2
Standard Gauge Railway (phase 1) loan from China	2.1	1.8	0.8	1.4	1.0	0.9	0.0	0.0
Repayments due	-1.4	-0.7	-0.5	-0.7	-1.7	-0.8	-1.6	-0.7
Net domestic financing	4.4	3.2	3.1	2.7	4.3	3.0	2.6	1.8
Memorandum items:								
Primary balance incl. grants (Central government)	-5.5	-5.0	-4.2	-3.4	-3.8	-2.6	-0.5	-0.2
Primary balance excluding SGR (phase 1) expenditure (incl. grants)	-3.4	-3.1	-3.4	-2.0	-2.8	-1.7	-0.5	-0.2
Cyclically adjusted Primary balance incl. grants (in percent of potential GDP)	-5.5	-4.9	-4.3	-3.4	-4.0	-2.7	-0.6	-0.3
Total gross public debt, gross	48.7	52.1	54.1	54.2	52.5	53.3	52.3	51.1
of which: external debt [3]	24.0	28.8	26.6	30.7	26.1	27.3	26.3	25.9
of which: domestic debt	24.7	23.3	27.6	23.5	26.4	26.0	26.0	25.2
Total gross public debt, PV	43.4	47.0	47.5	48.4	48.8	48.8	47.9	46.2
Total net public debt [4]	44.5	50.0	47.9	52.2	49.4	51.3	50.4	49.2
Government deposits (in months of domestically financed expenditures)	1.0	1.0	3.1	1.5	1.5	1.0	1.0	1.0

Sources: Kenyan authorities and IMF staff estimates and projections.

[1] Fiscal year runs from July to June.

[2] Includes proceeds from (i) syndicated loans and (ii) planned sovereign bonds.

[3] External debt excludes guarantees.

[4] Total net debt in 2013/14 includes proceeds from US$2.0bn Eurobond.

Table 3. Kenya: Monetary Survey, September 2015–June 2017

	Sep-15	Dec-15	Mar-16		Jun-16		Sep-16		Dec-16		Mar-17	Jun-17
	Act.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Prelim.	Prog.	Proj.	Proj.	
	(In billions of Kenyan shillings, unless otherwise indicated)											
Central Bank of Kenya (CBK)												
Net foreign assets	529	621	663	641	671	690	667	687	716	697	727	832
(in millions of US dollars) [1 2]	5,027	6,073	6,299	6,323	6,375	6,829	6,337	6,786	6,798	6,833	7,081	8,045
Net domestic assets	-153	-229	-272	-239	-251	-300	-240	-294	-270	-288	-296	-400
Net domestic credit	16	-65	-96	-89	-79	-152	-48	-148	-79	-136	-141	-238
Government (net)	47	-44	0	-81	16	-155	16	-190	16	-179	-151	-205
Commercial banks (net)	-31	-22	-99	-8	-98	3	-67	42	-97	40	7	-36
Other items (net)	-168	-164	-176	-150	-171	-149	-191	-147	-191	-152	-156	-162
Reserve money	377	392	391	402	421	390	428	393	446	409	430	432
Currency outside banks	175	191	159	183	179	188	176	187	189	179	193	180
Bank reserves	202	201	232	219	241	202	252	206	257	230	237	252
Banks												
Net foreign assets	-140	-130	-133	-169	-135	-132	-138	-95	-140	-103	-106	-110
(in millions of US dollars)	-1,329	-1,270	-1,259	-1,671	-1,284	-1,306	-1,309	-941	-1,334	-1,011	-1,036	-1,061
Reserves	202	201	232	219	241	202	252	206	257	230	237	252
Credit to CBK	31	22	99	8	98	-3	67	-42	97	-40	-7	36
Net domestic assets	2,263	2,344	2,380	2,400	2,477	2,476	2,620	2,476	2,639	2,469	2,508	2,625
Net domestic credit	2,735	2,834	2,913	2,901	3,027	3,008	3,190	3,038	3,240	3,070	3,136	3,253
Government (net)	507	568	603	624	596	715	627	707	610	714	743	825
Other public sector	52	50	46	49	46	50	46	51	46	51	51	51
Private sector	2,177	2,216	2,264	2,227	2,386	2,242	2,516	2,280	2,583	2,305	2,342	2,377
Other items (net)	-472	-490	-533	-501	-550	-532	-570	-562	-601	-601	-628	-627
Total deposits	2,356	2,438	2,578	2,457	2,682	2,543	2,801	2,545	2,853	2,557	2,632	2,804
Monetary survey												
Net foreign assets	389	491	531	471	536	558	529	592	575	594	620	722
(in millions of US dollars)	3,698	4,804	5,040	4,652	5,091	5,523	5,028	5,845	5,464	5,822	6,045	6,984
Net domestic assets	2,167	2,167	2,281	2,191	2,389	2,195	2,526	2,170	2,536	2,181	2,236	2,321
Net domestic credit	2,785	2,794	2,915	2,824	3,046	2,856	3,208	2,852	3,259	2,895	2,988	3,051
Government (net)	553	524	603	544	612	561	643	517	626	535	592	620
Other public sector	52	50	46	49	46	50	46	51	46	51	51	51
Private	2,180	2,220	2,266	2,231	2,388	2,245	2,519	2,284	2,586	2,309	2,345	2,381
Other items (net)	-619	-627	-634	-632	-657	-661	-683	-682	-722	-714	-752	-730
M1	980	1,024	1,078	1,077	1,121	1,131	1,171	1,237	1,193	1,243	1,279	1,363
Money and quasi-money (M2)	2,133	2,235	2,363	2,263	2,458	2,331	2,567	2,321	2,614	2,332	2,400	2,557
M2 plus resident foreign currency deposits (M3)	2,556	2,658	2,812	2,663	2,925	2,754	3,055	2,762	3,112	2,775	2,856	3,043
M3 plus nonbank holdings of government debt (L)	3,232	3,391	3,590	3,430	3,735	3,590	3,901	3,635	3,973	3,652	3,758	4,005
Memorandum items	(Annual percent change unless otherwise specified)											
M2	12.7	12.8	15.4	10.5	14.9	8.9	20.3	8.8	17.4	4.3	6.1	9.7
M3	13.5	14.1	17.2	11.0	14.6	7.9	19.5	8.1	17.4	4.4	7.3	10.5
Deposits	14.3	14.4	17.2	11.7	14.3	8.4	18.9	8.0	17.4	4.9	7.1	10.2
Reserve money	16.7	3.4	12.9	16.1	13.1	4.9	13.5	4.3	13.6	4.3	7.0	10.8
Net domestic credit	23.3	20.8	19.3	15.5	15.5	8.2	15.2	2.4	17.0	3.6	5.8	6.8
Government (net)	38.3	38.2	28.3	15.7	17.1	7.4	16.3	-6.5	21.4	2.1	9.0	10.5
Private	20.6	17.8	17.5	15.5	15.3	8.6	15.4	4.8	16.4	4.0	5.1	6.0
Net domestic assets of the banking sector	20.0	17.1	17.8	13.1	12.8	3.7	16.6	0.1	17.5	0.7	2.0	5.7
NDA growth (as percent of the base period M3)	12.6	10.7	11.4	8.4	8.5	2.4	11.1	0.1	11.2	0.4	1.3	3.5
Multiplier (Average M2/RM)	5.6	5.8	5.8	5.7	5.8	5.7	5.9	5.8	5.9	5.8	5.8	5.8
Multiplier (Average M3/RM)	6.7	6.8	6.9	6.8	6.9	6.8	7.0	6.9	7.1	6.9	6.9	6.9
Velocity (GDP/M3)	2.4	2.4	2.4	2.5	2.4	2.5	2.3	2.5	2.3	2.6	2.6	2.6
Velocity (GDP/M2)	2.9	2.9	2.8	2.9	2.8	2.9	2.8	3.0	2.7	3.0	3.1	3.1
Nominal GDP growth	14.5	15.3	17.6	14.8	20.0	14.5	22.5	13.7	13.1	12.4	15.0	12.9

Sources: Kenyan authorities and IMF staff estimates and projections.

[1] For historical data, at implicit CBK exchange rate.

[2] Starting in June 2014, it includes government deposits abroad on account of the Eurobond issuance, as an asset and as a liability.

Table 4a. Kenya: Balance of Payments, 2015–20
(Millions of U.S. dollars, unless otherwise indicated)

	2015		2016		2017	2018	2019	2020
	Prog.	Act.	Prog.	Proj.	Projections			
Current account	-5,012	-4,335	-5,169	-3,792	-4,295	-4,515	-4,848	-5,223
Trade balance	-10,314	-9,603	-10,853	-8,846	-9,729	-10,427	-11,297	-12,279
Goods: exports, f.o.b.	6,427	5,997	6,245	6,215	7,015	7,749	8,514	9,318
Coffee	209	210	152	219	250	281	306	328
Tea	1,220	1,247	1,372	1,349	1,647	1,818	2,000	2,190
Horticulture	787	760	749	783	907	1,013	1,124	1,237
Other	4,211	3,779	3,973	3,864	4,211	4,638	5,084	5,563
Goods: imports, f.o.b.	16,741	15,600	17,098	15,060	16,745	18,176	19,811	21,597
Oil products	2,419	2,500	1,716	2,229	2,687	2,915	3,178	3,463
Other	14,322	13,100	15,382	12,832	14,057	15,261	16,633	18,134
Capital imports	5,581	5,432	6,356	5,207	5,722	6,303	6,963	7,718
Services balance	1,968	2,335	2,183	2,204	2,543	2,950	3,307	3,716
Services, credit	4,795	4,508	5,115	4,669	5,288	5,968	6,631	7,354
Transportation	2,054	1,819	2,111	1,862	2,108	2,386	2,666	2,940
Travel	739	726	874	857	1,101	1,417	1,683	1,981
Services, debit	2,827	2,174	2,933	2,465	2,746	3,018	3,324	3,638
Goods and services balance	-8,346	-7,269	-8,670	-6,642	-7,187	-7,476	-7,991	-8,563
Primary income, balance	-778	-507	-850	-464	-513	-616	-691	-753
Credit	185	311	303	401	556	591	666	743
Debit	963	818	1,154	865	1,069	1,208	1,357	1,496
Secondary income, balance	4,112	3,440	4,351	3,314	3,405	3,578	3,834	4,093
Credit	4,170	3,504	4,414	3,381	3,476	3,653	3,914	4,178
Remittances	1,551	1,573	1,630	1,827	1,955	2,099	2,256	2,426
Debit	59	64	63	68	71	75	80	85
Capital account	208	257	209	284	366	439	477	530
Financial account	-4,487	-5,082	-5,267	-3,812	-4,800	-5,032	-4,533	-5,450
Foreign direct investment	-1,069	-1,090	-1,497	-1,296	-1,544	-1,890	-2,034	-2,242
Direct investment, assets	217	399	283	319	322	277	300	347
Direct investment, liabilities	1,285	1,489	1,780	1,615	1,867	2,167	2,334	2,589
Portfolio investment	-434	157	-1,842	-226	-825	-776	-220	-1,015
Portfolio investment, assets	56	191	59	207	222	232	246	262
Portfolio investment, liabilities	489	34	1,901	433	1,047	1,009	467	1,277
Equity and investment fund shares	484	9	900	410	524	743	971	1,008
Debt securities	5	25	1,000	23	523	265	-505	270
Financial derivatives	0	0	0	0	0	0	0	0
Other investment	-2,984	-4,149	-1,928	-2,290	-2,430	-2,366	-2,279	-2,192
Net errors and omissions	0	-1,259	0	0	0	0	0	0
Overall balance	-318	-254	306	303	872	957	162	756
Reserves and related items	-318	-295	306	303	872	957	162	756
Reserve assets (gross)	-384	-361	239	274	752	813	7	620
Use of Fund credit and loans to the Fund (net)	-66	-66	-67	-29	-119	-144	-155	-136
Disbursements	0	0	0	0	0	0	0	0
Repayments	66	66	67	29	119	144	155	136
Memorandum items:								
Gross official reserves (end of period) [1]	7,511	7,511	7,750	7,785	8,537	9,351	9,358	9,978
(in months of next year's imports)	4.5	5.1	4.5	4.8	4.8	4.9	4.5	4.4
(in months of 3-year-rolling average imports) [2]	4.6	4.8	4.6	5.0	5.6	5.8	5.3	5.2
(in percent of M3)	28.3	28.3	25.7	28.1	26.8	26.1	23.0	21.6
WEO oil price (APSP; US$)	50.8	50.8	29.9	42.7	51.2	53.1	54.5	55.7
Terms of trade [3]	8.7	9.4	3.7	2.7	-2.1	0.6	0.1	0.2

Sources: Kenyan authorities and IMF staff estimates and projections.

[1] For end-2015, includes proceeds from commercial borrowing by the government in Q4, some of which will be drawn down in 2016Q1.

[2] CBK definition of reserve cover: in months of imports of goods and services over the previous 36 months (annualized rolling averag

[3] Percentage change, goods and services.

Table 4b. Kenya: Balance of Payments, 2015–20

(Percent of GDP)

	2015		2016		2017	2018	2019	2020
	Prog.	Act.	Prog.	Proj.	Projections			
Current account	-8.2	-6.8	-8.0	-5.5	-5.7	-5.6	-5.5	-5.5
Trade balance	-16.8	-15.1	-16.8	-12.8	-13.0	-12.9	-12.9	-12.9
Goods: exports, f.o.b.	10.5	9.4	9.7	9.0	9.3	9.6	9.7	9.8
Coffee	0.3	0.3	0.2	0.3	0.3	0.3	0.3	0.3
Tea	2.0	2.0	2.1	2.0	2.2	2.3	2.3	2.3
Horticulture	1.3	1.2	1.2	1.1	1.2	1.3	1.3	1.3
Other	6.9	5.9	6.2	5.6	5.6	5.7	5.8	5.9
Goods: imports, f.o.b.	27.3	24.5	26.5	21.9	22.3	22.5	22.6	22.7
Oil products	3.9	3.9	2.7	3.2	3.6	3.6	3.6	3.6
Other	23.3	20.6	23.8	18.6	18.7	18.9	19.0	19.1
Capital imports	9.1	8.5	9.8	7.6	7.6	7.8	7.9	8.1
Services balance	3.2	3.7	3.4	3.2	3.4	3.7	3.8	3.9
Services, credit	7.8	7.1	7.9	6.8	7.0	7.4	7.6	7.7
Transportation	3.3	2.9	3.3	2.7	2.8	3.0	3.0	3.1
Travel	1.2	1.1	1.4	1.2	1.5	1.8	1.9	2.1
Services, debit	4.6	3.4	4.5	3.6	3.7	3.7	3.8	3.8
Goods and services balance	-13.6	-11.4	-13.4	-9.6	-9.6	-9.3	-9.1	-9.0
Primary income, balance	-1.3	-0.8	-1.3	-0.7	-0.7	-0.8	-0.8	-0.8
Credit	0.3	0.5	0.5	0.6	0.7	0.7	0.8	0.8
Debit	1.6	1.3	1.8	1.3	1.4	1.5	1.5	1.6
Secondary income, balance	6.7	5.4	6.7	4.8	4.5	4.4	4.4	4.3
Credit	6.8	5.5	6.8	4.9	4.6	4.5	4.5	4.4
Remittances	2.5	2.5	2.5	2.7	2.6	2.6	2.6	2.6
Debit	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Capital account	0.3	0.4	0.3	0.4	0.5	0.5	0.5	0.6
Financial account	-7.3	-8.0	-8.2	-5.5	-6.4	-6.2	-5.2	-5.7
Foreign direct investment	-1.7	-1.7	-2.3	-1.9	-2.1	-2.3	-2.3	-2.4
Direct investment, assets	0.4	0.6	0.4	0.5	0.4	0.3	0.3	0.4
Direct investment, liabilities	2.1	2.3	2.8	2.3	2.5	2.7	2.7	2.7
Portfolio investment	-0.7	0.2	-2.9	-0.3	-1.1	-1.0	-0.3	-1.1
Portfolio investment, assets	0.1	0.3	0.1	0.3	0.3	0.3	0.3	0.3
Portfolio investment, liabilities	0.8	0.1	2.9	0.6	1.4	1.2	0.5	1.3
Equity and investment fund shares	0.8	0.0	1.4	0.6	0.7	0.9	1.1	1.1
Debt securities	0.0	0.0	1.5	0.0	0.7	0.3	-0.6	0.3
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment	-4.9	-6.5	-3.0	-3.3	-3.2	-2.9	-2.6	-2.3
Net errors and omissions	0.0	-2.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-0.5	-0.4	0.5	0.4	1.2	1.2	0.2	0.8
Reserves and related items	-0.5	-0.5	0.5	0.4	1.2	1.2	0.2	0.8
Reserve assets (gross)	-0.6	-0.6	0.4	0.4	1.0	1.0	0.0	0.7
Use of Fund credit and loans to the Fund (net)	-0.1	-0.1	-0.1	0.0	-0.2	-0.2	-0.2	-0.1
Disbursements	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repayments	0.1	0.1	0.1	0.0	0.2	0.2	0.2	0.1
Memorandum items:								
Gross official reserves (end of period)	12.2	11.8	12.0	11.3	11.4	11.6	10.7	10.5
Exports of goods and nonfactor services	18.3	16.5	17.6	15.8	16.4	17.0	17.3	17.6
Imports of goods and nonfactor services	31.9	27.9	31.0	25.4	26.0	26.2	26.4	26.6

Sources: Kenyan authorities and IMF staff estimates and projections.

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

	Dec-10	Dec-11	Dec-12	Dec-13	Dec-14	Dec-15	Mar-16	Jun-16	Sep-16
					(Percent)				
Capital adequacy									
Regulatory capital to risk-weighted assets	20.8	19.4	21.9	23.2	19.2	18.8	18.8	18.1	19.0
Regulatory tier 1 capital to risk-weighted assets	18.7	17.3	18.9	19.4	15.9	15.7	16.0	15.6	16.3
Total capital to total assets	13.2	13.2	14.2	14.9	15.6	15.5	15.6	14.8	14.7
Asset quality									
Non-performing loans to total gross loans[1]	6.2	4.4	4.5	5.0	5.4	6.8	7.6	8.4	8.8
Bank provisions to NPLs	75.3	82.2	80.9	70.7	65.0	57.8	54.0	49.2	52.9
Non-performing loans net of provisions to capital	6.4	3.5	3.5	5.8	7.4	11.0	12.7	12.1	10.8
Earning assets to total assets	88.8	87.8	87.4	88.9	88.2	89.0	89.4	90.6	90.8
Earning and profitability									
Return on assets (ROA)	3.7	3.3	3.8	3.6	3.4	2.9	3.4	3.2	3.3
Return on equity (ROE)	30.7	32.2	34.2	28.9	26.5	23.8	27.7	27.2	27.0
Interest margin to gross income	34.7	38.6	32.7	37.2	36.0	34.0	33.3	34.5	35.1
Non-interest expenses to gross income	48.2	44.6	37.8	41.7	40.9	41.3	39.4	41.3	41.9
Liquidity									
Liquid assets to total assets	38.4	33.3	35.2	34.3	32.7	27.8	32.6	33.0	34.3
Liquid assets to short-term liabilities	44.5	37.0	41.9	38.6	37.7	38.1	39.9	40.4	42.9
liquid assets to total deposits	51.0	43.8	46.8	47.0	45.2	38.5	45.1	46.0	48.1
Total loans to total deposits	72.5	77.4	76.9	80.4	83.7	81.9	86.5	83.0	81.4
Sensitivity to market risk									
Net open position in foreign exchange to capital	4.3	3.3	2.6	2.2	4.3	3.5	3.5	2.7	4.7
Interest bearing assets to interest bearing liabilities	117.8	115.4	116.2	121.6	122.1	123.2	123.7	126.1	127.5
FX currency denominated assets to total assets	10.6	11.8	13.2	13.7	15.4	16.7	17.1	16.4	16.1
FX currency denominated liabilities to total liabilities	17.1	21.5	20.9	22.9	22.6	24.3	23.1	23.0	23.6
Spread between lending and deposit rate	9.3	8.4	10.3	8.9	8.0	7.3	8.0	8.1	8.2

Source: Central Bank of Kenya.

[1] The data for Chase Bank in receivership and Charterhouse Bank under statutory mangement have been excluded from May 2016 to September 2016.

Table 6. Kenya: Schedule of Reviews and Available Purchases, 2016–18

Availability Date	Condition	Available Purchases under the SBA		Available Loans under the SCF		Total Available Purchases and Loans	
		(SDR millions)	(Percent of quota)	(SDR millions)	(Percent of quota)	(SDR millions)	(Percent of quota)
March 14, 2016	Approve the 24-month SBA and SCF arrangements	361.867	66.67	180.933	33.33	542.800	100.00
November 15, 2016	Completion of the first SBA-SCF reviews and observance of continuous and end-June 2016 performance criteria	37.996	7.00	18.998	3.50	56.994	10.50
June 15, 2017	Completion of the second SBA-SCF reviews and observance of continuous and end-December 2016 performance	135.700	25.00	67.850	12.50	203.550	37.50
December 15, 2017	Completion of the third SBA-SCF reviews and observance of continuous and end-June 2017 performance criteria	135.700	25.00	67.850	12.50	203.550	37.50
March 5, 2018	Completion of the fourth SBA-SCF reviews and observance of continuous and end-December 2017 performance	37.996	7.00	18.998	3.50	56.994	10.50
Total available		709.259	130.67	354.629	65.33	1,063.888	196.00

Source: IMF staff estimates.

[1] Excludes amounts available under the precautionary SBA and SCF arrangements approved in 2015, which are assumed to be cancelled effective March 14, 2016 with their balances undrawn.

Table 7. Kenya: Indicators of Fund Credit, 2016–24

(Millions of SDRs)

				Projections					
	2016	2017	2018	2019	2020	2021	2022	2023	2024
Fund obligations based on existing credit									
(In millions of SDRs)									
Principal	13.6	85.8	103.3	111.3	97.7	91.2	50.3	21.6	0.0
Charges and interest [1]	0.0	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Obligations to the Fund from existing									
and prospective credit [2]									
(In millions of SDRs)	13.6	94.4	112.7	120.8	290.5	514.5	302.3	106.2	79.6
Principal	13.6	85.8	103.3	111.3	281.6	508.1	299.9	105.1	78.8
Stand-by Arrangements (SBA)	0.0	0.0	0.0	0.0	183.9	349.9	170.8	4.8	0.0
ESF Rapid Access Component (RAC)	13.6	27.1	27.1	13.6	0.0	0.0	0.0	0.0	0.0
ECF Arrangements	0.0	58.6	76.1	97.7	97.7	91.2	50.3	21.6	0.0
SCF Arrangements	0.0	0.0	0.0	0.0	0.0	67.1	78.8	78.8	78.8
Charges and interest [1]	0.0	8.6	9.5	9.5	8.9	6.4	2.3	1.1	0.8
Obligations to the Fund from existing and									
prospective credit [1]									
In millions of U.S. dollars	18.9	131.3	156.8	168.0	404.1	715.7	420.4	147.7	110.8
In percent of gross international reserves	0.2	1.5	1.7	1.8	4.0	6.6	3.6	1.2	0.9
In percent of exports of goods and services	0.2	1.2	1.3	1.2	2.7	4.3	2.3	0.7	0.5
In percent of GDP	0.0	0.2	0.2	0.2	0.4	0.7	0.4	0.1	0.1
In percent of quota	2.5	17.4	20.8	22.2	53.5	94.8	55.7	19.6	14.7
Outstanding Fund credit based on existing drawings									
(end-of-period, all PRGT)									
In millions of SDRs	561.1	475.4	372.1	260.8	163.1	71.9	21.6	0.0	0.0
In percent of quota	103.4	87.6	68.6	48.1	30.0	13.2	4.0	0.0	0.0
Outstanding Fund credit based on existing and									
prospective drawings (end-of-period) [2]									
In millions of SDRs	561.1	1,482.3	1,436.0	1,324.7	1,043.1	535.0	235.1	130.0	51.2
In millions of U.S. dollars	780.5	2,061.9	1,997.5	1,842.7	1,451.1	744.2	327.0	180.8	71.2
In percent of gross international reserves	10.0	24.2	21.4	19.7	14.5	6.9	2.8	1.4	0.6
In percent of exports of goods and services	7.4	18.9	16.2	13.4	9.6	4.5	1.8	0.9	0.3
In percent of GDP	1.1	2.7	2.5	2.1	1.5	0.7	0.3	0.1	0.1
In percent of quota	103.4	273.1	264.6	244.0	192.2	98.6	43.3	23.9	9.4
General Resources Account	0.0	123.7	130.7	130.7	96.8	32.3	0.9	0.0	0.0
Poverty Reduction and Growth Trust	103.4	149.4	133.9	113.4	95.4	66.2	42.4	23.9	9.4
Memorandum items:									
Nominal GDP (in billions of U.S. dollars)	68.9	75.1	80.7	87.7	95.0	103.2	112.7	122.9	134.1
Exports of goods and services (in billions of U.S. dollars)	10.5	10.9	12.3	13.7	15.1	16.7	18.3	19.9	21.7
Gross international reserves (in billions of U.S. dollars)	7.8	8.5	9.4	9.4	10.0	10.8	11.7	12.8	12.8
Quota (in millions of SDRs)	542.8	542.8	542.8	542.8	542.8	542.8	542.8	542.8	542.8

Sources: Fund staff estimates; and projections.

Table 8. Kenya: External Financing Requirements and Sources, 2015–19

	2015		2016		2017	2018	2019
	Prog.	Act.	Prog. [1]	Proj.	Projections		
Total requirements	6,597	6,635	6,906	5,660	7,093	7,415	7,932
Current account deficit	5,012	4,335	5,169	3,792	4,295	4,515	4,848
Capital outflows	1,585	2,300	1,737	1,868	2,799	2,899	3,084
Repayments of MLT loans	1,369	1,900	1,454	1,549	2,477	2,623	2,034
Portfolio investment (sovereign bond)	0	0	0	0	0	0	750
Foreign direct investment abroad	217	399	283	319	322	277	300
Total sources	6,597	6,635	6,906	5,660	7,093	7,415	7,932
Capital inflows	6,915	6,930	6,600	5,367	6,222	6,458	7,770
Public sector	3,128	2,943	3,808	3,391	3,638	2,741	2,785
Project grants	208	257	209	284	366	439	477
Long-term loan disbursements to public sector	2,920	2,686	2,600	3,108	2,772	2,051	2,083
Portfolio investment (sovereign bond)	0	0	1,000	0	500	250	225
Private sector	3,788	3,987	2,792	1,976	2,583	3,717	4,985
Foreign direct investment in Kenya	1,285	1,489	1,780	1,615	1,867	2,167	2,334
Long-term loan disbursements to private secto	500	500	750	750	1,200	1,000	1,600
Other net inflows (including errors and omissio	2,003	1,998	261	-389	-483	551	1,051
Financing	-318	-295	306	293	872	957	162
IMF (net)	-66	-66	-67	-19	-119	-144	-155
Disbursements	0	0	0	0	0	0	0
Repayments	66	66	67	19	119	144	155
Reserve assets (gross)	-384	-361	239	274	752	813	7
Financing gap	0	0	0	0	0	0	0
Total requirements	10.7	10.4	10.7	8.2	9.4	9.2	9.0
Total sources	10.7	10.4	10.7	8.2	9.4	9.2	9.0
Capital inflows	11.3	10.9	10.2	7.8	8.3	8.0	8.9
IMF (net)	-0.1	-0.1	-0.1	0.0	-0.2	-0.2	-0.2
Reserve assets (gross)	-0.6	-0.6	0.4	0.4	1.0	1.0	0.0

Sources: Kenyan authorities and IMF staff estimates and projections.

[1] Program projections reflect the baseline scenario, with no Fund financing.

Appendix I. Letter of Intent

Nairobi, Kenya
December 23, 2016

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C. 20431
United States of America

Dear Ms. Lagarde:

1. Kenya's growth accelerated in the first half of the year in 2016 reaching 6.1 percent, from 5.6 percent in 2015, supported by favorable weather conditions, public infrastructure investments, lower global energy prices, and a strong recovery of tourism. Inflation has been brought within our target range (5±2.5 percent) since early 2016 despite a resurgence of food prices in recent months. Our external position has strengthened, reflecting a narrowing of the current account deficit and a strong recovery of capital inflows. As a result, the Kenyan shilling has stabilized, and the CBK has accumulated international reserves, which stood at US$8.2 billion (5.3 months of next year imports) as of end-September 2016.

2. Performance under our economic program supported by the Stand-By Arrangement (SBA) and an arrangement under the Standby Credit Facility (SCF) has been broadly satisfactory. We met all continuous and end-June quantitative performance criteria (PCs). We also met all end-March, end-June and end-September quantitative indicative targets with the exception of the end-June target on priority social spending, which was missed by a small margin (Table 1). We made significant progress towards the program's structural benchmarks, although there were delays in completing them. We propose to reset and update these benchmarks (Tables 2 and 3).

3. The outlook is for continued robust growth, lower fiscal deficits, inflation remaining within our target range, and a sustainable external current account. However, amendments to the Banking Act that became effective in September 2016 have created uncertainties as banks are adjusting to the limits set on banks' deposit and lending rates, which is expected to weigh on growth. We are closely monitoring the implementation of the new law, and are continuing with initiatives to support transparency and disclosure of all fees and charges on loans. Additional risks to the outlook are possible security threats, which could impact tourism while the impact of weather-related shocks could lower agricultural production and affect hydro power generation, thereby requiring higher imports of food and fuel products. On the external side, the highest risks emanate from the fall-out from Brexit that may create additional uncertainties for the outlook for trade and investment, and heightened volatility in global financial markets.

4. We are taking determined steps to strengthen our resilience to shocks. Our policies focus on sustaining inclusive, investment-led growth while continuing to build resilience. We remain committed to a gradual consolidation of fiscal policy, to maintain low inflation, further improve

public financial management, strengthen the financial sector supervision and regulation, make further progress in our transition to a modern inflation targeting framework, and deepen structural reforms aimed at improving the business environment.

5. Against this background, and on the basis of our established track record of program implementation to date and the policy priorities outlined in the attached Memorandum of Economic and Financial Policies (MEFP), we request completion of the first reviews under the 24-month SBA and SCF, which continue to provide a buffer against exogenous shocks, and a policy anchor for our reform program. We also request: (i) waivers of applicability for the end-December 2016 quantitative performance criteria, given the unavailability of data for assessing these; (ii) a rephasing of the second and third reviews under the SBA and SCF to provide sufficient time for the completion of the reviews; and (iii) a modification of the performance criterion on the primary budget balance for end-December 2016 to KSh-100 billion consistent with the higher fiscal deficit target for 2016/17. Under the rephasing, we expect to complete the second, third, and fourth reviews on or after June 15, 2017, December 15, 2017, and March 5, 2018, respectively.

6. While we do not have balance of payments needs under our baseline projections, potential needs could materialize if major capital account, security or weather-related shocks were to hit our economy. Therefore, we intend to continue treating both arrangements as precautionary, and we do not intend to draw under these arrangements unless exogenous shocks generate an actual balance of payments financing need. We believe that the envisaged package of macroeconomic policies and structural reforms under the new program, with the performance criteria and structural benchmarks summarized in Tables 1 to 3, would significantly reduce the likelihood of potential balance of payments need after 2017/18.

7. We are confident that the policies set out in the attached MEFP will enable us to achieve our program objectives. However, we will take any further measures that may become necessary for this purpose. We will consult with the IMF on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the IMF's policies on such consultations. We will provide such information as the IMF may request in connection with progress in implementing our economic and financial policies. We authorize the publication of the staff report for the first reviews under the SBA and SCF arrangements, this letter of intent, and the attached MEFP and technical memorandum of understanding.

Sincerely yours,

/s/	/s/
Mr. Henry Rotich, Cabinet Secretary of the National Treasury	Mr. Patrick Njoroge, Governor of the Central Bank of Kenya

Attachments:
1. Memorandum of Economic and Financial Policies.
2. Technical Memorandum of Understanding.

Attachment I. Memorandum of Economic and Financial Policies

I. BACKGROUND

1. **The Kenyan economy has continued to perform well and inflation remains under control.** Real GDP growth reached 5.6 percent in 2015 up from 5.3 percent in 2014, accelerating further to 6.1 percent in the first half of 2016. The growth was supported by favorable weather conditions that boosted agricultural production, public investment spending, lower global oil prices and strong recovery in tourism. Inflation has remained within our target range (5±2.5 percent), despite increase in food prices in recent months. Headline inflation stood at 6.7 percent in November 2016, with non-food, non-fuel inflation remaining relatively stable at around 5 percent.

2. **Our external position has strengthened.** The current account deficit narrowed to 6.8 percent of GDP in 2015 (from 9.8 percent of GDP in 2014), and has declined further in 2016, to an estimated 5.2 percent of GDP for the 12 months to September. This reflects mainly lower international oil prices, improved tea and horticulture exports, strong remittance inflows and a recovery of tourism. The latter reflects partly improved security and the removal in 2015 of travel warnings to tourist destinations in Kenya by key tourism source markets. The narrowing of the current account deficit together with strong capital inflows have led to a stabilization of the shilling in the foreign exchange market and also allowed the CBK to accumulate international reserves, which stood at US$7.9 billion (4.8 months of next year's imports) as of end-November 2016.

3. **Budget deficits were reduced in 2015/16 in line with program objectives.** Total revenues declined relative to 2014/15 as a share of GDP and fell by about 1 percent of GDP short of the program target. This reflected in part lower-than-programed personal income tax revenues, lower import volumes, and lower reported profits in the financial sector, which accounted for 28 percent of corporate income tax (CIT) collection in 2015/16. However, the revenue shortfall was more than offset by lower spending on the Standard Gauge Railway (SGR) project (by 1 percent of GDP) and domestically financed investment (0.5 percent). As a result, the overall cash deficit was 7.5 percent of GDP in 2015/16, compared to 8 percent of GDP in 2014/15 and 8 percent of GDP under the program. Financing of the budget was broadly in line with the program, with higher domestic borrowing temporarily substituting for the delayed disbursement of an external loan of about 1 percent of GDP in the second half of 2015/16. Gross public debt (in NPV terms) rose to 47 percent of GDP, as expected in the program.

4. **The banking system remains stable despite a number of challenges.** The growth of private sector credit has slowed steadily during 2016, to 4.6 percent at end-November 2016 compared to 18 percent at end-December 2015. Gross non-performing loans (NPLs) have increased as a share of gross loans, to 8.8 percent in September 2016, from 6.8 percent in December 2015, in part reflecting our stepped-up efforts to enforce better reporting. Increases in NPLs have been particularly pronounced in the building and construction sector. In addition to the two banks that were put under receivership in 2015, a third bank (Chase Bank Ltd.) was put under receivership in April 2016. We took steps to prevent negative spillovers to the rest of the financial sector, including by providing additional liquidity to the banking sector. The core and total regulatory capital to risk weighted assets ratios for the banking system stood at 16.3 and 19 percent, respectively, as of end-September 2016, above the respective statutory minimums of 10.5 and 14.5 percent.

5. **The Banking (Amendment) Act, 2016, that became effective in mid-September, set limits on banking lending and deposit rates.** The amendment was enacted against the backdrop of public concerns on the high cost of credit. This follows two previous unsuccessful attempts to cap commercial interest rates in 2001 and 2011. Banks are in the process of adjusting their strategies and business models to the interest rate caps and we are closely monitoring the implementation of the new law. We are also continuing with initiatives to support transparency and disclosure of all fees and charges on loans. In addition, we have continued to strengthen the credit information sharing system to promote its usage in credit risk pricing by banks.

6. **The precautionary SBA-SCF arrangements continue to anchor the macroeconomic policy framework, and also backstopped the foreign exchange reserve buffers.** All continuous and end-June 2016 performance criteria (PCs) and the end-June inflation target under the Monetary Policy Consultation Clause (MPCC) were met (Table 1). All end-June and end-September quantitative indicative targets were also met, except for the end-June target on priority social expenditure that was missed by a small margin, due to delay in disbursement of donor commitments on the cash transfers to the elderly persons, orphans, and vulnerable children. We made significant progress towards the program's structural benchmarks, although there were delays in completing them. These are proposed to be reset and updated (Tables 2 and 3).

II. MACROECONOMIC OUTLOOK

7. **The outlook is for continued robust growth, lower fiscal deficits, inflation remaining within our target range, and a sustainable external current account:**

- ***Real GDP.*** Leading indicators suggest a continued robust pace of economic expansion, and we project real GDP growth to increase to 6 percent in 2016 (from 5.6 percent in 2015). However, private sector credit growth is expected to remain subdued as the banking system adjusts to the recent amendment to the Banking Act on deposit and lending rates. On this basis, although we believe growth will remain broadly unchanged at about 6 percent next year, to be prudent we will base the fiscal program for 2016/17 (see below) on a growth rate of 5¼ percent in 2017.

- ***Inflation*** is projected to remain within our target band and to gradually converge towards the mid-point of our target band in the medium term.

- Kenya's ***external position*** is projected to strengthen further over the program period. The current account deficit is projected at about 5.5 percent of GDP in 2016, and to remain around 5.5-6 percent over the medium term.

8. **There are downside risks to the outlook.** The impact of interest rate controls on the banking sector and growth is uncertain. Depending on how the banking sector reacts, it could contribute to slower credit growth, curtail access to finance for SMEs and smaller borrowers, and lower our economic growth potential. In addition, possible security threats could impact tourism while the impact of weather-related shocks could lower agricultural production and affect hydro power generation, thereby requiring higher imports of food and fuel products. On the external side, the main risks emanate from slower global and regional growth, the fall-out from Brexit that may

create additional uncertainties for the outlook for trade and investment, and heightened volatility in global financial markets.

III. PROGRAM OBJECTIVES

9. **Our main policy objective is to ensure the sustainability of investment-driven, inclusive growth through prudent macroeconomic management and structural reforms.** We remain committed to an ambitious reform and investment plan to raise our growth potential in an inclusive and sustainable manner. The Fund-supported program continues to provide a policy anchor and provide insurance in response to shocks. Our key policy priorities are:

- ***Fiscal policy.*** Continuing fiscal consolidation over the medium term to reduce the burden on monetary policy in demand management, maintain public debt sustainability, and support a reduction in the current account deficit while protecting high-priority public investment and social spending.

- ***Public financial management.*** Taking decisive steps to increase the efficiency, effectiveness, transparency, and accountability of public spending, in order to ensure that there is sufficient fiscal space for priority social and investment projects.

- ***Monetary policy.*** Gradually bringing inflation towards the mid-point of our target range of 5±2.5 percent in the context of a flexible exchange rate, and further improving the monetary policy framework to facilitate transition towards a modern inflation targeting framework.

- ***Financial stability.*** Safeguarding financial stability by enhancing prudential regulation and supervision in the face of increased growth and complexity of the financial sector. This is in tandem with bolstering the "new normal" regime in the banking sector that is premised on greater transparency, strengthened governance, and resilient business models, and on Kenya's Vision 2030 objective of promoting a sound, safe, and inclusive financial system.

- ***Structural reforms.*** Deepening structural and governance reforms to improve the business environment and thus boost investment and employment creation.

- ***Data provision.*** Improving data quality in line with international best practices, to support economic policy making, transparency and accountability.

IV. PROGRAM POLICIES

A. Fiscal Policy

10. **Policy anchor.** Our fiscal anchor remains a gross public debt target of 45 percent of GDP (in net present value terms) over the medium term. Consistent with this objective, we are committed to gradually reducing fiscal deficits, with a focus on higher revenues to protect growth-enhancing public investment and social spending. We target a reduction in the fiscal deficit to put debt on a downward path.

11. **We target a deficit of 6.9 percent of GDP for 2016/17.** Revenue collection during July-September has improved, with particularly high receipts of VAT and excise revenues. This reflects improvements in revenue administration from the I-tax system, new excise tax measures, and the re-introduction of withholding VAT. Revenues are nevertheless expected to be 0.3 percent of GDP lower than anticipated in the program, mainly due to projected shortfalls in income tax revenue. To ensure that the deficit target will be met, we will reduce lower-priority spending.

12. **To maintain fiscal sustainability and move towards the EAC monetary union convergence criterion, we remain committed to take fiscal measures to reduce the fiscal deficit to 5.9 percent in 2017/18.** These measures will include steps to:

- **Reduce tax *expenditures*.** Supported by World Bank technical assistance (TA), we are conducting a review of existing tax expenditures in order to identify their size, type (e.g., exemptions, reduced rates) and evolution over time. Based on the results of this study expected to be completed by January 2017 (**structural benchmark**), we will devise measures to reduce tax expenditures starting in July 2017. In parallel, we are working on a new simplified and modern Income Tax Law with a view to ease administration and enhance compliance.

- **Standardize remuneration across the national government and start a public sector rationalization effort.** We will streamline allowances and harmonize salary scales for civil servants in line with recommendations from the Salaries and Remuneration Commission. In addition, we will prepare for the implementation of actions identified in our Capacity Assessment and Rationalization of the Public Sector study, with IMF technical assistance.

- **Rationalize expenditure.** We will take steps to contain growth of lower-priority recurrent and development expenditure. We intend to maintain the overall wage bill of the national government constant as a share of GDP, in part supported by our continued freeze in public sector employment outside essential areas (including security, health, and education).

- **Improve tax administration.** We are taking steps to capture a larger share of the tax base and decrease tax fraud, including through: first, the integration of KRA IT systems with IFMIS, which is at a testing stage; second, a pilot project with seven counties that would allow the KRA to collect taxes on their behalf; third, the valuation benchmarking of imports that has been undertaken by the KRA to address the undervaluation of imports; and forth, the roll out of the new Customs Management System planned for January 2017, which will permit integration of the various tax departments thereby providing additional and more consistent information on importers. These steps will help add a large number of taxpayers into the KRA's database and will have positive synergies with efforts to strengthen the collection of other taxes. In addition, based on the outcome of the Tax Administration Diagnostic Assessment Tool (TADAT) assessment mission in November 2016, we will identify additional areas of improvement in our tax administration and incorporate these into our reform agenda for 2017/18.

- **Strengthen revenue performance at the county level.** We will submit to parliament by end-March 2017 draft legislation to clarify powers by counties to set taxes/user fees (**structural benchmark**), aimed at increasing revenue at the county level, while maintaining a business-friendly tax system. In addition, we are discussing Memoranda of Understanding aimed at initiating KRA's engagement with county governments regarding the shared administration of property taxes. Data from 11 county suppliers in 2015/16 has been collected and is being analyzed. KRA is awaiting the signing of MOUs by governors in three pilot counties i.e. Laikipia, Kiambu and Makueni. We have developed county revenue collection module in I-tax. We intend to raise additional property tax revenue from 0.15 percent of GDP in 2014/15 to 0.5 percent of GDP by 2019/20.

13. **We will closely monitor revenue developments during the remainder of 2016/17.** If revenues are falling short of expectations during the course of the year, we will take measures to ensure that the deficit target for 2016/17 is met. In addition, we will continue to update and refine our analysis of the effects of administrative measures on revenues, taking into account recent developments in revenues. If necessary, we will introduce additional reforms to tax policy and revenue administration to ensure that we can meet the revenue targets for 2017/18.

14. **We will continue to improve public finance management.**

- **Achieve better value for money in implementation of investment projects through stricter selection and monitoring procedures.** We will ensure separation of the project approval process from the annual budgeting process by adopting cabinet guidelines on the appraisal and monitoring of new investment projects by end-March 2017 **(structural benchmark)**. In addition, we will set up a Committee within the Directorate of Budget and Fiscal Affairs to coordinate Public Investment Management (PIM), and we will also set up an integrated PIM system for tracking projects through the project cycle by end-June 2017 (**structural benchmark**). This will serve as a databank for public investment projects with a positive appraisal decision. The system will build on the existing e-Promis system, which will be brought under the responsibility of the Directorate of Budget, Fiscal and Economic Affairs. In parallel, we will verify and update by December 2017 information included in the existing database (Annex 7), distinguishing projects for which funding is justified from projects in need of a reassessment.

- **Establish a Centralized Payment System (CPS)/Treasury Single Account (TSA)** to ensure better control of the payment process by helping simplify processes, facilitating the automation of bank account reconciliation, and establishing a link between release of funds from the exchequer account at the central bank and approved payment instructions. We will test the use of a Central Payment Account (CPA) during January-June 2017 with the view to making it fully operational by end-June 2017 (**structural benchmark**). The CPA will replace the accounts currently held by Ministries, Departments and Agencies (MDAs), and will be fully linked to IFMIS in such a way that payments are made directly by Treasury to service providers. In preparation for this, we will automate the release of funds from the exchequer account, first through the current system of MDA accounts by March 2017 (**structural benchmark**) and later through the CPS. We will complete the preparation of the issuance of electronic payment advice (ePA) by March 2017 in order to allow for the processing of debt payments and foreign currency payments through IFMIS. This will help ensure timely payments of all obligations and thus avoid any recurrence of external payments arrears.

- **Improve the monitoring and reporting of government pending bills.** We have established a committee in charge of reviewing and recommending necessary actions for the liquidation of pending bills. Going forward, we will produce and monitor a report of the stock of pending bills measured as the difference between requisitions received by IFMIS for payment process and the corresponding release of funds from the exchequer account, disaggregated by time lag. We will monitor the change in the stock of pending bills through an indicative target under the program starting in December 2016 (Table 1). Other pending bills reported by MDAs will be assessed and resolved prior to the shift to the new CPA system.

- **Produce consolidated financial statements.** Building on the recent creation of consolidated financial statements (CFS) for MDAs, Consolidated Fund Accounts, SAGAs, development projects, and county governments, we will move forward in producing a CFS for the entire public sector. This will be achieved in a stepwise manner. In the first phase, a CFS of the budgetary central government, that is the MDAs, their development projects, and the Consolidated Fund Accounts, will be completed. In the second phase, the CFS of the central government and county governments will be produced and published by end-March 2017 (**structural benchmark**). In the final phase, we will integrate semi-autonomous entities and the rest of the public sector, incorporating public corporations, both financial and nonfinancial.

- **Strengthen the role of e-procurement.** We are working with the ICT Authority to extend coverage to include all government entities (including all state-owned enterprises). A system to monitor the dispersion of prices across Government is already in place and is able to compute the variance in these prices. We are working with the PPOA to continuously monitor and update the price index. The draft regulations to implement the recent procurement law are ready and will be submitted to the Attorney General for drafting after validation. We expect to table them in Parliament by December 2016.

B. Monetary Policy

15. **Policy objectives:** Our primary policy objective is to bring headline inflation towards the midpoint of our target range (5±2.5 percent) in the context of a floating exchange rate regime, and further improve the monetary policy framework to facilitate transition towards a modern inflation targeting framework.

16. **We are committed to strengthening the monetary policy framework in the context of a floating exchange rate regime.** However, the introduction of interest rate caps limits the effectiveness of CBK's monetary policy, and consequently, the pace of the transition to an inflation-targeting framework will be slower-than-envisaged. To that end, we will take the following measures:

- **Increasing the effectiveness of our policy rate (CBR).** We remain committed to a closer alignment of the interbank rate with the CBR by establishing an interest rate corridor. This would enhance the role of the CBR as a signaling device for our monetary policy stance. However, reflecting the uncertainties from the impact on our economy and on the effectiveness of monetary policy of the new legislation on interest rates, the pace of this alignment will be slower than was envisaged at the inception of the program. Against this backdrop, we are conducting liquidity operations to gradually bring interbank rates towards the policy rate, as economic conditions permit.

- **Improving liquidity distribution among banks.** To improve liquidity management, the CBK will set up a central depository for government securities that will act as collateral for Horizontal Repo transactions and enhance collateralized lending between banks. In addition, the CBK is working with the World Bank Group, the National Treasury, State Law Office, and other agencies to establish a central collateral register. A draft bill will be finalized by end–December 2016**.** These steps are expected to improve liquidity distribution among banks.

- **Reducing structural rigidities in government securities market.** The government is committed to supporting the ongoing development of Kenya's capital markets through the development of an efficient primary and secondary market for government securities by taking steps to broaden participation and lower transactions costs. These include: (i) the ongoing preparatory process to adopt an electronic bond auction system that will enable over-the-counter (OTC) trading for government securities and thus promote market making activities by allowing two-way quotes for government securities starting initially with Treasury bills. This will result in cost savings for both the government and market participants, and ensure greater market access for investors by a clear separation of retail and wholesale investors in government securities; (ii) establishing innovative means for retail investors to participate in the securities market through using mobile phone platforms such as M-Akiba and Treasury Mobile Direct (TMD); and (iii) our recent introduction of a regular Issuance Calendar that is released on a quarterly basis.

C. Financial Sector

17. **Policy objectives:** Safeguarding financial stability remains one of our key priorities. We will continue to take steps to further strengthen prudential regulation and supervision, with a view to addressing the increased complexity of the financial sector. This is in tandem with a "new normal" in the banking sector that is premised on greater transparency, strengthened governance and resilient business models.

18. **The banking system's financial stability indicators remain sound and we are closely monitoring potential risks.** As noted above, while the NPLs have increased during 2016, the core capital and total capital to total risk weighted assets ratios for the banking system are well above the respective statutory minimums. The sector's liquidity has also improved (from 37.4 percent in September 2015 to 42.9 percent in September 2016). In addition, the liquidity distribution has also started to even out across the sector unlike in the last and first quarters of 2015 and 2016 when liquidity distribution was skewed to the large banks. Over the last one year, three problem banks were identified largely due to their weak corporate governance and poor liquidity management. Dubai Bank was placed under liquidation, while Imperial Bank and Chase Bank were placed under receivership. These three banks were not systemic and therefore the banking sector has continued to be resilient. The sector as a whole has continued to comply with the minimum prudential requirements in terms of capital, liquidity and asset quality. We continue to closely monitor credit

and liquidity risks through assessment of adequacy of provisions, sufficiency of capital buffers and robustness of liquidity management strategies for banks.

19. **The banking sector has continued to demonstrate robust growth and resilience both in its domestic and regional operations.** We have adopted an action plan on banking regulations and supervision, and on that basis are taking steps to strengthen the legal and regulatory framework for banks, including by:

- **Requiring greater transparency on the part of banks.** Banks are now required to disclose on their websites details of significant shareholders who own 5 percent or more shareholding.
- **Rolling out onsite risk-based AML/CFT inspections** for commercial banks and microfinance banks.
- **Auditing ICT systems of banks.** The CBK engaged external auditors of banks in 2015 to review the effectiveness of ICT systems of all banks. Those banks whose ICT systems were found with weaknesses have provided time-bound plans on remedying them.
- **Reviewing insider lending by banks.** The CBK has directed external auditors of banks to review the effectiveness of banks insider lending practices as part of efforts to strengthen banks corporate governance practices.
- **Strengthening regulatory guidance on ICAAP.** In order to enhance sector-wide risk and capital management, the CBK will issue a Guidance Note to the banking industry on development and preparation of Internal Capital Adequacy Assessment Planning (ICAAP), to guide institutions in capital planning. In August 2016, the Central Bank released a draft Guidance Note on ICAAP for public review and comments.

20. **To further strengthen banking supervision going forward, we have identified strategic priority areas,** including:

- Recruiting an additional 15 members of staff by January 2017, to enhance banking sector monitoring, in particular as regards IT systems audit.
- Improving capital adequacy assessment by issuing a Guidance Note on ICAAP to the banking sector by January 2017 and ensuring that all banks submit an ICAAP to the CBK by June 2017 (**structural benchmark**).
- Integrating a risk based approach in Anti-Money Laundering/Combatting Financing of Terrorism (AML/CFT) supervision of banks and non-banks under CBK's regulatory purview by June 2017.

21. **We are also reducing barriers to competition in the credit markets and taking other steps to reduce borrowing costs.** These include:

- Strengthening further the credit reference system to enhance borrower monitoring, data quality and integrity, and public sensitization to promote usage of credit reference for credit-risk pricing. Technical assistance on this work is being provided by the World Bank Group.

- Adopting in 2017 a single annual percentage rate (APR) methodology that includes all fees and charges in a single rate, and require banks to post APRs for all of their credit facilities.

D. Other Structural Reforms

22. **Policy objectives:** We are deepening structural and governance reforms, with a view to easing the cost of doing business and thus boosting investment and employment creation.

23. **We will continue implementing our ambitious reforms aimed at strengthening the business environment and improving governance.** Kenya climbed to position 92 in the 2017 World Bank Doing Business ranking, thanks to significant simplification of processes to start a business; better provision of electricity; and the implementation of the Companies Act and the Insolvency Act, which protects the interest of minority investors while allowing more flexibility to distressed companies to reorganize themselves. We will continue strengthening Huduma Centers, which provide services to citizens in 52 areas; the E-citizens Portal managed by the National Treasury; the Electronic Single Window for customs clearance; and measures to further reduce the cost and time for trade along the Northern Corridor and through Mombasa. We will complement these achievements with new legislation to strengthen governance in business operations (Anti-Bribery Bill) and in the construction of roads (The Roads Bill). In addition, we will introduce regulations to the recently enacted Procurement Bill to develop a clear framework for the establishment of procurement units in counties. These will be aligned with National Treasury Systems to ensure a cost effective utilization of public resources. The Public Procurement Oversight Authority (PPOA) is also preparing The Code of Ethics for Suppliers in Public Procurement and Disposal. Furthermore, we also plan to introduce amendments to the Competition Bill to enhance consumer protection from unfair market conduct.

E. Data Quality

24. **Policy objectives**: To enhance our macroeconomic data, we will continue to improve the availability, quality, coverage, and timeliness of our statistics.

25. **Data quality and timeliness.** In order to improve macroeconomic data dissemination practices, we intend to participate in the Enhanced General Data Dissemination System (e-GDDS) initiative, subject to data sensitivities. The Kenya National Bureau of Statistics (KNBS) is conducting the 2016 Foreign Investment Survey and the results will be integrated into the 2016 Balance of Payments and International Investment Position (IIP) statistics. The Economic Survey, to be published in May 2017, will include the first ever IIP statistics for Kenya covering 2011–16. We are working toward publishing quarterly consolidated GFS-compliant fiscal accounts for the budgetary central government (national government) by December 2016. Data collection for the Household Budget Survey has been completed and we are on track to publish the results by March 2017. The CBK will start reporting additional information on average loan and deposits interest rates. For loans, rates by type of lender (large corporates, SME, mortgage loans, retail/personal unsecured loans), and maturity

(less than 1 year, 1–3 years, more than 3 years) will be provided. For deposits, a breakdown by maturity (savings accounts, fixed-term up to 1 year, and more than 1 year) will be provided.

Table 1. Kenya: Quantitative Performance Criteria and Indicative Targets, March 2016—June 2017

(in billions of Kenyan shillings, unless otherwise indicated)

	2015	Performance Criteria (PC)/Indicative targets (IT)													
		2016												2017	
	End-Dec	End-Mar (IT)			End-Jun (PC)				End-Sep (IT)			End-Dec (PC)		End-Mar (IT)	End-Jun (PC)
	Act.	Prog.	Prel.	Met / Not Met	Prog.	Prel.	Adj Prog.	Met / Not Met	Prog.	Prel.	Met / Not Met	Prog.	Proj.	Proposed	Proposed
Quantitative performance criteria [1]															
Fiscal targets															
Primary budget balance of the national government (-=deficit, floor) [2, 3]	-99.5	-164.1	-83.8	Met	-206.0	-206.9	-220.7	Met	-46.0	-7.9	Met	-82.9	-100.0	-169.5	-211.5
Monetary targets [4, 5]															
Stock of central bank net international reserves (floor, in millions of US$) [6, 7]	6,367	5,784	6,535	Met	5,900	6,846	5,941	Met	5,852	7,105	Met	6,283	6,283	6,266	7,230
Public debt target															
National government external payment arrears (ceiling, millions of US$) [8]	0	0	0	Met	0	0	0	Met	0	0	Met	0	0	0	0
Monetary policy consultation clause															
Upper band	...	8.5	...	...	7.5	...	...		7.5	...		7.5	7.5	7.5	7.5
Center inflation target [9]	7.4	5.0	7.0	Met	5.0	5.4	...	Met	5.0	6.3	Met	5.0	5.0	5.0	5.0
Lower band	...	2.5	...	...	2.5	...	...		2.5	...		2.5	2.5	2.5	2.5
Indicative targets															
Stock of net domestic assets of the central bank (ceiling)	-246	-169	-268.5	Met	-151	-303	...	Met	-139	-330	Met	-165	-165	-193	-289
Priority social expenditures of the national government (floor) [3]	25	41	44	Met	60	57	...	Not Met	14.5	14.6	Met	20.5	10.5	30.0	57.4
Stock of all guarantees issued by the national government (ceiling) [3]	50	50	0	Met	50	0	...	Met	50	0	Met	50	50	50	50
Change in the stock of national government domestic bills pending for 90 days or more [3]	...	...	...	...	...	...	...	...	...	...		...	...	0	0
Memorandum items:															
Maximum upward adjustment of the primary deficit ceiling owing to excess in concessional loans relative to program projections [3]	42.0	36.7	-17.5	...	37.7	14.4	...		13.6	-16.6	...	27.1	27.1	30.0	39.6
Programmed project loans [3, 10]	69.5	61.6	64.5	...	86.4	84.6	...		20.0	20.0	...	56.8	56.8	85.7	96.0
Budgeted project loans [3, 10]	111.4	98.3	47.0	...	124.1	99.0	...		33.6	3.4	...	83.9	83.9	115.7	135.6
Programmed external commercial debt (millions of US$) [3]	750	1,350	733.6	...	1,350	1,431	...		0	100	...	1,000	750	750	1,500
Program grants [3]	2.9	4.5	4.3	...	6.4	4.3	...		1.5	0.2	...	2.7	2.7	3.5	6.1

[1] Performance criteria for end-December 2016 and end-June 2017, and indicative target for end-September 2016 and end-March 2017.

[2] The primary budget balance of the national government and related adjusters are defined, respectively, in paragraph 6 and paragraph 7 of the TMU. The adjusted target for end-June 2016 reflects the shortfalls in program grants (KSh 4.3 billion actual versus a programmed level of KSh 6.4 billion) and higher project loans relative to the program (respectively, KSh 99 billion and KSh 86.4 billion), as indicated in the memorandum items of this table.

[3] All targets are cumulative flows from July 1, 2016, except for government pending bills that are cumulative from January 1, 2017.

[4] For program monitoring, the daily average for the month when testing dates are due.

[5] The adjustors to the NIR and NDA targets are specified, respectively, in paragraph 8 and paragraph 13 of the TMU.

[6] Excludes encumbered reserves. Includes Kenya's reserve tranche position in the Fund starting from March 16, 2016.

[7] Using exchange rates as at end-January 2016 (see TMU ¶9).

[8] Continuous. Payment on an external obligation of US$0.321 million was made with a delay of 11 days in August 2016. Kenya has since been current on all external payment obligations.

[9] Compliance will be evaluated based on the 12-month inflation average of the latest three months.

[10] Excludes the first phase of the Standard Gauge Railway (Mombasa to Nairobi).

Table 2. Kenya: Structural Benchmarks Under the SBA-SCF Program, March–September 2016

Measure	Target Date	Status
Publish consolidated financial statements of all entities in the public sector (includes SAGAs, AGAs, and other state-owned enterprises), as part of the regular annual reporting (IMF Country Report No. 16/85, MEFP ¶16)	End-March 2016	Not met. Partially consolidated statements were published in the National Treasury website in August 2016. Modified and re-phased for end-March 2017 (see Table 3).
Establish an interest rate corridor for the interbank interest rate around CBR (IMF Country Report No. 16/85, MEFP ¶16)	End-September 2016	Not met. The establishment of the corridor will be delayed until constraints on Kenya's interest-rate based monetary framework from the interest rate controls are lifted.
Establish a tracking system to closely monitor the accumulation of pending bills and produce monthly Aging Pending Bills reports starting in June 2016 (IMF Country Report No. 16/85, MEFP ¶16)	End-June 2016	Not met. Treasury established the tracking system in June and started producing a monthly Aging Pending Bill in November.
Incorporate personnel payments into IFMIS by interfacing it with the human resources management information systems (IPPD) (IMF Country Report No. 16/85, MEFP ¶16)	End-June 2016	Not met. The platform for interfacing personnel payments into IFMIS has been completed, and the new system is being tested in 3 ministries. Roll out to all national government entities is expected to be completed by June 2017.
Finalize an action plan containing measures to further strengthen banking regulations and supervision to align them with best practices (IMF Country Report No. 16/85, MEFP ¶19)	End-June 2016	Not met. Completed in November 2016.
Complete a study on tax expenditures, in order to identify their size, type (e.g., tax exemptions, reduced tax rates), their evolution over time, and the category of taxation to which they apply (IMF Country Report No. 16/85, MEFP ¶15)	End-September 2016	Not met. A World Bank TA mission on strengthening domestic revenue mobilization took place in September 2016. Re-phased for end-January 2017 (see Table 3).
Issue and adopt Cabinet guidelines on the selection, appraisal, and funding for major investments projects (IMF Country Report No. 16/85, MEFP ¶15)	End-September 2016	Not met. An AFRITAC mission to help the Treasury with the preparation on guidelines took place in October 2016. Re-phased for end-January 2017 (see Table 3).
As part of the Treasury Single Account reform, capture all public debt payments in IFMIS (IMF Country Report No. 16/85, MEFP ¶15)	End-September 2016	Not met. Capture of public debt payments by IFMIS is part of the structural benchmark on the Centralized Payment System planned for June 2017 (see Table 3).
Submit to parliament draft legislation to clarify powers by counties to set taxes/user fees, aimed at increasing revenue at the county level, while maintaining a business-friendly tax system (IMF Country Report No. 16/85, MEFP ¶16)	End-December 2016	Delayed. FAD TA mission in November 2016 reviewed progress of the task force working on counties revenue enhancement measures. Stakeholder consultations planned for January-February 2017. Rephased for end-March 2017 (see Table 3).

Table 3. Kenya: Proposed Structural Benchmarks

Measure	Target Date	Macro criticality
Complete a study on tax expenditures, in order to identify their size, type (e.g., tax exemptions, reduced tax rates), their evolution over time, and the category of taxation to which they apply (¶12). Rephased from end-September 2016.	End-January 2017	To help reduce tax expenditures and help achieve the fiscal deficit targets over the medium term
Adopt Cabinet guidelines on the selection, appraisal, and funding for major investments projects (¶14). Rephased from end-September 2016.	End-March 2017	To improve the efficiency of public investment
Submit to parliament draft legislation to clarify powers by counties to set taxes/user fees, aimed at increasing revenue at the county level, while maintaining a business-friendly tax system ((¶12). Rephased from end-December 2016.	End-March 2017	To reduce pressures on transfers to counties while maintaining a business-friendly environment
Automate the release of funds from the exchequer account, first through the current system of MDA accounts (¶14)	End-March 2017	To strengthen control on public expenditure
Publish consolidated financial statements for the budgetary central government (i.e., the MDAs, their development projects, and the Consolidated Fund Accounts) (¶14). Modified and re-phased from end-March 2016.	End-March 2017	To improve the coverage of fiscal reports
Set up an integrated Public Investment Management (PIM) system for tracking projects through the project cycle (¶14)	End-June 2017	To improve the efficiency of public investment
Make operational a Centralized Payment System to ensure better control of public expenditure (¶14).	End-June 2017	To strengthen control on public expenditure
Improve capital adequacy assessment by issuing a Guidance Note on Internal Capital Adequacy Assessment Planning (ICAAP) to the banking sector, and ensure that all banks submit an ICAAP to the CBK (¶20).	End-June 2017	To help maintain financial stability

Attachment II. 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 24-month Stand-By Arrangement and the arrangement under the Standby Credit Facility.

2. For the purposes of the program, the National Government of Kenya corresponds to the budgetary central government encompassing the activities of the national executive, legislative and judicial powers covered by the National Budget. Specifically, it includes the parliament, presidential office, national judiciary, Ministries, Departments, Agencies, and Constitutional Commissions and Independent Offices.

I. QUANTITATIVE PERFORMANCE CRITERIA AND BENCHMARKS

3. Quantitative performance criteria are established for December 31, 2016 and June 30, 2017 with respect to:

- the primary balance of the national government including grants, and excluding spending related to the first phase of the Standard Gauge Railway project (connecting Mombasa to Nairobi), cash basis (**floor**);
- the net official international reserves (NIR) of the Central Bank of Kenya (CBK) (**floor**);
- national government medium- and long-term external public debt arrears (**continuous ceiling**);
- monetary policy consultation clause (**band**).

4. The program sets indicative targets for March 31, 2017 with respect to the above variables, and for December 31, 2016, March 31, 2017, and June 30, 2017 unless otherwise specified with respect to:

- the net domestic assets (NDA) of the CBK (**ceiling**);
- change in the stock of national government domestic bills pending for 90 days or longer (**ceiling**) effective from end-December, 2016;
- priority social spending of the national government (**floor**); and
- stock of guarantees issued by the national government (**ceiling**).

II. PERFORMANCE CRITERION ON THE PRIMARY BALANCE OF THE NATIONAL GOVERNMENT

5. **The national government primary balance** on cash basis is defined as national government revenues and grants minus expenditures and net lending, plus due interest payments, and spending related to the Standard Gauge Railway project, adjusted for cash basis.

6. For program purposes, the **national government primary balance**[1] on cash basis will be measured from the financing side as the sum of the following: (a) the negative of net domestic financing of the national government; (b) the negative of net external financing of the national government, excluding the executed amount of disbursements related to the first phase of the Standard Gauge Railway project (connecting Mombasa to Nairobi); and (c) domestic and external interest payments of the national government. For all test dates, the national government primary balance will be measured cumulatively from July 1, 2016.

The above items are defined as follows:

- **Net domestic financing** of the national government is defined as the sum of:
  - net domestic bank financing;
  - net domestic nonbank financing; and
  - proceeds from privatization.
- **Net external financing at actual transaction exchange rates** is defined as the sum of:
  - disbursements of **external project loans**, including securitization and excluding executed amounts of disbursements related to the first phase of the Standard Gauge Railway project;
  - disbursements of **budget support loans;**
  - the negative of principal repayments due 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.
- **Domestic and external interest payments** of the national government are defined as the due interest charges on domestic and external national government debt.

[1] The definition of the national government primary balance presented in the TMUs published as IMF Country report No. 15/31 and 15/269 contained inadvertent errors. The actual data reporting was done based on the understandings reached at the time of the initial program discussions. The current version of the TMU reflects these understandings.

7. **Adjustors.** The national government primary balance target will be: (i) adjusted downward by the amount of the shortfall in program grants, which are expected as refunds for Kenya's participation in African Union Mission in Somalia (AMISOM), as specified in TMU Table 1 below; and (ii) adjusted downwards by the excess in project loans (excluding first phase of the Standard Gauge Railway project) relative to the programmed amounts, as specified in MEFP Table 3, up to the maximum amounts, as specified in MEFP Table 3.

TMU Table 1. Kenya: African Mission in Somalia (AMISOM) Grant Schedule
(Billions of Kenyan Shillings)

	2016		2017	
	Sep.	Dec.	Mar.	Jun.
Program Amount [1]	1.2	2.7	3.5	6.4

Source: Authorities' data.
[1] For FY2016/17 cumulative from July 1, 2016.

III. PERFORMANCE CRITERION ON THE NET INTERNATIONAL RESERVES OF THE CENTRAL BANK OF KENYA

8. **The net official international reserves** (NIR) (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);
  - CBK holdings of convertible currencies in cash or in nonresident financial institutions (deposits, securities, or other financial instruments); and
  - Kenya's reserve tranche position with the IMF.

- **Gross official international reserves** exclude:
  - 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.

- **Gross official reserve liabilities** are defined as:
  - the total outstanding liabilities of the CBK to the IMF, excluding the SDR allocations;

- ➢ convertible currency liabilities of the CBK to nonresidents with an original maturity of up to and including one year; and
- ➢ 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 external program grants and external commercial debt exceed the programmed amounts set out in TMU Table 2 below, the target for NIR will be adjusted upward by half of the difference; and
- ➢ if budgetary external program grants and external commercial debt fall short of the programmed amounts set out in TMU Table 2 below, the target for NIR will be adjusted downward by the difference.

TMU Table 2. Projected Budgetary External Grants and Loans [1]
(US$ millions)

	2016		2017	
	Sep.	Dec.	Mar.	Jun.
Program grants	1.5	2.7	3.5	6.4
External commercial debt	0	750	750	1,500

Source: Kenyan authorities.
[1] Cumulative from July 1, 2016.

9. **NIR are monitored in U.S. dollars,**

10. 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 TMU Table 3 below, and net international reserves will be computed as the daily average for the month when the testing date is due.

TMU Table 3. Kenya: Program Exchange Rates

(Rates as of January 26, 2016)

Currency	Kenyan Shillings per currency unit	US Dollars per currency unit
US Dollar	102.24	1.00
STG Pound	145.48	1.42
Japanese Yen	0.87	117.52
Canadian Dollars	71.53	1.43
Euro	110.91	1.08
Swiss Franc	100.85	1.01
Swedish Kronor	11.93	8.57
Danish Kronor	14.87	6.88
Chinese Yuan	15.54	6.58
Australian Dollars	71.02	1.44
SDR	140.87	1.38

Source: Central Bank of Kenya.

IV. CONTINUOUS PERFORMANCE CRITERION ON THE NATIONAL GOVERNMENT EXTERNAL PAYMENT ARREARS

10. National government external payment arrears to official and private external 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 by the national government. National government guaranteed external debt payment arrears (principal or interest) to official and private creditors are defined as overdue payments beyond 30 days after the original contract due date in order to allow the national government sufficient time to process the due repayment after the original debtor has notified of its inability to pay. The definition excludes arrears relating to debt subject to renegotiation (dispute) or rescheduling.

11. The performance criterion on the national government external payment arrears is defined as a cumulative flow in gross terms from July 1, 2015 and applies on a continuous basis.

V. MONETARY POLICY CONSULTATION CLAUSE

12. The quarterly bands around the projected 12-month rate of inflation in consumer prices (as measured by the headline consumer price index (CPI) published by the Kenya National Bureau of Statistics), are specified in the TMU Table 4 below.

- If the observed average for the latest three months of the 12-months rate of CPI inflation falls outside the lower or upper bands specified in the TMU Table 4 below for end-

December 2016 and end-June 2017 test dates, the authorities will complete a consultation with the IMF Executive Board which would focus on: (i) the stance of monetary policy and whether the Fund-supported program remains on track; (ii) the reasons for program deviations, taking into account compensating factors; and (iii) proposed remedial actions if deemed necessary. When the consultation with the IMF Executive Board is triggered, access to Fund resources will be interrupted until the consultation takes place.

- If the observed average for the latest three months of the 12-month rate of CPI inflation falls outside the lower or upper bands specified in the TMU Table 4 below for end-March 2017 test date, the authorities will conduct discussions with the Fund staff.

TMU Table 4. Inflation Consultation Band

	2016				2017	
	Jan.-Mar. Actual	Apr.-Jun. Actual	Jul.-Sep. Actual	Oct.-Dec. Target	Jan.-Mar. Indicat.	Apr.-Jun. Target
Upper band				7.5	7.5	7.5
Actual/ *Center point*	*7.0*	*5.4*	*6.3*	*5.0*	*5.0*	*5.0*
Lower band				2.5	2.5	2.5

VI. INDICATIVE TARGET ON THE NET DOMESTIC ASSETS OF THE CENTRAL BANK OF KENYA

13. Net domestic assets (NDA) are defined as reserve money minus NIR converted in shillings at the accounting exchange rate specified in TMU Table 3, plus medium- and long-term liabilities (i.e., liabilities with a maturity of one year or more) of the CBK; minus the value in shillings of encumbered reserves converted at the accounting exchange rate specified in TMU Table 3.

- NDA is composed of:
  - net CBK credit to the national 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 half of the difference; and
  - 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.

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

VII. INDICATIVE TARGET ON NATIONAL GOVERNMENT DOMESTIC PENDING BILLS

15. For the purposes of the program, national government domestic pending bills are defined as outstanding invoices for which requisitions for payment have been received in Integrated Financial Management Information System (IFMIS) but no corresponding release of funds from the exchequer account has taken place. The Indicative Target (ceiling) applies to the change in the total stock of bills that have been pending for 90 days or more.

VIII. INDICATIVE TARGET ON PRIORITY SOCIAL SPENDING

16. For the purposes of the program, priority social spending of the national government is defined as the sum of:

- cash transfers to orphans and vulnerable children;
- cash transfers to elderly;
- free primary education expenditure; and
- free secondary education expenditure.

IX. INDICATIVE TARGET ON GUARANTEES ISSUED BY THE NATIONAL GOVERNMENT

17. The guarantees issued by the national government include all guarantees extended by the national government to counties, public enterprises and all parastatal entities. All indicative targets are cumulative from July 1, 2016.

X. DATA REPORTING

18. To monitor program performance, the National Treasury and the CBK will provide to the IMF the information at the frequency and within the reporting deadlines specified in TMU Table 5 below.

TMU Table 5. Kenya: Summary of Data to be Reported

Information	Frequency	Reporting Deadline	Responsible Entity
1. Primary balance of the national government			
Net domestic bank financing (including net commercial bank credit to the national government and net CBK credit to the national government)	Monthly	Within 20 days after the end of the month.	CBK
Net nonbank financing of the national government	Monthly	Within 20 days after the end of the month.	National Treasury (NT)
Proceeds from privatization	Monthly	Within 20 days after the end of the month.	NT
Interest due and paid on domestic debt	Monthly	Within 20 days after the end of the month.	CBK
Interest due and paid on external debt	Quarterly	Within 4 weeks after the end of the quarter.	CBK
Disbursements of external concessional and nonconcessional project loans, including securitization	Quarterly	Within 45 days after the end of the quarter.	NT
Disbursements of budget support loans	Quarterly	Within 45 days after the end of the quarter.	NT
Principal repayments due and paid on all external loans	Quarterly	Within 20 days after the end of the month.	CBK
Net proceeds from issuance of external debt	Monthly	Within 20 days after the end of the month.	CBK
Any exceptional financing (including rescheduled principal and interest)	Monthly	Within 20 days after the end of the month.	NT
Net changes in the stock of short-term external debt	Quarterly	Within 45 days after the end of the quarter.	NT
Net change in external arrears, including interest and principal, and penalties	Monthly	Within 45 days after the end of the quarter.	NT
2. Gross official international reserves			
CBK's holding of monetary gold (excluding amounts pledged as collateral)	Monthly	Within 20 days after the end of the month.	CBK
Holdings of SDRs.	Monthly	Within 20 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 20 days after the end of the month.	CBK

TMU Table 5. Summary of Data to be Reported (concluded)

3. Official reserve liabilities			
Total outstanding liabilities of the CBK to the IMF excluding the SDR allocations.	Monthly	Within 20 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 20 days after the end of the month.	CBK
Commitments to sell foreign exchange arising from derivatives.	Monthly	Within 20 days after the end of the month.	CBK
4. Net domestic assets			
Net CBK credit to the national government.	Monthly	Within 20 days after the end of the month.	CBK
Outstanding net CBK credit to domestic banks (including overdrafts).	Monthly	Within 20 days after the end of the month.	CBK
5. Other indicators			
Currency in circulation.	Monthly	Within 20 days after the end of the month.	CBK
Required and excess reserves	Monthly	Within 20 days after the end of the month.	CBK
Concessional and nonconcessional medium- and long-term external debt contracted or guaranteed by the national government.	Quarterly	Within 45 days after the end of the quarter.	NT
Accumulation of national government external payment arrears.	Monthly	Within 45 days after the end of the quarter.	NT
Change in the stock of national government domestic bills pending for 90 days or more starting June 2016.	Quarterly	Within 45 days after the end of the quarter.	NT
Social priority spending of the national government	Quarterly	Within 45 days after the end of the quarter.	NT
Grants to government entities and total subsidies.	Quarterly	Within 45 days after the end of the quarter.	NT
Guarantees issued by the national government to counties, public enterprises and all parastatal entities.	Monthly	Within 45 days after the end of the quarter.	NT
Inflows/outflows related to the SGR project.	Quarterly	Within 45 days after the end of the quarter.	NT
12-month CPI inflation.	Monthly	Within 20 days after the end of the month.	KNBS
Financial Soundness Indicators (core and expanded) for other depository corporations.	Quarterly	Within 20 days after the end of the quarter.	CBK

The envisaged fiscal consolidation that targets a 3.7 percent of GDP deficit by 2018/19 is critical to maintain a low risk of debt distress while preserving fiscal space for development priorities. Continued public financial management reforms, aimed at upgrading the efficiency of public spending and expenditure control, are key to strengthening fiscal policies and institutions.

Establishing a formal interest rate corridor remains a priority for strengthening the monetary policy framework. While adoption of such a corridor has been delayed given the uncertainties created by interest rate controls, it will be important to conduct liquidity operations to realign interbank rates to the policy rate as economic conditions permit.

The authorities are taking actions to strengthen financial stability and to enforce reporting requirements. These include steps to implement the action plan on banking regulation and supervision to enhance capacity to monitor credit and liquidity risks and limit insider lending.

Continued improvements in macroeconomic statistics and acceleration of governance reforms will be essential to reinforcing efficiency, transparency, and accountability”.

KENYA

December 23, 2016

FIRST REVIEWS UNDER THE TWENTY-FOUR MONTH STAND-BY ARRANGEMENT AND THE ARRANGEMENT UNDER THE STANDBY CREDIT FACILITY AND REQUESTS FOR WAIVERS OF APPLICABILITY, REPHASING OF DISBURSEMENTS, AND MODIFICATION OF PERFORMANCE CRITERION—DEBT SUSTAINABILITY ANALYSIS UPDATE

Approved By
Roger Nord (IMF) and Paloma Anos-Casero (IDA)

Prepared by staffs of the International Monetary Fund and the International Development Association

Risk of external debt distress:	Low
Augmented by significant risks stemming from domestic public and/or private external debt?	No

Kenya's risk of external debt distress remains low, while overall public sector debt dynamics continue to be sustainable.[1] *However, margins have generally narrowed, and standardized stress tests suggest that the vulnerability to export shocks has increased. Public debt has risen in recent years, with most new debt financing infrastructure to address bottlenecks and boost sustainable growth. The bulk of Kenya's external public debt carries concessional terms, but recent commercial borrowing entails significant repayment needs in 2017 (2015 syndicated loan), in 2019 and, especially, in 2024 (2014 sovereign bond issuance). Implementation of the planned reduction in the fiscal deficit over the medium term is essential to limit and eventually reverse the rise in public debt ratios. In addition, the composition of fiscal financing between domestic and foreign sources should seek to contain risks of public external debt from export shocks while avoiding a crowding out of domestic bank credit to the private sector.*

[1] Kenya's policies and institutions are classified as "strong" under the World Bank's Country Policy and Institutional Assessment (CPIA) Index (average score in 2013–15: 3.83). The relevant indicative thresholds for this category are: 50 percent for the NPV of debt-to-GDP ratio, 200 percent for the NPV of debt-to-exports ratio, 300 percent for the NPV of debt-to-revenue ratio, 25 percent for the debt service-to-exports ratio, and 22 percent for the debt service-to-revenue ratio. These thresholds are applicable to public and publicly guaranteed external debt.

BACKGROUND

1. **This DSA consists of two parts: external and public.** The external DSA covers external debt of the central government and the central bank, as well as of the private sector; stress tests apply to public and publicly guaranteed (PPG) debt. The public DSA covers total debt—external and domestic—incurred or guaranteed by the central government. Public domestic debt comprises central government debt. Government finance statistics are to be expanded to cover the recently created county governments. In this analysis, total public debt refers to the sum of public domestic and public external debt, but does not cover the entire public sector (e.g., parastatal borrowing without a government guarantee is not covered).

2. **Kenya's overall public debt has increased in the past two years.** Gross public debt increased from 44 percent of GDP at end-2013 to 52.4 percent at end-2015. In the baseline, public debt is expected to stabilize around 54–55 percent of GDP in 2017–18 and gradually decline thereafter. Half of Kenya's public debt is owed to external creditors.

3. **Most of Kenya's external public debt remains on concessional terms, but its commercial component has increased.** Nominal public external debt at end-2015 was US$16.1 billion (text table), equivalent to 26.4 percent of GDP.

- Multilateral creditors account for just under half of external credit to Kenya as the share of debt from commercial creditors has increased. Debt to bilateral creditors is roughly half to Paris Club creditors, and half to other bilateral creditors, mainly semi-concessional loans from China to finance construction of the first phase (Mombasa-Nairobi) of the Standard Gauge Railway project (SGR). In December 2015, Kenya contracted a further semi-concessional loan from China of US$1.5 billion, to be disbursed in the coming years, for the second SGR phase (Nairobi-Naivasha).

- Kenya's commercial financing has two main elements. In 2014, Kenya issued its inaugural sovereign bonds, at 5-year and 10-year maturities, raising US$2 billion in June and a further US$750 million in December 2014.[2] More recently, in October 2015, Kenya contracted a two-year US$750 million syndicated loan at LIBOR plus 570 basis points, equivalent to an effective yield of 8 percent.

4. **Kenya's gross domestic public debt was 26 percent of GDP at end-2015.** Domestic debt is issued mostly in the form of Treasury bonds (66 percent of domestic debt) and Treasury bills (32 percent). Commercial banks hold 57 percent of the domestic debt, with nonbanks (pension and trust funds, insurance companies and others) holding 43 percent. Rollover risks appear moderate. The average maturity of Kenya's domestic debt shortened, from 5.8 years in June 2011 to 5.2 years in June 2013 and 4.3 years in June 2016.

[2] The June 2014 issuance comprised two tranches: a five-year $500 million bond at a yield of 5.875 percent, and a 10-year $1.5 billion bond at 6.875 percent. In December 2014, Kenya added $250 million to the five-year tranche at a 5.0 percent yield and $500 million to the 10-year tranche at 5.9 percent.

Kenya External Public Debt

	2012		2013		2014		2015	
	Billion US$	Share	Billion US$	Share	Billion US$	Share	Billion US$	Share
Mulilateral creditors	5.56	57.6	6.47	60.5	7.07	49.2	7.30	44.3
Bilateral creditors	2.71	28.1	2.84	26.6	3.86	26.9	5.18	31.4
Commercial creditors	0.68	7.0	0.69	6.5	2.82	19.6	3.60	21.8
Others (supplier credits)	0.18	1.9	0.18	1.7	0.18	1.3	0.00	0.0
Total (excluding guarantees)	9.13	94.6	10.18	95.2	13.93	96.9	16.08	97.5
Publicly guaranteed debt	0.52	5.4	0.51	4.8	0.44	3.1	0.41	2.5
Total (including guarantees)	9.65	100.0	10.69	100.0	14.37	100.0	16.49	100.0

Source: Kenyan National Treasury.

UNDERLYING ASSUMPTIONS

5. **This DSA is based on macroeconomic assumptions that are consistent with the framework for the accompanying staff report.** Compared with the previous projections, the growth outlook is modestly weaker and external commercial borrowing is lower in light of a slower pace of public investment.

- Real GDP growth is modestly weaker in the short term, reflecting mainly the expected impact of interest rate caps, but recovers in the medium term. Faster growth in the longer term is predicated on the assumption that the present infrastructure push successfully addresses key bottlenecks.

- The primary fiscal deficit peaked in 2015 owing to a frontloading of SGR-related spending, and is projected to be brought down in the medium to longer term consistent with the East African Community (EAC) Monetary Union convergence criteria.[3] The higher primary balance compared with the previous DSA mainly reflects delayed SGR spending in FY2015/16 that spilled over to FY2017/18. In the long term, the primary deficit would converge to its previously projected level, consistent with keeping the overall deficit below 3 percent while making room for higher interest payments.

- The current account deficit narrowed substantially in 2015 owing mainly to lower imports of oil products and investment-related imports. Exports were also weaker than expected due to temporary regulatory issues with the EU in the horticulture sector and lower tourism following the terrorist attacks. The current account is projected to narrow further in 2016 on account of lower oil prices and as exports recover from temporary shocks. In the medium term fiscal consolidation as well as a pickup in trade is expected as demand in key export markets accelerates, progress is made in regional integration, in part due to infrastructure investment, and reforms to the business environment contribute to gains in competitiveness.[4]

[3] The EAC Monetary Union Protocol provides for fiscal convergence criteria, including a ceiling on the fiscal deficit (defined including grants) of 3 percent of GDP; and a ceiling on the gross public debt of 50 percent of GDP in present value terms. The other macroeconomic convergence criteria include a ceiling on headline inflation (8 percent) and a floor on reserve cover (4.5 months of imports). The fiscal plans outlined in the authorities' budget policy statement are consistent with Kenya meeting the EAC convergence criteria by 2021.

[4] Kenya's ranking in the World Bank's Doing Business Report (2016) improved 21 places relative to 2015, one of the top 10 increases across the globe. Ongoing reforms will, amongst other areas, seek to further reduce transportation and trading costs.

The macro-framework projections do not include potential exports from recent oil discoveries. Both exports and imports are lower than previously projected, as a share of GDP.

Kenya: Selected Macroeconomic Assumptions

	2015	2016	2017	2018	2019	Long-term 1/
Real GDP Growth						
Current DSA	5.6	6.0	5.3	5.8	6.2	6.5
Previous DSA (March 2016)	5.6	6.0	6.1	6.5	6.5	6.5
Primary Fiscal Deficit (percent of GDP)						
Current DSA	4.9	4.1	3.3	1.5	0.4	0.2
Previous DSA (March 2016)	5.4	4.1	2.6	1.3	0.7	0.6
Non-interest Current Account (percent of GDP)						
Current DSA	5.8	4.4	4.5	4.3	4.2	4.2
Previous DSA (March 2016)	7.4	7.0	5.5	5.4	5.4	5.9

Source: IMF staff estimates.
1/ For current DSA average 2022–36. For previous DSA, average 2021–35.

EXTERNAL DEBT SUSTAINABILITY ANALYSIS

6. **External debt indicators remain well below the policy-dependent debt burden thresholds under the DSA baseline scenario.** The PV of PPG external debt as a share of GDP is expected to rise moderately to 22.6 percent in 2017 from 20.3 percent in 2015. This is lower than projections in the previous DSA reflecting a lower rate of externally financed investment projects. The PV of PPG external debt then gradually declines over time in line with the planned fiscal consolidation, remaining well below the 50 percent indicative threshold. The PV of external debt to exports and revenues both remain well below the indicative thresholds of 200 percent and 300 percent respectively.

7. **Under the standard stress tests, all relevant indicators remain below the thresholds with the exception of one temporary breach.**

- Under most extreme stress scenario of an exports shock, the PV of debt to exports breaches the threshold for two years by an average of 8.0 percentage points (Figure 1 and Table 2). This is related to temporary shocks in 2015 which lowered services and horticulture exports resulting in a lower export base. Looking forward, services exports have already begun to recover due to the removal of travel restrictions reflecting substantial improvements in counter-terrorism strategies, which have resulted in a decline in security and crime-related incidents. Horticulture exports have also recovered as the horticulture sector in Kenya has established systems to ensure EU regulatory standards are met on a consistent basis. Moreover, the discovery of significant oil and gas resources—which is an important upside to GDP growth, fiscal balances, and export projections—have not been incorporated into the baseline.

- A one-time nominal exchange rate depreciation of 30 percent is the shock which has the largest impact on the PV of debt to GDP and debt to revenue ratios. Under both of these scenarios, debt remains well below the indicative thresholds.

- Shocks to the debt service indicators relative to exports and revenues also remain well below the relevant thresholds, with peaks reflecting repayment of the 2014 sovereign bond.

8. Staff continues to assess that the risk of external debt distress remains low, although risks have increased. The breach in the threshold of the PV of external debt to exports ratio is small and temporary, and therefore staff continues to assess that the risk of external debt distress is low. The increase in public investment, in part financed by external commercial borrowing, has led to an increase in vulnerabilities. The authorities intend to maximize reliance on concessional borrowing to keep financing costs low and limit refinancing risks. In addition, continued commitment to fiscal consolidation will be key to maintaining debt sustainability. Risks to export growth remain, particularly from security-related threats. If export growth fails to materialize, this could adversely impact Kenya's risk rating (highlighted in Figure 1, panel c).

PUBLIC DEBT SUSTAINABILITY ANALYSIS

9. Total public debt as a share of GDP is set to stabilize in 2017–18 and then gradually decline over the medium term. In 2016, public sector debt is projected to rise to 54.4 percent, from 52.4 percent in 2015. Looking forward, fiscal consolidation will reduce the primary deficit to 1.5 percent of GDP in 2018 down to 0.4 percent of GDP in 2019 resulting in a decline in debt to 52.9 percent of GDP. In PV terms, the debt is stable at 48-49 percent of GDP from 2016-2018 and falls thereafter. The authorities' medium-term debt anchor is 45 percent in PV terms (within the EAC convergence criterion of 50 percent). The PV of public debt-to-revenue ratio would ease from 241 percent in 2016 to 209 percent in 2020 (Table 4).

10. Total public debt as a share of GDP remains well below the LIC DSA public debt benchmark. Under the baseline and all stress scenarios, debt remains below the benchmark of 74 percent of GDP in PV terms. This is the benchmark applicable for LICs whose CPIA score for quality of policies and institutions is assessed as strong and covers the entire public sector. In Kenya, public debt does not include legacy debts of the pre-devolution county governments (whose size is not yet fully clear) as well as borrowings of state-owned enterprises. In addition, public debt should include planned annuities intended to finance road construction: although the annuity obligations may not necessarily be classified as debt under local law, they nevertheless represent public debt obligations according to international (GFS) methodology.

11. The alternative scenarios and bound tests indicate that the projected paths for public debt indicators remain within the relevant benchmarks. Under a standard scenario that keeps the primary balance unchanged from its 2016 level, the PV of public debt to GDP would remain on a steady upwards trajectory but does not exceed the 74 percent benchmark during the projection period. There are risks to this outlook linked to a slippage in the authorities' medium-term fiscal consolidation plans, and possible recourse to commercial external borrowing. In addition, fixing the primary deficit at the 2016 level results in a gradual increase in the debt to revenue ratio, rising to 254 percent in 2020.

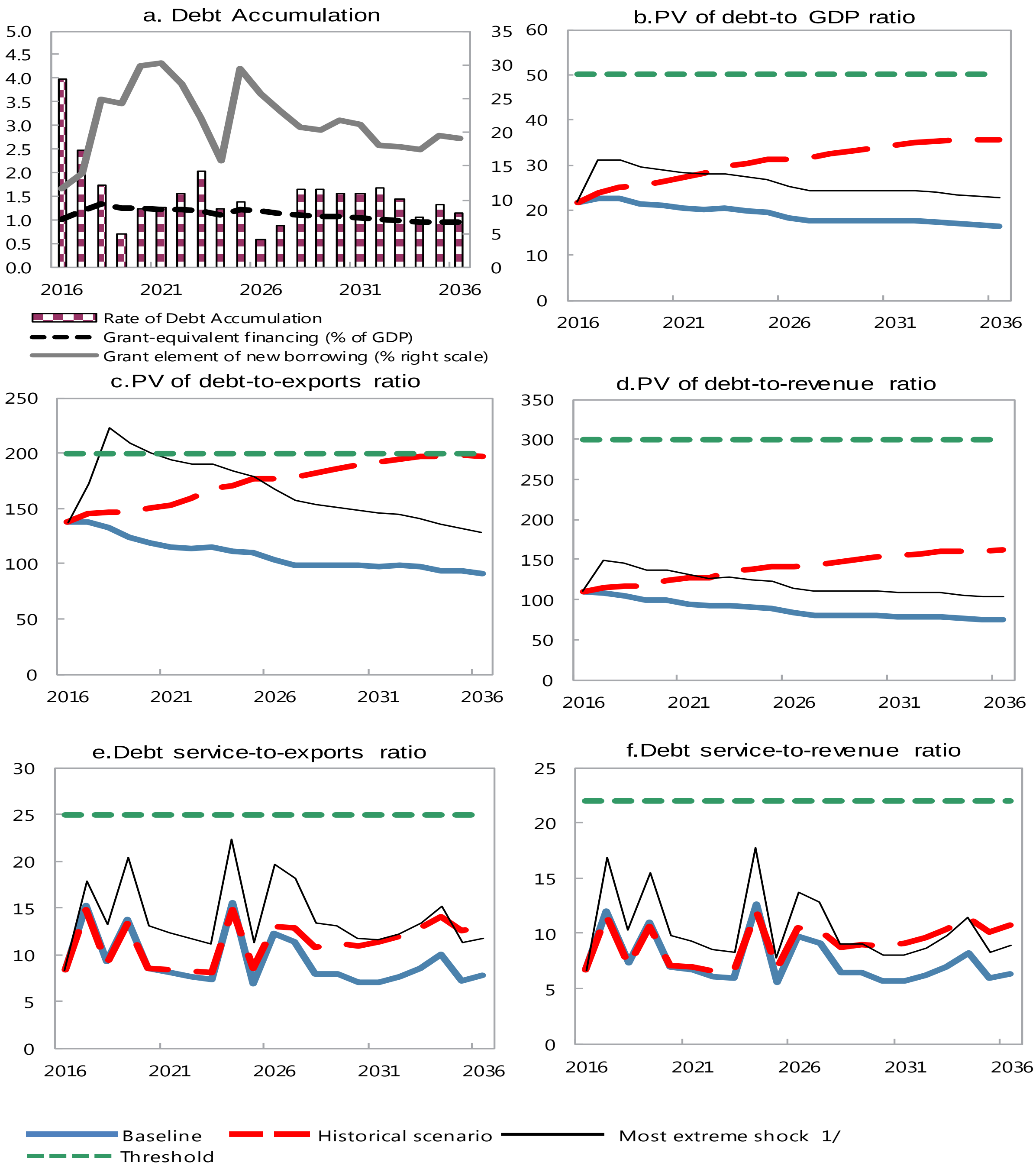
MAIN FINDINGS AND CONCLUSIONS

12. This DSA finds that Kenya continues to face low risk of external debt distress. External debt under the baseline and standard stress tests scenarios show that debt remains within sustainable bounds. Standardized stress tests indicate a small and temporary breach under the exports shock. A large exchange rate shock continues to represent a significant risk to external debt. The authorities are strengthening their debt management capacity to manage and prepare for large repayments on commercial borrowing. At the same time, concessional borrowing will continue to play an important role in financing investment projects due to its lower cost and longer maturity profile. Looking ahead, the planned investment in infrastructure will be critical to raise growth and export potential, both of which will support Kenya's external debt sustainability.

13. Fiscal consolidation is essential to ensure debt remains sustainable. The increase in debt is due to a much needed boost to public investment. Fiscal consolidation began last year and the authorities will need to remain committed to their medium-term plans of gradual adjustment. The baseline public debt path remains consistent with the EAC convergence criteria (deficit and debt) and debt indicators are below the relevant public debt benchmark in the baseline and stress scenarios, subject to coverage issues. Standard stress-testing scenarios show that if the primary deficit were to remain at current levels, public debt would remain on an upward path which highlights the need to follow through on the intended medium-term fiscal consolidation.

14. The authorities are committed to their public investment plan to raise growth in output and exports while ensuring debt sustainability. The increase in infrastructure is continuing and the authorities are committed to fiscal consolidation to maintain debt sustainability. They agree that they remain at low risk of external debt distress. However, they emphasize that their externally financed infrastructure investments will address bottlenecks that have constrained past growth and export performance.

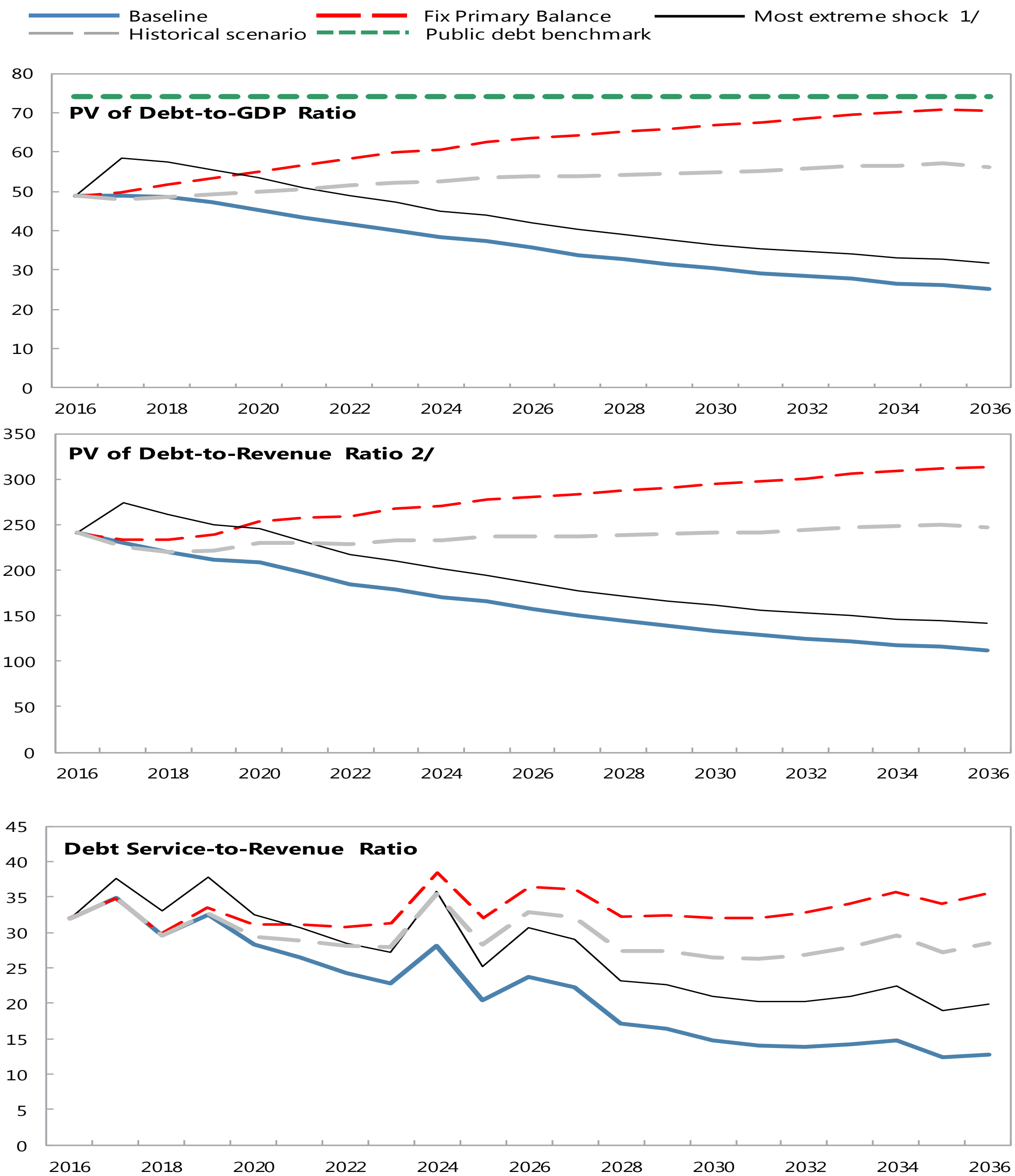
Figure 1. Kenya: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2016–36 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2026. In figure b. it corresponds to a One-time depreciation shock; in c. to a Exports shock; in d. to a One-time depreciation shock; in e. to a Exports shock and in figure f. to a One-time depreciation shock

Figure 2. Kenya: Indicators of Public Debt Under Alternatives Scenarios, 2016–36 1/



Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio on or before 2026.
2/ Revenues are defined inclusive of grants.

Table 1. Kenya: External Debt Sustainability Framework, Baseline Scenario, 2013–36 1/

(Percent of GDP, unless otherwise indicated)

	Actual			Historical 6/ Average	Standard 6/ Deviation	Projections									
	2013	2014	2015			2016	2017	2018	2019	2020	2021	2016-2021 Average	2026	2036	2022-2036 Average
External debt (nominal) 1/	**29.4**	**36.6**	**42.6**			**42.9**	**44.9**	**47.0**	**46.7**	**46.7**	**46.9**		**51.7**	**61.7**	
of which: public and publicly guaranteed (PPG)	19.4	23.5	26.4			27.4	28.3	28.3	27.2	26.8	26.2		23.9	20.8	
Change in external debt	1.0	7.3	6.0			0.3	2.0	2.1	-0.4	0.0	0.2		0.8	1.0	
Identified net debt-creating flows	4.7	5.0	3.9			1.3	1.6	0.9	0.5	0.3	0.4		0.7	0.9	
Non-interest current account deficit	**7.8**	**9.1**	**5.8**	**5.8**	**2.6**	**4.4**	**4.5**	**4.3**	**4.2**	**4.2**	**4.2**		**4.3**	**4.2**	4.2
Deficit in balance of goods and services	13.6	15.1	11.4			11.2	10.3	10.2	9.7	9.7	9.7		9.4	9.5	
Exports	19.9	18.4	16.5			15.8	16.4	17.0	17.3	17.6	17.7		17.6	18.0	
Imports	33.5	33.5	27.9			27.0	26.7	27.2	27.0	27.3	27.4		27.1	27.5	
Net current transfers (negative = inflow)	-5.6	-5.7	-5.4	-6.1	0.5	-4.8	-4.5	-4.4	-4.4	-4.3	-4.2		-3.8	-3.8	-3.9
of which: official	-0.2	-0.1	-0.1			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other current account flows (negative = net inflow)	-0.2	-0.3	-0.2			-2.0	-1.3	-1.5	-1.2	-1.2	-1.2		-1.3	-1.5	
Net FDI (negative = inflow)	**-1.7**	**-1.7**	**-1.7**	**-1.4**	**1.1**	**-1.9**	**-2.1**	**-2.3**	**-2.3**	**-2.4**	**-2.3**		**-2.0**	**-1.4**	-1.8
Endogenous debt dynamics 2/	**-1.4**	**-2.4**	**-0.2**			**-1.2**	**-0.8**	**-1.1**	**-1.3**	**-1.5**	**-1.5**		**-1.6**	**-1.9**	
Contribution from nominal interest rate	1.0	0.7	1.0			1.1	1.3	1.3	1.3	1.3	1.3		1.4	1.7	
Contribution from real GDP growth	-1.5	-1.4	-2.0			-2.4	-2.1	-2.4	-2.7	-2.8	-2.8		-3.0	-3.6	
Contribution from price and exchange rate changes	-0.9	-1.6	0.8			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	**-3.7**	**2.3**	**2.1**			**-1.0**	**0.4**	**1.3**	**-0.9**	**-0.3**	**-0.2**		**0.1**	**0.1**	
of which: exceptional financing	-0.6	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		...	...	
PV of external debt 4/	...	...	36.5			37.2	39.2	41.2	40.9	40.9	41.0		46.0	57.2	
In percent of exports	...	...	220.8			235.6	239.2	242.8	236.7	232.8	231.9		261.0	317.0	
PV of PPG external debt	**...**	**...**	**20.3**			**21.7**	**22.6**	**22.5**	**21.4**	**20.9**	**20.3**		**18.3**	**16.3**	
In percent of exports	**...**	**...**	**122.8**			**137.4**	**137.9**	**132.2**	**124.1**	**119.3**	**115.0**		**103.5**	**90.6**	
In percent of government revenues	**...**	**...**	**107.7**			**110.1**	**108.7**	**104.7**	**98.9**	**98.9**	**94.8**		**82.8**	**74.4**	
Debt service-to-exports ratio (in percent)	**52.7**	**58.4**	**55.4**			**29.7**	**45.8**	**44.2**	**41.4**	**34.8**	**36.7**		**53.9**	**56.0**	
PPG debt service-to-exports ratio (in percent)	**4.4**	**16.3**	**7.3**			**8.3**	**15.2**	**9.2**	**13.8**	**8.4**	**8.0**		**12.2**	**7.7**	
PPG debt service-to-revenue ratio (in percent)	**4.5**	**15.5**	**6.4**			**6.7**	**12.0**	**7.3**	**11.0**	**7.0**	**6.6**		**9.8**	**6.3**	
Total gross financing need (Billions of U.S. dollars)	11.1	13.2	11.8			10.7	13.5	15.0	17.8	18.6	21.0		45.2	143.2	
Non-interest current account deficit that stabilizes debt ratio	6.8	1.8	-0.2			4.1	2.4	2.1	4.6	4.1	4.0		3.5	3.2	
Key macroeconomic assumptions															
Real GDP growth (in percent)	5.7	5.3	5.6	5.2	2.2	6.0	5.3	5.8	6.2	6.5	6.5	6.0	6.5	6.6	6.5
GDP deflator in US dollar terms (change in percent)	3.5	5.9	-2.1	6.5	7.7	2.2	3.5	1.7	2.3	1.7	2.1	2.2	2.6	2.6	2.6
Effective interest rate (percent) 5/	3.9	2.6	2.9	2.7	0.9	2.9	3.2	3.2	3.1	3.1	3.1	3.1	3.0	3.1	3.1
Growth of exports of G&S (US dollar terms, in percent)	-2.0	2.9	-7.0	7.6	11.3	3.6	13.0	11.5	10.4	10.1	9.5	9.7	9.1	9.6	9.4
Growth of imports of G&S (US dollar terms, in percent)	3.0	11.5	-13.7	11.0	13.8	4.7	7.8	9.5	7.8	9.5	8.9	8.0	8.9	9.6	9.3
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	11.7	14.0	24.9	24.2	29.9	30.3	22.5	25.7	19.2	21.3
Government revenues (excluding grants, in percent of GDP)	19.2	19.3	18.8			19.7	20.8	21.5	21.7	21.2	21.5		22.1	22.0	22.1
Aid flows (in Billions of US dollars) 7/	0.3	0.3	0.3			1.1	1.3	1.4	1.4	1.5	1.6		2.4	4.8	
of which: Grants	0.3	0.3	0.3			0.3	0.4	0.5	0.5	0.5	0.5		0.9	2.1	
of which: Concessional loans	...	...	...			0.8	0.9	0.9	0.9	1.0	1.1		1.6	2.6	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			1.0	1.2	1.3	1.3	1.2	1.2		1.2	0.9	1.1
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			20.4	24.2	38.3	38.3	43.2	43.1		39.2	35.9	35.3
Memorandum items:															
Nominal GDP (Billions of US dollars)	55.1	61.5	63.6			68.9	75.1	80.7	87.7	95.0	103.2		160.1	389.0	
Nominal dollar GDP growth	9.3	11.5	3.5			8.3	9.0	7.5	8.6	8.3	8.7	8.4	9.3	9.3	9.2
PV of PPG external debt (in Billions of US dollars)			12.3			14.9	16.6	17.9	18.5	19.6	20.7		28.9	62.8	
(PVt-PVt-1)/GDPt-1 (in percent)						4.0	2.5	1.8	0.7	1.2	1.3	1.9	0.6	1.1	1.4
Gross workers' remittances (Billions of US dollars)	1.3	1.4	1.6			1.8	2.0	2.1	2.3	2.4	2.6		3.8	9.7	
PV of PPG external debt (in percent of GDP + remittances)	...	...	19.8			21.1	22.0	21.9	20.9	20.4	19.8		17.8	16.0	
PV of PPG external debt (in percent of exports + remittances)	...	...	106.8			117.7	119.0	114.7	108.0	104.1	100.6		91.3	79.6	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	6.4			7.1	13.1	8.0	12.0	7.4	7.0		10.8	6.8	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

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

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

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

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

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

7/ Defined as grants, concessional loans, and debt relief.

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

Table 2. Kenya: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2016–36
(Percent)

	Projections							
	2016	2017	2018	2019	2020	2021	**2026**	2036
PV of debt-to GDP ratio								
Baseline	22	23	22	21	21	20	**18**	16
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	22	24	25	25	26	27	**31**	36
A2. New public sector loans on less favorable terms in 2016-2036 2	22	23	24	23	23	23	**24**	25
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	22	23	23	22	22	21	**19**	17
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	22	24	28	27	26	25	**22**	17
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	22	23	24	23	22	22	**19**	17
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	22	23	24	22	22	21	**19**	16
B5. Combination of B1-B4 using one-half standard deviation shocks	22	24	27	26	25	24	**21**	17
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	22	31	31	30	29	28	**25**	23
PV of debt-to-exports ratio								
Baseline	137	138	132	124	119	115	**104**	91
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	137	145	147	147	150	153	**177**	197
A2. New public sector loans on less favorable terms in 2016-2036 2	137	141	141	135	133	132	**135**	140
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	137	135	130	122	117	113	**102**	89
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	137	173	223	209	200	193	**167**	128
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	137	135	130	122	117	113	**102**	89
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	137	139	139	130	125	120	**107**	90
B5. Combination of B1-B4 using one-half standard deviation shocks	137	159	188	176	168	163	**142**	112
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	137	135	130	122	117	113	**102**	89
PV of debt-to-revenue ratio								
Baseline	110	109	105	99	99	95	**83**	74
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	110	114	116	117	124	126	**142**	162
A2. New public sector loans on less favorable terms in 2016-2036 2	110	111	111	108	111	109	**108**	115
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	110	109	108	102	102	98	**85**	77
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	110	116	130	122	122	117	**98**	77
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	110	111	111	105	105	101	**88**	79
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	110	109	110	103	103	99	**86**	74
B5. Combination of B1-B4 using one-half standard deviation shocks	110	115	126	118	118	114	**96**	78
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	110	150	145	137	137	132	**115**	103

Table 2. Kenya: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2016–36 (continued)

(In percent)

				Debt service-to-exports ratio				
Baseline	8	15	9	14	8	8	**12**	8
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	8	15	9	13	9	8	**13**	13
A2. New public sector loans on less favorable terms in 2016-2036 2	8	15	8	13	8	8	**9**	11
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	8	15	9	14	8	8	**12**	8
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	8	18	13	20	13	12	**20**	12
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	8	15	9	14	8	8	**12**	8
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	8	15	9	14	9	8	**13**	8
B5. Combination of B1-B4 using one-half standard deviation shocks	8	17	12	18	11	11	**17**	10
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	8	15	9	14	8	8	**12**	8
				Debt service-to-revenue ratio				
Baseline	7	12	7	11	7	7	**10**	6
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	7	12	7	11	7	7	**10**	11
A2. New public sector loans on less favorable terms in 2016-2036 2	7	12	7	11	7	7	**7**	9
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	7	12	8	12	7	7	**10**	7
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	7	12	8	12	8	8	**12**	7
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	7	13	8	12	8	7	**11**	7
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	7	12	7	11	7	7	**10**	7
B5. Combination of B1-B4 using one-half standard deviation shocks	7	12	8	12	8	7	**11**	7
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	7	17	10	15	10	9	**14**	9
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	17	17	17	17	17	17	**17**	17

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.

2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.

3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after an offsetting adjustment in import levels).

4/ Includes official and private transfers and FDI.

5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table 3. Kenya: Public Sector Debt Sustainability Framework, Baseline Scenario, 2013–36

(Percent of GDP, unless otherwise indicated)

	Actual					Estimate	Projections								
	2013	2014	2015	Average 5/	Standard Deviation 5/	2016	2017	2018	2019	2020	2021	2016-21 Average	2026	2036	2022-36 Average
Public sector debt 1/	44.0	48.6	52.4			54.4	54.7	54.4	52.9	51.2	49.1		41.3	29.7	
of which: foreign-currency denominated	19.4	23.5	26.4			27.4	28.3	28.3	27.2	26.8	26.2		23.9	20.8	
Change in public sector debt	2.3	4.6	3.8			2.0	0.3	-0.3	-1.5	-1.8	-2.1		-1.7	-1.2	
Identified debt-creating flows	1.5	2.9	4.1			1.4	1.9	-0.2	-1.4	-1.9	-2.3		-1.9	-0.2	
Primary deficit	3.0	4.7	4.9	2.2	1.7	4.1	3.3	1.5	0.4	-0.1	-0.3	1.5	0.0	1.2	0.2
Revenue and grants	19.7	19.8	19.3			20.2	21.4	22.1	22.3	21.7	22.0		22.6	22.5	
of which: grants	0.5	0.5	0.5			0.5	0.6	0.6	0.6	0.5	0.5		0.5	0.5	
Primary (noninterest) expenditure	22.7	24.4	24.2			24.3	24.6	23.6	22.7	21.6	21.7		22.6	23.7	
Automatic debt dynamics	-1.5	-1.7	-0.8			-2.7	-1.4	-1.7	-1.8	-1.8	-1.9		-1.9	-1.4	
Contribution from interest rate/growth differential	-0.9	-1.5	-1.8			-1.5	-1.4	-1.6	-1.9	-1.9	-1.8		-1.6	-1.2	
of which: contribution from average real interest rate	1.3	0.7	0.8			1.5	1.3	1.4	1.3	1.3	1.3		1.0	0.7	
of which: contribution from real GDP growth	-2.2	-2.2	-2.6			-3.0	-2.7	-3.0	-3.2	-3.2	-3.1		-2.6	-1.9	
Contribution from real exchange rate depreciation	-0.6	-0.2	1.1			-1.2	0.0	-0.1	0.1	0.1	-0.1		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	0.8	1.7	-0.3			0.6	-1.6	-0.1	-0.1	0.2	0.2		0.2	-0.9	
Other Sustainability Indicators															
PV of public sector debt	...	...	46.3			48.7	49.0	48.6	47.1	45.3	43.2		35.6	25.2	
of which: foreign-currency denominated	...	...	20.3			21.7	22.6	22.5	21.4	20.9	20.3		18.3	16.3	
of which: external	...	...	20.3			21.7	22.6	22.5	21.4	20.9	20.3		18.3	16.3	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	14.8	18.9	17.5			17.5	18.0	15.2	14.6	12.9	12.0		10.1	6.6	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	239.9			241.1	229.2	220.1	211.5	208.7	196.6		157.5	112.1	
PV of public sector debt-to-revenue ratio (in percent)	...	...	245.7			247.2	235.7	226.6	217.4	214.1	201.4		161.4	114.9	
of which: external 3/	...	...	107.7			110.1	108.7	104.7	98.9	98.9	94.8		82.8	74.4	
Debt service-to-revenue and grants ratio (in percent) 4/	29.1	39.2	31.6			32.0	34.8	29.6	32.5	28.4	26.5		23.7	12.8	
Debt service-to-revenue ratio (in percent) 4/	29.9	40.2	32.4			32.8	35.8	30.5	33.4	29.1	27.1		24.3	13.1	
Primary deficit that stabilizes the debt-to-GDP ratio	0.8	0.0	1.1			2.1	3.0	1.8	1.9	1.7	1.8		1.6	2.4	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	5.7	5.3	5.6	5.2	2.2	6.0	5.3	5.8	6.2	6.5	6.5	6.0	6.5	6.6	6.5
Average nominal interest rate on forex debt (in percent)	1.4	2.4	2.6	1.6	0.5	2.9	3.2	3.2	3.1	3.1	3.1	3.1	2.9	3.2	3.0
Average real interest rate on domestic debt (in percent)	6.3	2.6	1.7	1.4	4.0	4.4	3.8	4.5	4.3	4.5	4.5	4.3	4.0	3.8	4.1
Real exchange rate depreciation (in percent, + indicates depreciation	-3.2	-1.2	4.7	-3.0	8.0	-4.7	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	5.4	8.0	9.1	9.1	3.6	6.0	5.8	5.4	5.5	5.3	5.1	5.5	5.1	5.1	5.1
Growth of real primary spending (deflated by GDP deflator, in percer	12.1	13.2	4.6	3.0	5.3	6.4	6.8	1.5	1.9	1.4	6.8	4.1	6.7	8.1	7.1
Grant element of new external borrowing (in percent)	...	...	...	...	...	11.7	14.0	24.9	24.2	29.9	30.3	22.5	25.7	19.2	...

Sources: Country authorities; and staff estimates and projections.

1/ Refers to gross debt of the central government, including CBK obligations to the IMF, excluding government deposits.

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 4. Kenya: Sensitivity Analysis for Key Indicators of Public Debt, 2016–36

	Projections							
	2016	2017	2018	2019	2020	2021	2026	2036
PV of Debt-to-GDP Ratio								
Baseline	49	49	49	47	45	43	36	25
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	49	48	49	49	50	51	54	56
A2. Primary balance is unchanged from 2016	49	50	52	53	55	57	63	70
A3. Permanently lower GDP growth 1/	49	49	49	48	47	45	42	43
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2017-2018	49	50	52	52	51	49	45	39
B2. Primary balance is at historical average minus one standard deviations in 2017-2018	49	50	51	50	48	46	37	26
B3. Combination of B1-B2 using one half standard deviation shocks	49	49	51	50	49	47	41	33
B4. One-time 30 percent real depreciation in 2017	49	59	58	56	53	51	42	32
B5. 10 percent of GDP increase in other debt-creating flows in 2017	49	58	57	56	53	51	42	29
PV of Debt-to-Revenue Ratio 2/								
Baseline	241	229	220	211	209	197	157	112
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	241	225	220	221	230	230	237	247
A2. Primary balance is unchanged from 2016	241	233	234	239	254	257	281	312
A3. Permanently lower GDP growth 1/	241	231	223	217	216	207	184	191
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2017-2018	241	236	237	232	233	224	199	175
B2. Primary balance is at historical average minus one standard deviations in 2017-2018	241	232	232	223	220	207	166	117
B3. Combination of B1-B2 using one half standard deviation shocks	241	231	231	224	224	213	182	147
B4. One-time 30 percent real depreciation in 2017	241	274	261	250	246	231	186	141
B5. 10 percent of GDP increase in other debt-creating flows in 2017	241	272	260	249	246	232	185	129
Debt Service-to-Revenue Ratio 2/								
Baseline	32	35	30	32	28	26	24	13
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	32	35	29	33	29	29	33	28
A2. Primary balance is unchanged from 2016	32	35	30	34	31	31	36	35
A3. Permanently lower GDP growth 1/	32	35	30	33	29	27	27	21
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2017-2018	32	36	31	35	31	29	28	20
B2. Primary balance is at historical average minus one standard deviations in 2017-2018	32	35	30	33	30	28	25	13
B3. Combination of B1-B2 using one half standard deviation shocks	32	35	30	34	30	28	26	17
B4. One-time 30 percent real depreciation in 2017	32	38	33	38	32	31	31	20
B5. 10 percent of GDP increase in other debt-creating flows in 2017	32	35	32	37	33	31	27	15

Sources: Country authorities; and staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.

2/ Revenues are defined inclusive of grants.

KENYA

January 23, 2017

FIRST REVIEWS UNDER THE TWENTY-FOUR MONTH STAND-BY ARRANGEMENT AND THE ARRANGEMENT UNDER THE STANDBY CREDIT FACILITY AND REQUESTS FOR WAIVERS OF APPLICABILITY, REPHASING OF DISBURSEMENTS, AND MODIFICATION OF PERFORMANCE CRITERIA—SUPPLEMENTARY INFORMATION, SUPPLEMENTARY LETTER OF INTENT

This supplement provides information that has become available since the Staff Report was circulated to the Executive Board on December 28, 2016. The information does not alter the thrust of the staff appraisal.

Recent macroeconomic data releases indicate continued robust economic growth and contained inflation. GDP growth in the third quarter of 2016 came at 5.7 percent, compared to 6.1 percent registered in the first half of the year, bringing growth in the first nine months of the year to 5.9 percent. While strong growth continues in the electricity, transportation, construction, and tourism-related sectors, agriculture experienced a slowdown (to 3.9 percent in 2016Q3 compared to 5.5 percent during the same period last year). Inflation fell to 6.3 percent in December (from 6.7 percent in November), due to the phasing out of base effects related to excise tax increases introduced in December 2015.

As reported in the attached supplement to the Letter of Intent, all end-December 2016 quantitative program targets for which data are available have been met. This includes the performance criterion on net international reserves, the inflation target under the monetary policy consultation clause, and the indicative target on net domestic assets of the Central Bank of Kenya.

Supplement to Letter of Intent

January 18, 2017

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C. 20431
United States of America

Dear Ms. Lagarde:

Information that has become available since the Letter of Intent dated December 23, 2016 requesting completion of the first reviews under the 24-month SBA and SCF shows that for the end-December 2016 test date we have met: (i) the performance criterion on net international reserves; (ii) the inflation target under the monetary policy consultation clause; and (iii) the indicative target on net domestic assets of the Central Bank of Kenya (Table 1). Information assessing performance against the other end-December 2016 quantitative targets under the program is not yet available.

Sincerely yours,

/s/	/s/
Henry Rotich Cabinet Secretary The National Treasury	Patrick Njoroge Governor Central Bank of Kenya

Table 1. Kenya: Quantitative Performance Criteria and Indicative Targets, 2016-17

(In billions of Kenyan shillings; unless otherwise indicated)

	2015	Performance Criteria (PC)/Indicative targets (IT)																
		2016															2017	
	End-Dec	End-Mar (IT)			End-Jun (PC)				End-Sep (IT)			End-Dec (PC)					End-Mar (IT)	End-Jun (PC)
	Act.	Prog.	Prel.	Met / Not Met	Prog.	Prel.	Adj Prog.	Met / Not Met	Prog.	Prel.	Met / Not Met	Prog.	Rev. Prog.	Adj. Prog.	Act.	Met / Not Met	Proposed	Proposed
Quantitative performance criteria [1]																		
Fiscal targets																		
Primary budget balance of the national government (-=deficit, floor) [2,3]	-99.5	-164.1	-83.8	Met	-206.0	-206.9	-220.7	Met	-46.0	-7.9	Met	-82.9	-100.0	...	...	...	-169.5	-211.5
Monetary targets [4,5]																		
Stock of central bank net international reserves (floor, in millions of US$) [6,7]	6,367	5,784	6,535	Met	5,900	6,846	5,941	Met	5,852	7,105	Met	6,283	6,283	5,633	6,788	Met	6,266	7,230
Public debt target																		
National government external payment arrears (ceiling, millions of US$) [8]	0	0	0	Met	0	0	0	Met	0	0	Met	0	0	...	...	...	0	0
Monetary policy consultation clause																		
Upper band	...	8.5	...	...	7.5	...	...		7.5	...		7.5	7.5	7.5	...		7.5	7.5
Center inflation target [9]	7.4	5.0	7.0	Met	5.0	5.4	...	Met	5.0	6.3	Met	5.0	5.0	5.0	6.5	Met	5.0	5.0
Lower band	...	2.5	...	...	2.5	...	...		2.5	...		2.5	2.5	2.5	...		2.5	2.5
Indicative targets																		
Stock of net domestic assets of the central bank (ceiling)	-246	-169	-268.5	Met	-151	-303	...	Met	-139	-330	Met	-165	-165	-99	-279	Met	-193	-289
Priority social expenditures of the national government (floor) [3]	25	41	44	Met	60	57	...	Not Met	14.5	14.6	Met	20.5	10.5	...	...	...	30.0	57.4
Stock of all guarantees issued by the national government (ceiling) [3]	50	50	0	Met	50	0	...	Met	50	0	Met	50	50	...	...	...	50	50
Change in the stock of national government domestic bills pending for 90 days or more [3]	...	...	...	...	...	...	...	...	...	...		...	...	...	...	...	0	0
Memorandum items:																		
Maximum upward adjustment of the primary deficit ceiling owing to excess in concessional loans relative to program projections [3]	42.0	36.7	-17.5	...	37.7	14.4	...		13.6	-16.6	...	27.1	27.1	27.1	...	...	30.0	39.6
Programmed project loans [3,10]	69.5	61.6	64.5	...	86.4	84.6	...		20.0	20.0	...	56.8	56.8	56.8	...	...	85.7	96.0
Budgeted project loans [3,10]	111.4	98.3	47.0	...	124.1	99.0	...		33.6	3.4	...	83.9	83.9	83.9	...	...	115.7	135.6
Programmed external commercial debt (millions of US$) [3]	750	1,350	733.6	...	1,350	1,431	...		0	100	...	1,000	750	750	100	...	750	1,500
Program grants [3]	2.9	4.5	4.3	...	6.4	4.3	...		1.5	0.2	...	2.7	2.7	2.7	...	...	3.5	6.1

[1] Performance criteria for end-December 2016 and end-June 2017, and indicative target for end-September 2016 and end-March 2017.

[2] The primary budget balance of the national government and related adjusters are defined, respectively, in paragraph 6 and paragraph 7 of the TMU. The adjusted target for end-June 2016 reflects the shortfalls in program grants (KSh 4.3 billion actual versus a programmed level of KSh 6.4 billion) and higher project loans relative to the program (respectively, KSh 99 billion and KSh 86.4 billion), as indicated in the memorandum items of this table.

[3] All targets are cumulative flows from July 1, 2016, except for government pending bills that are cumulative from January 1, 2017.

[4] For program monitoring, the daily average for the month when testing dates are due.

[5] The adjustors to the NIR and NDA targets are specified, respectively, in paragraph 8 and paragraph 13 of the TMU.

[6] Excludes encumbered reserves. Includes Kenya's reserve tranche position in the Fund starting from March 16, 2016.

[7] Using exchange rates as at end-January 2016 (see TMU ¶9).

[8] Continuous. Payment on an external obligation of US$0.321 million was made with a delay of 11 days in August 2016. Kenya has since been current on all external payment obligations.

[9] Compliance will be evaluated based on the 12-month inflation average of the latest three months.

[10] Excludes the first phase of the Standard Gauge Railway (Mombasa to Nairobi).

STATEMENT BY

MR. MKWEZALAMBA, EXECUTIVE DIRECTOR FOR KENYA
AND
MR. SITIMAWINA, SENIOR ADVISOR TO THE EXECUTIVE DIRECTOR

JANUARY 25, 2017

Introduction

1. We thank staff for the constructive dialogue with our Kenyan authorities during the recent program review mission. As our authorities pursue the objective of sustaining an investment-driven inclusive growth, they appreciate the candid advice from the Fund. They also find the Stand-By Arrangement (SBA) and the arrangement under the Standby Credit Facility (SCF) instrumental in anchoring the macroeconomic policy framework and backstopping the foreign exchange reserve buffers. Our authorities broadly concur with the staff assessment and conclusions.

2. The Kenyan economy remains strong and has continued to show robust growth supported by strong macroeconomic fundamentals. As a result, our authorities' performance under the economic program supported by the SBA and SCF arrangements has been satisfactory. With this performance and on the basis of an existing track record of program implementation, our Kenyan authorities request Executive Directors' support for completion of the first reviews under the 24-month SBA and SCF arrangements. In addition, they request for: (i) waivers of applicability for the end-December 2016 quantitative performance criteria, given the unavailability of data for assessment; (ii) a re-phasing of the second and third reviews under the SBA and SCF arrangements to allow sufficient time for the completion of the reviews; and (iii) a modification of the performance criterion on the primary budget balance for end-December 2016, consistent with the higher fiscal deficit target for 2016/17.

Performance under the SBA and SCF Arrangements

3. The authorities met all continuous and end-June 2016 performance criteria (PCs) and the end-June inflation target under the Monetary Policy Consultation Clause (MPCC). In addition, they met all end-March, end-June, and end-September quantitative indicative targets with the exception of the end-June target on priority social spending, which was missed by a small margin due to delays in disbursement of donor commitments on social cash transfers. Performance on structural benchmarks was slower than expected. However, steps have been taken, including through utilization of additional technical assistance, to ensure completion within the revised timeframe.

Recent Economic Developments and Macroeconomic Outlook

4. Real GDP growth in Kenya remains strong, recording 5.3 percent and 5.6 percent in 2014 and 2015, respectively. It is expected to have grown by around 6 percent in 2016. This growth

has largely been driven by a continued strong expansion in the construction sector, in particular public investment in the Standard Gauge Railway linking Mombasa and Nairobi. The favorable weather conditions also boosted agricultural production with record yields in tea and coffee. In addition, there has been some recovery in tourism on the back of improved security. In the period ahead, growth is expected to remain robust, supported by resilient exports, continued infrastructure investments, and benefits from ongoing regional integration efforts.

5. Inflation remains within the authorities' target range of 5±2.5 percent and therefore within the monetary policy consultation clause. Headline inflation, after falling to a record low of 5 percent in May 2016, trended upwards to 6.7 percent in November 2016 but slowed down to 6.4 percent in December 2016. These developments reflected price increases in food that masked a slowdown in housing, utilities, and transport prices. Overall, inflation is expected to remain within the target range in the near to medium term.

6. The current account deficit has continued to narrow in the past two years, reflecting largely lower international oil prices; improved tea, coffee and horticulture exports; strong remittance inflows; and higher tourism earnings. The improvement of the current account deficit coupled with strong capital inflows have led to a stabilization of the exchange rate and an accumulation of international reserves which stood at 5.3 months of prospective imports at end-December 2016.

Fiscal Policy and Public Financial Management

7. The authorities are committed to fiscal consolidation over the medium term as well as ensuring that public debt remains sustainable. While the 2015/16 overall fiscal deficit was 0.5 percent of GDP lower than programmed, the 2016/17 budget deficit will be slightly higher than under the program to accommodate one-off election related expenditures. However, consistent with the fiscal consolidation objective, the authorities plan to put in place additional revenue and expenditure measures, including reducing tax expenditures, improving tax administration, and cutting low priority spending, in order to return to the original program target of 3.7 percent of GDP by 2018/19 fiscal year. This pace of fiscal deficit reduction would also bring the country closer to the East African Monetary Union deficit ceiling of 3 percent by 2020/21. In addition, our authorities remain focused on the public debt fiscal anchor set at 45 percent of GDP. In this regard, they will further strengthen the debt management framework, and are taking steps to begin capturing all public debt payments in IFMIS.

8. Additional measures to improve public financial management will also be taken, including stricter selection and monitoring of public investment projects to ensure value for money, establishing a Treasury Single Account (TSA), and improving the monitoring and reporting of government pending bills. With respect to public investment projects, the authorities plan to separate the project approval process from the annual budgeting process by adopting guidelines on the appraisal and monitoring of new investment projects. To further enhance fiscal transparency, the authorities are also taking steps to start publishing consolidated financial statement (CFS) for the entire public sector.

Monetary and Financial Sector Issues

9. The primary monetary policy objective remains to bring headline inflation towards the midpoint of the target range in the context of a floating exchange rate regime. As noted earlier, in 2016, the Central Bank of Kenya (CBK) accumulated foreign reserves and the exchange rate remained relatively stable, thereby positively impacting headline inflation. The current monetary policy stance is broadly appropriate. However, the CBK stands ready to take further action should it become necessary.

10. Effective September 2016, the Kenyan Parliament introduced a new law on interest rate controls aimed at reducing the cost of borrowing and increasing the return on savings. While this law somewhat constrains the conduct of monetary policy, our authorities remain committed to strengthening the monetary policy framework. Consistent with this objective, the monetary authorities reiterate their intention to establish an interest rate corridor when conditions permit. In addition, the CBK is taking action to improve liquidity distribution among banks and to reduce structural rigidities in the government securities market. The latter will entail authorities' support to ongoing work in the capital markets through the development of an efficient primary and secondary market for government securities, including taking steps to broaden participation and lower transaction costs.

11. Furthermore, to reduce borrowing costs and barriers to competition in the credit markets, the CBK, with technical assistance from the World Bank Group, is strengthening the credit reference system to enhance borrower monitoring, data quality and integrity, and conducting sensitization to promote use of credit reference for credit-risk pricing. It will also adopt, in the course of this year, a single annual percentage rate (APR) methodology that includes all fees and charges in a single rate, and require banks to post APRs for all of their credit facilities.

12. Kenya's banking sector remains adequately capitalized and profitable. However, in view of the increased complexity of the financial sector, the authorities continue to take steps to further strengthen prudential regulation and supervision with a view to safeguard financial stability. In the course of 2016, the CBK addressed emerging risks to financial stability by resolutely intervening in banks deemed unviable. They also quickly stepped in to provide the necessary liquidity facilities to smaller banks that had been cut off from the highly segmented interbank market. In the period ahead, the implementation of the action plan on banking regulation and supervision will increase the authorities' capacity to monitor credit and liquidity risks and insider lending. Overall, the CBK is closely monitoring developments and stands ready to take necessary steps as needed to ensure continued financial stability.

Structural Reforms and Data

13. The authorities are continuing with various efforts in structural reforms to improve the business environment and remove any impediments to an investment-led inclusive growth. Consequently, Kenya's ranking in the World Bank's Doing Business Report (2016) improved 21 places from the 2015 position and was one of the top 10 reformers across the globe. In the period ahead, ongoing reforms will seek to further strengthen governance in business operations through the introduction of anti-bribery legislation; reduction of transportation and trading costs; and improvement in procurement procedures and frameworks at the national and county levels.

14. The authorities are also making considerable progress in improving macroeconomic statistics. Currently, the Kenya Bureau of National Statistics (KNBS) is conducting a foreign investment survey to collect data for 2014 and 2015 and will be publishing the first estimate of the annual International Investment Position (IIP) within this year.

Conclusion

15. The authorities reiterate their commitment to strengthening macroeconomic stability and enhancing resilience to shocks. In this connection, they will implement an appropriate policy mix aimed at sustaining an inclusive and investment-led growth. They also remain committed to a gradual consolidation of fiscal policy, maintaining low and stable inflation, further improving public financial management, strengthening the financial sector supervision and regulation, and deepening structural reforms aimed at further improving the business environment. Thus, they count on Executive Directors' support in completing these first reviews and approval of the associated request.