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

November 18, 2011

The following item is a Letter of Intent of the government of Kenya, which describes the policies that Kenya intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Kenya, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.
Ms. Christine Lagarde  
Managing Director  
International Monetary Fund  
Washington, D.C. 20431  

Dear Ms. Lagarde:  

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

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

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

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

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

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

Sincerely yours,

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

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

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

I. Background

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

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

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

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

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

   - The country’s external position has deteriorated not only because of higher than originally expected international prices and drought-related import needs but also because of the strength of domestic demand.
5. **The shilling’s exchange rate has depreciated substantially in response to a widening current account deficit.** The shilling’s slide has added immediate pressures on domestic prices that, if not addressed, could feed back on the external position and the exchange rate raising the risk of destabilizing macroeconomic conditions. To address this risk and protect the ongoing economic expansion we intend to promptly adjust our macroeconomic policy stance by:

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

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

II. The Economic Program for 2011/12

A. Monetary Policy

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

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

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

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

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

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

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

14. **Poverty reduction:** Consistent with our Vision 2030, we are updating the Poverty Reduction Strategy Paper (PRSP) taking into account current macroeconomic conditions and emerging challenges. This framework will provide for social expenditure in the transition towards a new government following elections in 2012, consistent with the overall poverty reduction strategy of the country.
15. **Financing policy:** We will remain prudent in approving new project loans to ensure public debt dynamics remain sustainable. We will aim at obtaining the necessary domestic financing by accepting interest rates on our securities that are consistent with money market rates in order to reduce reliance on the use of the overdraft facility at the CBK. We will also monitor closely the risks related to contingent liabilities exposure, including through the integration of projects funded through public private partnerships into the medium term debt management strategy. We continue to maintain non-concessional financing, including guarantees, below US$700 million for the remainder of 2011/12 (performance criterion). While we still plan to issue a sovereign bond in 2012/13, we will monitor developments in the international markets with the view to issuing the bond early to take advantage of the favorable interest rates, market conditions permitting. The non-concessional financing, including the sovereign bond proceeds, will be limited to investment projects that demonstrate revenue streams and are of high social returns. As before, we will continue with our policy of not incurring external arrears (performance criterion).

**C. Financial Sector Policy**

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

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

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

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

20.  **Program monitoring.** Our program will be monitored using the definitions, data sources, and frequency of monitoring set out in the accompanying revised TMU. The government will make available to Fund staff all data appropriately reconciled and on a timely basis, as specified in the TMU. Table 1 shows the quantitative performance criteria to be used in monitoring performance in 2011/12, and structural benchmarks, with corresponding dates, are identified in Table 2. Fiscal performance criteria will cover the budgetary central government, but the authorities will prepare to expand coverage to include the budget of national government and county governments as early as possible in anticipation of fiscal decentralization. The third review under the ECF arrangement, assessing end-December performance criteria, is expected to be completed by April 15, 2012, the fourth review will be completed by October 15, 2012, based on end-June 2012 performance criteria, and the fifth review will be completed by April 15, 2013, based on end-December 2012 performance criteria.
### Table 1. Kenya: Revised and New Performance Criteria for the 2011/2014 ECF Arrangement

(In billions of Kenyan shillings; unless otherwise indicated)

<table>
<thead>
<tr>
<th></th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Indicative Targets</td>
<td>Performance Criteria</td>
</tr>
<tr>
<td>Primary budget balance of the central government (−=deficit, floor)</td>
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<td></td>
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<tr>
<td>Stock of central bank net international reserves (floor, in millions of US$)</td>
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<td>3,600</td>
</tr>
<tr>
<td>Stock of net domestic assets of the central bank (ceiling)</td>
<td>-45</td>
<td>-45</td>
</tr>
<tr>
<td>Contracting or guaranteeing of medium- and long-term nonconcessional external debt</td>
<td>700</td>
<td>700</td>
</tr>
<tr>
<td>New central government and central government guaranteed external payment arrears (ceiling, millions of US$)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Priority Social Expenditures of the central government(floor)</td>
<td>12.1</td>
<td>12.1</td>
</tr>
</tbody>
</table>

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

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

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

I. **QUANTITATIVE PERFORMANCE CRITERIA AND BENCHMARKS**

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

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

3. The program sets indicative targets March 31, 2012 and September 30, 2012 with respect to:
   - priority social spending of the central government (**floor**).

II. **PERFORMANCE CRITERION ON THE PRIMARY BALANCE INCLUDING GRANTS OF THE CENTRAL GOVERNMENT**

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

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

The above items are defined as follows:

- **Net domestic financing** of the central government is defined as the sum of:
  - net domestic bank financing;
  - net nonbank financing;
  - change in the stock of domestic arrears of the central government; and
  - proceeds from privatization.

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

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

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

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

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

- **Gross official international reserves** are defined as the sum of:
  - the CBK’s holdings of monetary gold (excluding amounts pledged as collateral);
  - holdings of Special Drawing Rights (SDRs), including the August 28, 2009 General allocation and the September 9, 2009 Special allocation;
CBK holdings of convertible currencies in cash or in nonresident financial institutions (deposits, securities, or other financial instruments).

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

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

- The following **adjustors** will apply to the target for NIR:
  - If budgetary support (external grants and loans)\(^1\) and external commercial debt exceed the programmed amounts, the target for NIR will be adjusted upward by the difference.
  - If budgetary support (external grants and loans) and external commercial debt fall short of the programmed amounts, the target for NIR will be adjusted downward by the difference.

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

\(^1\) No budgetary support in the form of external grants and loans is expected in the next 12 months.
IV. PERFORMANCE CRITERION ON THE NET DOMESTIC ASSETS (NDA) OF THE CENTRAL BANK OF KENYA

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

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

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

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

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

V. PERFORMANCE CRITERION ON NONCONCESSIONAL EXTERNAL DEBT CONTRACTED OR GUARANTEED BY THE CENTRAL GOVERNMENT

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

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

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

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

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

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

11. Debt is considered concessional if, on the date on which the contract was signed, the ratio of the present value of the loan, based on the commercial interest reference rates (CIRRs), to the nominal value of the loan is less than 65 percent (that is, the grant element of the loan is at least equal to 35 percent of its nominal value). The present value of the loan will be calculated by discounting future payments of interest and principal using the CIRRs established by the Organization for Economic Cooperation and Development (OECD). Specifically, the 10-year average of CIRRs reported by the OECD will be used for loans with maturities longer than 15 years while the six-month average of CIRRs will be used for loans with shorter maturities. To both the 10-year and 6-month averages of the reference rate, the margin for different repayment periods will be added, as established by the OECD (0.75 percent for repayment periods of less than 15 years; 1 percent for repayment periods of
15–19 years; 1.15 percent for repayment periods of 20–29 years; and 1.25 percent for repayment periods of 30 years or more).

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

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

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

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

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

16. The performance criterion on the stock of central government and central government guaranteed external payment arrears applies only to newly accumulated arrears on or after January 1, 2011.
VII. **Indicative Target on Priority Social Spending**

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

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

VIII. **Coverage**

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

<table>
<thead>
<tr>
<th>Currency</th>
<th>Kenyan Shillings per currency unit</th>
<th>Dollars per currency unit</th>
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</thead>
<tbody>
<tr>
<td>Canadian dollar</td>
<td>95.93</td>
<td>0.963</td>
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<tr>
<td>Danish krone</td>
<td>18.13</td>
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<td>SDR</td>
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<td>US dollar</td>
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Table 1. Kenya: (Program) Exchange Rates for the ECF
(Rates as of September 30, 2011)
<table>
<thead>
<tr>
<th>Information</th>
<th>Frequency</th>
<th>Reporting Deadline</th>
<th>Responsible Entity</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Primary balance of the central government including grants</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net domestic bank financing (including net commercial bank credit to the central government and net CBK credit to the central government)</td>
<td>Monthly</td>
<td>Within 15 days after the end of the month.</td>
<td>CBK</td>
</tr>
<tr>
<td>Net nonbank financing</td>
<td>Monthly</td>
<td>Within 15 days after the end of the month.</td>
<td>CBK</td>
</tr>
<tr>
<td>Central government arrears accumulation to domestic private parties and public enterprises outstanding for 60 days or longer.</td>
<td>Monthly</td>
<td>Within 15 days after the end of the month.</td>
<td>MoF</td>
</tr>
<tr>
<td>Proceeds from privatization</td>
<td>Monthly</td>
<td>Within 15 days after the end of the month.</td>
<td>CBK</td>
</tr>
<tr>
<td>Interest paid on domestic debt</td>
<td>Monthly</td>
<td>Within 15 days after the end of the month.</td>
<td>CBK</td>
</tr>
<tr>
<td>Interest paid on external debt</td>
<td>Quarterly</td>
<td>Within 4 weeks after the end of the quarter.</td>
<td>CBK</td>
</tr>
<tr>
<td>Disbursements of external nonconcessional project loans, including securitization</td>
<td>Quarterly</td>
<td>Within 45 days after the end of the quarter.</td>
<td>MoF</td>
</tr>
<tr>
<td>Disbursements of budget support loans</td>
<td>Quarterly</td>
<td>Within 45 days after the end of the quarter.</td>
<td>MoF</td>
</tr>
<tr>
<td>Principal repayments on all external loans</td>
<td>Monthly</td>
<td>Within 15 days after the end of the month.</td>
<td>CBK</td>
</tr>
<tr>
<td>Net proceeds from issuance of external debt</td>
<td>Monthly</td>
<td>Within 15 days after the end of the month.</td>
<td>CBK</td>
</tr>
<tr>
<td>Any exceptional financing (including rescheduled principal and interest)</td>
<td>Monthly</td>
<td>Within 15 days after the end of the month.</td>
<td>MoF</td>
</tr>
<tr>
<td>Net changes in the stock of short-term external debt</td>
<td>Quarterly</td>
<td>Within 45 days after the end of the quarter.</td>
<td>MoF</td>
</tr>
<tr>
<td>Net change in external arrears, including interest</td>
<td>Quarterly</td>
<td>Within 45 days after the end of the quarter.</td>
<td>MoF</td>
</tr>
<tr>
<td><strong>2. Gross official international reserves</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CBK’s holding of monetary gold (excluding amounts pledged as collateral)</td>
<td>Monthly</td>
<td>Within 15 days after the end of the month.</td>
<td>CBK</td>
</tr>
<tr>
<td>Holdings of SDRs</td>
<td>Monthly</td>
<td>Within 15 days after the end of the month.</td>
<td>CBK</td>
</tr>
<tr>
<td>CBK holdings of convertible currencies in cash or in nonresident financial institutions (deposits, securities, or other financial instruments)</td>
<td>Monthly</td>
<td>Within 15 days after the end of the month.</td>
<td>CBK</td>
</tr>
</tbody>
</table>
3. Official reserve liabilities

<table>
<thead>
<tr>
<th>Description</th>
<th>Frequency</th>
<th>Due Date</th>
<th>Responsible Party</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total outstanding liabilities of the CBK to the IMF except those arising from</td>
<td>Monthly</td>
<td>Within 15 days after the end of the month.</td>
<td>CBK</td>
</tr>
<tr>
<td>August 28, 2009 SDR general allocation and the September 9, 2009 SDR special allocation;</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Convertible currency liabilities of the CBK to nonresidents with an original maturity of up to and including one year</td>
<td>Monthly</td>
<td>Within 15 days after the end of the month.</td>
<td>CBK</td>
</tr>
<tr>
<td>Commitments to sell foreign exchange arising from derivatives.</td>
<td>Monthly</td>
<td>Within 15 days after the end of the month.</td>
<td>CBK</td>
</tr>
</tbody>
</table>

4. Net domestic assets

<table>
<thead>
<tr>
<th>Description</th>
<th>Frequency</th>
<th>Due Date</th>
<th>Responsible Party</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net CBK credit to the central government</td>
<td>Monthly</td>
<td>Within 15 days after the end of the month.</td>
<td>CBK</td>
</tr>
<tr>
<td>Outstanding net CBK credit to domestic banks (including overdrafts)</td>
<td>Monthly</td>
<td>Within 15 days after the end of the month.</td>
<td>CBK</td>
</tr>
</tbody>
</table>

5. Reserve money

<table>
<thead>
<tr>
<th>Description</th>
<th>Frequency</th>
<th>Due Date</th>
<th>Responsible Party</th>
</tr>
</thead>
<tbody>
<tr>
<td>Currency in circulation</td>
<td>Monthly</td>
<td>Within 15 days after the end of the month.</td>
<td>CBK</td>
</tr>
<tr>
<td>Required and excess reserves</td>
<td>Monthly</td>
<td>Within 15 days after the end of the month.</td>
<td>CBK</td>
</tr>
<tr>
<td>Nonconcessional medium- and long-term external debt contracted or guaranteed by the central government</td>
<td>Quarterly</td>
<td>Within 45 days after the end of the quarter.</td>
<td>MoF</td>
</tr>
<tr>
<td>Accumulation of central government and central government guaranteed external payment arrears.</td>
<td>Quarterly</td>
<td>Within 45 days after the end of the quarter.</td>
<td>MoF</td>
</tr>
<tr>
<td>Social priority spending</td>
<td>Quarterly</td>
<td>Within 45 days after the end of the quarter.</td>
<td>MoF</td>
</tr>
</tbody>
</table>