INTERNATIONAL MONETARY FUND

IMF Country Report No. 18/295

KENYA

2018 ARTICLE IV CONSULTATION AND ESTABLISHMENT OF PERFORMANCE CRITERIA FOR THE SECOND REVIEW UNDER THE STAND–BY ARRANGEMENT—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR KENYA

October 2018

In the context of the Article IV Consultation and Establishment of Performance Criteria for the second review under the Stand-By Arrangement, 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 June 13, 2018, following discussions that ended on March 2, 2018, with the officials of Kenya on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 31, 2018.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF International Development Association (IDA).
- 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 *
  Technical Memorandum of Understanding *
  Selected Issues
  *Also included in the 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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October 23, 2018

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IMF Executive Board Concludes 2018 Article IV Consultation and Establishes Performance Criteria for the Second Review Under the Stand-By Arrangement with Kenya

On June 13, 2018 the Executive Board of the International Monetary Fund (IMF) concluded the 2018 Article IV consultation[1] and established performance criteria for the second review under the Stand-By Arrangement with Kenya.

Kenya has maintained strong growth in recent years and external imbalances have narrowed, strengthening resilience to shocks. The business environment continues to improve, supporting private investment. However, a severe drought, an extended presidential election, and weak bank lending—due in part to interest rate controls—slowed growth in 2017. In addition, public debt has risen as revenue shortfalls have not been matched by spending cuts. Moreover, interest rate controls continue to hamper lending (especially to small- and medium-size enterprises), growth, and monetary policy.

The Executive Board approved a six-month extension of Kenya's SBA until September 14, 2018 (its SCF expired on March 13, 2018). Since the performance criteria (PCs) for the second review (end-June 2017) are now outdated, new PCs for end-June 2018, a monetary policy consultation clause, and new structural benchmarks were established. The authorities plan to continue treating the SBA as precautionary.

Kenya's medium-term growth prospects are favorable, supported by infrastructure investment and an improving business environment. However, continued strong growth and macroeconomic stability hinge on the implementation of reforms. In addition, headwinds from fiscal consolidation and weak credit growth will weigh on economic activity in the near term. Kenya also remains vulnerable to a deterioration of security conditions, and to external shocks that could spur capital outflows, such as a pullback on investors from emerging markets or tightening global monetary conditions.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Executive Board Assessment[2]

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for maintaining macroeconomic stability and sustained economic growth in recent years, together with gains in financial inclusion and poverty reduction. While domestic shocks reduced the pace of expansion in 2017, the economy is recovering and medium-term growth prospects remain favorable. To safeguard the gains achieved, Directors encouraged further reduction of fiscal deficits to preserve debt sustainability; the repeal or significant modification of interest rate controls; and measures to strengthen the financial sector and business environment. The six-month extension of the Stand-By Arrangement will give the authorities more time to undertake these critical reforms.

Directors encouraged the authorities to take substantive steps to reduce the fiscal deficit to address Kenya's rising public debt. They commended the authorities on their ambitious plans for fiscal adjustment in 2017/18 and 2018/19 and agreed that the size of the adjustment would help put the public debt ratio on a downward path. Adjustment efforts should focus on both expenditures and revenues to preserve space for planned growth-enhancing public investment and key social programs, including the authorities' Big Four agenda. Directors welcomed the authorities' planned revenue measures while emphasizing the need for additional steps to meet the deficit targets for both 2017/18 and 2018/19. They stressed the importance of realistic revenue projections to increase fiscal transparency and to avoid ad hoc cuts in public investment and other high-priority expenditures.

Directors encouraged the authorities to repeal or significantly modify interest rate controls, noting that the controls have slowed growth, reduced access to finance, and hampered the effectiveness of monetary policy. They emphasized that any modification should include the removal of the link between the lending rate cap and the central bank policy rate, the removal of a floor on deposit rates, and an increase of the lending cap to a level that protects consumers from predatory practices.

Directors saw merit in modernizing the monetary policy framework. They recommended that, following the reform of interest rate controls, the Central Bank of Kenya move to establish an interest rate corridor. This would help align the policy rate with the interbank market rate, thus improving the policy rate's signaling role and strengthening the effectiveness of monetary policy.

Directors commended the authorities for the progress made in strengthening the banking supervision framework, and encouraged continued efforts in this area. At the same time, they saw merit in further measures to develop the bank resolution framework and risk-based AML/CFT supervisory tools.

Directors welcomed the improvements made in strengthening competitiveness and the business environment in recent years and encouraged the authorities to build on the progress made. In

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

particular, they emphasized the importance of implementing public financial management reforms to strengthen governance and anti-corruption efforts.

It is expected that the next Article IV consultation with Kenya will be held within 24 months, in accordance with the Executive Board decision on consultation cycles for members with Fund arrangements.

Kenya: Selected Economic and Financial Indicators, 2014/15–2021/22 [1/]

	2014/15	2015/16	2016/17		2017/18	2018/19	2019/20	2020/21	2021/22
	Act.	Act.	Prog.	Prel.			Proj.		
	(Annual percentage change, unless otherwise indicated)								
Output, prices, and exchange rate									
Real GDP	5.5	5.8	5.6	5.4	5.3	5.9	6.1	6.3	6.5
GDP deflator	9.1	9.0	5.9	5.2	5.1	4.7	4.4	5.2	5.1
CPI (period average)	6.6	6.5	6.4	8.1	5.2	5.5	5.0	5.0	5.0
CPI (end of period)	7.0	5.8	6.5	9.2	5.2	5.4	5.0	5.0	5.0
Core inflation (period average) [2/]	4.4	5.4	5.0	4.0	3.9	4.8	4.8	5.2	5.5
Exports volume	6.0	1.7	7.4	3.4	12.8	12.5	9.2	8.6	8.1
Imports volume	3.2	-1.3	4.1	3.4	6.4	6.2	9.4	9.6	8.9
Exchange rate (Kenyan shilling/US$)	92.7	102.1	.	.	.	.	.	.	.
Real effective exchange rate (depreciation, -)	6.0	1.5	.	.	.	.	.	.	.
Money and credit									
Broad money (M3)	18.4	8.1	10.5	6.0	.	.	.	.	.
Reserve money	14.9	4.9	10.8	2.4	.	.	.	.	.
Credit to non-government sector	18.3	8.9	6.0	1.5	.	.	.	.	.
Policy rate	10.0	10.5	.	.	.	.	.	.	.
M3/GDP (percent)	43.8	41.1	40.9	38.9	.	.	.	.	.
NPLs (percent of total gross loans)	5.7	n.a.		.	.	.	.	.	.
Central government budget									
Total revenue and grants	19.4	18.8	21.0	18.9	19.9	20.8	20.8	20.8	20.7
Tax revenues	16.4	15.9	17.0	16.1	16.0	17.2	17.3	17.4	17.5
Non-tax revenues	2.5	2.4	3.4	2.4	3.4	3.1	3.0	2.9	2.7
Grants	0.5	0.4	0.5	0.3	0.5	0.5	0.5	0.5	0.5
Expenditure	28.0	26.5	27.9	27.9	28.0	27.4	26.2	25.9	25.2
Current	19.3	19.3	19.9	19.5	21.4	20.8	19.7	19.3	19.0
Capital	8.7	7.2	8.0	8.4	6.6	6.6	6.5	6.6	6.2
Unidentified measures	0.0	0.0	0.0	0.0	0.6	0.9	1.4	1.6	1.1
Primary balance	-5.4	-4.1	-3.8	-5.6	-3.2	-0.5	1.5	2.1	1.3
Overall balance	-8.4	-7.3	-6.9	-9.0	-7.5	-5.7	-4.0	-3.5	-3.5
Excluding SGR (phase 1) related spending	-6.3	-6.5	-6.0	-7.6	-6.7	-5.2	-3.6	-2.9	-3.5
Excluding grants	-8.8	-7.7	-7.5	-9.4	-8.0	-6.2	-4.5	-4.0	-4.0
Net domestic borrowing	4.3	3.3	4.3	4.1	4.1	1.8	3.8	3.9	3.5
Public debt [3/]									
Public gross nominal debt	47.9	52.9	52.5	58.3	60.7	60.2	57.7	57.2	54.5
Public net nominal debt	43.7	47.0	49.4	52.6	55.5	56.1	55.8	55.3	52.6
of which: external public debt	23.6	26.0	26.1	30.4	31.2	32.5	30.6	28.5	25.6
Public gross debt, PV	43.5	45.5	48.8	53.0	58.0	60.2	58.4	55.6	53.7
Public net debt, PV	39.4	39.6	45.7	47.2	52.8	56.1	56.4	53.6	51.8
Gross domestic debt	24.3	27.0	26.4	28.0	29.5	27.8	27.1	28.7	28.9

Kenya: Selected Economic and Financial Indicators, 2014/15–2021/22 (concluded)

	2014/15	2015/16	2016/17		2017/18	2018/19	2019/20	2020/21	2021/22
	Act.	Act.	Prog.	Prel.			Proj.		
	(Annual percentage change, unless otherwise indicated)								
Investment and saving									
Investment	19.9	24.3	20.9	17.4	17.0	18.5	19.5	20.3	20.2
General government	8.7	7.2	9.6	8.5	6.7	6.6	6.5	6.4	6.2
Nongovernment	11.2	17.1	11.3	8.9	10.3	11.8	13.1	13.8	14.1
Saving	10.0	20.0	15.4	12.0	10.3	12.0	13.4	14.1	14.0
General government	-0.4	-0.8	2.1	-0.8	-1.3	0.5	2.0	2.6	2.3
Nongovernment	10.4	20.8	13.3	12.8	11.6	11.5	11.4	11.5	11.7
External sector									
Exports (goods and services)	17.0	15.9	17.1	15.2	16.1	16.7	17.1	17.4	17.4
Imports (goods and services)	-31.3	-24.0	-25.6	-24.1	-25.9	-25.9	-26.0	-26.4	-26.5
Current account balance (including grants)	-9.9	-4.3	-5.5	-5.5	-6.7	-6.4	-6.2	-6.2	-6.3
Gross international reserves									
In billions of US$	7.2	8.3	8.9	8.6	8.9	9.1	9.9	10.5	11.4
In months of next year imports	5.3	5.7	5.3	5.0	4.7	4.5	4.4	4.3	4.3
Memorandum items:									
GDP at current market prices									
Billion of Kenyan shillings	5,849	6,734	7,435	7,556	8,305	9,260	10,255	11,249	12,827
US$ billion	62.7	67.4	72.0	73.0	79.2	86.8	93.8	101.6	110.7
GDP per capita (nominal US$)	1,439	1,504	1,562	1,583	1,671	1,782	1,875	1,976	2,096

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.

INTERNATIONAL MONETARY FUND

KENYA

May 31, 2018

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION AND ESTABLISHMENT OF PERFORMANCE CRITERIA FOR THE SECOND REVIEW UNDER THE STAND-BY ARRANGEMENT

KEY ISSUES

Article IV Context: Kenya has enjoyed strong growth in recent years and external imbalances have narrowed, strengthening resilience to shocks. The business environment continues to improve, supporting private investment. However, a severe drought, an extended presidential election, and weak bank lending—due in part to interest rate controls—slowed growth in 2017. With better weather and a stable political environment, growth should improve in 2018. But public debt has risen as revenue shortfalls have not been matched by spending cuts. Moreover, interest rate controls continue to hamper lending (especially to SMEs), growth, and monetary policy.

Program Context: The Executive Board approved a six-month extension of Kenya's SBA until September 14, 2018 (its SCF expired on March 13, 2018). Since the performance criteria (PCs) for the second review (end-June 2017) are now outdated, establishment of new PCs for end-June 2018, a monetary policy consultation clause (MPCC), and new structural benchmarks are proposed. Staff will circulate a Staff Report for completion of the second review with relevant program parameters at a later date. The authorities plan to continue treating the SBA as precautionary. Staff supports the request for establishment of new performance criteria and an MPCC for end-June 2018. The PCs will cover a floor on the primary balance consistent with a 2017/18 overall fiscal deficit of 7.5 percent of GDP, a floor on international reserves, and a ceiling on new contracting or guaranteeing of public debt.

Key Policy Recommendations: *In the near term,* the authorities should deliver on their fiscal deficit target of 7.5 percent of GDP in 2017/18 (focusing measures on expenditure) and 5.7 percent in 2018/19 (focusing measures on revenue) to bring debt ratios onto a downward path. It is critical for the authorities to remove or significantly modify interest rate controls and move toward an interest rate corridor soon thereafter. *In the medium term,* the planned gradual fiscal consolidation is essential to preserving debt sustainability and reducing fiscal risks. Measures should focus on revenues to maintain space for public investment and social spending. Structural reforms should continue to focus on improving revenue administration, strengthening public financial management, modernizing the monetary policy framework, enhancing bank prudential frameworks, and improving the business environment and governance, with a view to sustaining strong growth and making it more inclusive.

Approved By
Michael Atingi-Ego (AFR) and Zuzana Murgasova (SPR)

Discussions were held in Nairobi during February 19–March 2. The staff team comprised B. Clements (head), N. Hobdari and J. Weiss (all AFR), S. Mbaye (FAD), R. Moya (MCM), and Z. Munkacsi (SPR). J. Mikkelsen (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, Central Bank of Kenya Governor Njoroge, as well as other senior government officials, members of parliament, and representatives of the private sector and civil society. F. Nyankiye provided research support and F. Morán Arce and J. Ogaja provided assistance in the preparation of this report.

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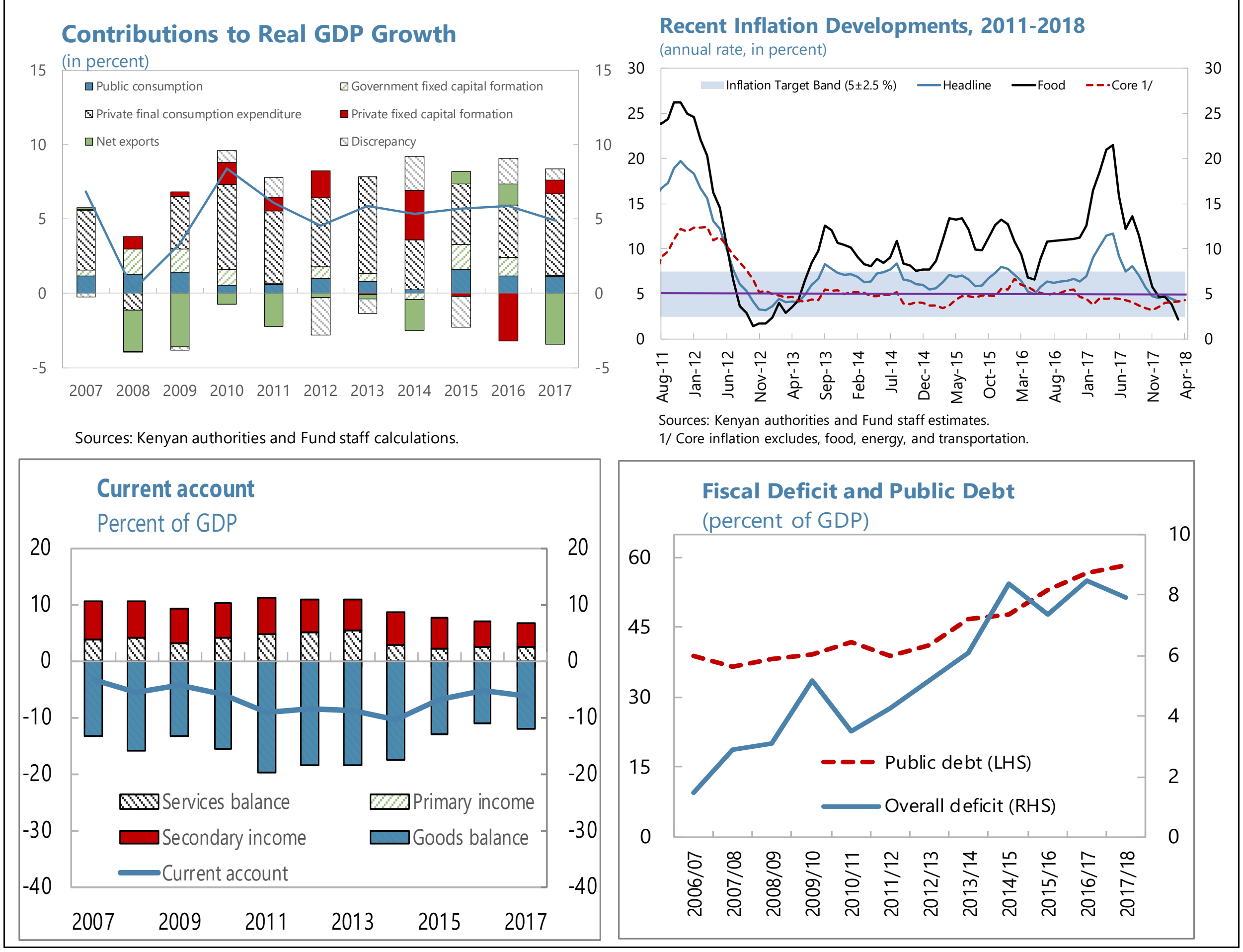
CONTEXT

1. **Kenya has achieved strong economic growth and reduced external imbalances in recent years, but the fiscal deficit has remained high and public debt is increasing, threatening medium-term growth and poverty reduction efforts.** Real GDP growth has averaged about 5½ percent since the 2008 global crisis. This reflects continued macroeconomic stability, a rapid increase in financial inclusion (see Selected Issues Paper), better provision of public infrastructure services, and significant improvements in the business environment. In turn, Kenya's poverty rate fell by over 10 percentage points over 2006–16 (to 36.1 percent) although inequality remained high (Box 1). While current account deficits have started to adjust and external buffers remain adequate, fiscal deficits have remained high. This has contributed to a significant increase in public debt, which is projected to reach 60.7 percent of GDP by June 2018 (the end of FY 2017/18). Achieving stronger growth in the medium term that will further reduce poverty requires a gradual fiscal consolidation that reverses Kenya's recent debt trajectory while preserving space for growth-friendly public investment.

Kenya: Key Macroeconomic Developments, 2006–18



2. **The political uncertainty of 2017 appears to have abated.** The result of the August 2017 presidential election was annulled by the Supreme Court and the opposition boycotted the repeat

election in October. Elevated political polarization weakened investor and business confidence, reduced economic activity, and stalled the authorities' reform agenda. Political uncertainty appears to have abated since the presidential inauguration in late November 2017, although some of the political fissures highlighted by the election remain.

RECENT ECONOMIC DEVELOPMENTS

3. **Economic growth slowed in 2017.** GDP growth fell to 4.9 percent in 2017 (from 5.9 percent in 2016). This was driven by a contraction in agriculture due to the severe drought of late-2016/early-2017, extended political uncertainty that adversely affected confidence, and weak credit growth, partly due to interest rate controls. The conclusion of the election period in November saw a return of confidence, with growth accelerating to 5 percent in the fourth quarter (up from 4.7 percent through the first three quarters). Higher-frequency indicators suggest that the pickup in activity continued in early 2018 as pent-up demand and investment from 2017 continues to carry over into this year, although credit to the private sector remained very weak.

4. **Inflation is back within the authorities' target range (5±2.5 percent).** A sharp rise in food prices pushed headline inflation above the target range starting in February 2017. With weather returning to normal, food inflation fell in July and headline inflation stayed within the target range for the rest of the year. The continued decline in food inflation has kept headline inflation in the lower half of the target range since November (3.4 percent in April). Core inflation has remained below 5 percent since late 2016.

5. **The current account deficit has widened.** While the current account deficit has fallen from its peak of several years ago, it increased to 6.8 percent of GDP in 2017 (from 5.2 percent in 2016). The increase reflected mainly higher food and fuel imports due to the drought and rising global oil prices. This outweighed a strong improvement in export growth. On balance, the external position appears to be weaker than Kenya's fundamentals and desirable policy settings (Annex II).

6. **The interest rate controls that were introduced in September 2016 have weakened economic performance.** The controls are contributing to lower credit growth, reduced financial inclusion, weaker bank profitability and tax revenues, higher financial stability risks, and a weakening of the effectiveness of monetary policy. Staff analysis suggests that interest rate controls reduced growth in 2017 by ¼–¾ percentage points (see Selected Issues Paper).

ECONOMIC OUTLOOK AND RISKS

7. **Kenya's medium-term outlook remains favorable but hinges on implementation of reforms, and headwinds from fiscal consolidation and weak credit growth will weigh on economic activity in the near term.**

- *Under the baseline,* with elections over and weather conditions returning to normal, growth is expected to increase to 5.7 percent in 2018 (from 4.9 percent in 2017). Supported by the supply effects from completed key investment projects (such as the Mombasa-Nairobi railway), better public investment management, and further improvements in the business environment—and assuming that interest rate controls are removed or significantly modified—Kenya's real GDP growth is expected to average 6.0–6.5 percent per year over the medium term. These reforms, projected improved export performance, and, in the near-term, better weather conditions, will more than offset the contractionary effects of the planned fiscal adjustment. The medium-term fiscal adjustment scenario envisages strong adjustment over 2018-19, driven largely by revenue measures, with the deficit gradually approaching, but not reaching, the EAC convergence criteria of 3.0 percent of GDP. Inflation is expected to remain within the authorities' target range in the near term, despite higher global fuel prices, reflecting the negative output gap. The current account deficit is projected to decline over the medium term as tea exports and tourism receipts continue to recover.

Kenya: Medium-Term Macroeconomic Framework – Baseline (Adjustment Scenario)

	2014	2015	2016	2017	2018	2019	2020	2021	2022
		Act.		Prel.			Proj.		
Real GDP growth (percent)	5.4	5.7	5.9	4.9	5.7	6.0	6.2	6.5	6.5
CPI inflation, average (percent)	6.9	6.6	6.3	8.0	5.0	5.3	5.0	5.0	5.0
CPI inflation, eop (percent)	6.0	8.0	6.3	4.5	5.5	5.1	5.0	5.0	5.0
Current account balance (percent of GDP)	-10.4	-6.7	-5.2	-6.8	-6.6	-6.3	-6.1	-6.3	-6.3
Overall fiscal balance (percent of GDP) [1]	-5.8	-8.4	-7.3	-9.0	-7.5	-5.7	-4.0	-3.5	-3.5
Gross international reserves (in billions of US$)	7.9	7.5	7.5	7.1	8.0	9.2	10.2	11.0	11.8
Gross international reserves (months of imports)	5.3	5.5	4.7	4.0	4.1	4.3	4.4	4.3	4.3
Total public debt (gross, percent of GDP)	48.6	51.2	53.2	58.0	63.2	62.9	60.0	57.5	56.3

Sources: Kenyan authorities and IMF staff estimates and projections.

[1] Fiscal years (e.g., 2015 refers to FY 2014/15).

- *Under an alternative scenario,* with unchanged policies (slower fiscal consolidation and no removal or modification of interest rate controls), staff project lower medium-term growth, and higher fiscal deficits and public debt.

Kenya: Medium-Term Macroeconomic Framework—Alt. Scenario Unchanged Policies

	2014	2015	2016	2017	2018	2019	2020	2021	2022
		Act.		Prel.			Proj.		
Real GDP growth (percent)	5.4	5.7	5.9	4.9	5.2	5.5	5.5	5.5	5.5
CPI inflation, average (percent)	6.9	6.6	6.3	8.0	4.8	5.0	5.0	5.0	5.0
CPI inflation, eop (percent)	6.0	8.0	6.3	4.5	5.0	5.0	5.0	5.0	5.0
Current account balance (percent of GDP)	-10.4	-6.7	-5.2	-6.8	-6.5	-5.9	-5.3	-5.0	-4.8
Overall fiscal balance (percent of GDP) [1]	-5.8	-8.4	-7.3	-9.0	-7.9	-7.0	-6.3	-5.8	-6.0
Gross international reserves (in billions of US$)	7.9	7.5	7.5	7.1	7.7	8.5	9.2	10.1	10.8
Gross international reserves (months of imports)	5.3	5.5	4.7	4.0	4.1	4.2	4.2	4.3	4.3
Total public debt (gross, percent of GDP)	48.6	51.2	53.2	58.0	63.7	65.4	66.2	66.6	67.4

Sources: Kenyan authorities and IMF staff estimates and projections.

[1] Fiscal years (e.g., 2015 refers to FY 2014/15).

8. **Risks to these macroeconomic projections are mostly to the downside.** Failure to remove or significantly modify interest rate controls—to an extent that fully mitigates their negative impact on credit growth—would reduce medium-term growth and, likely, increase fiscal deficits and debt. Other important risks include: (i) on the upside, a faster-than-projected recovery of tourist

arrivals; and (ii) on the downside, new security incidents in Kenya, protracted weak credit growth, and a larger-than-expected impact of the programmed fiscal consolidation. External shocks that spurred capital outflows——such as a pullback from emerging markets or tightening global monetary conditions——would come at a time when the authorities have little policy space, given the urgent need for fiscal adjustment and a still-constrained monetary policy due to interest rate controls. As such, if such a shock were to materialize, economic growth would weaken.

Authorities' Views

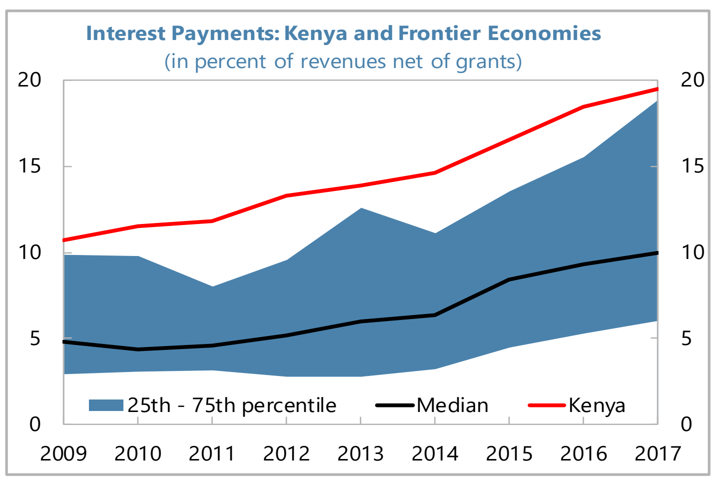
9. **The authorities were more optimistic than staff about near- and medium-term growth prospects.** The authorities expect somewhat stronger growth than staff in 2018 and considered staff's medium-term projections overly conservative given the envisioned role of the Big Four (Box 2) in supporting growth, as well as gains from infrastructure developments such as the Standard Gauge Railway. The authorities also saw the current account deficit declining at a faster pace than projected by staff due to the absence of one-off factors such as higher drought-related imports in 2017.

POLICY DISCUSSIONS

A. Fiscal Policies: Delivering Fiscal Consolidation to Maintain Debt Sustainability and Preserve Public Investment

Background

10. **Debt and debt service have increased as a result of the government's public investment drive and revenue shortfalls in recent years.** Public debt has been increasing at a relatively fast pace since 2013, with slippages in the runup to the 2017 elections pushing debt up to a projected 60.7 percent of GDP by June 2018. The higher level of debt, together with rising reliance on non-concessional borrowing, have raised fiscal vulnerabilities and increased interest payments on public debt to nearly one fifth of revenue, placing Kenya in the top quartile among its peers. As a result, Kenya's risk of debt distress has increased from low to moderate (see accompanying Debt Sustainability Analysis).



11. **Historically, overly-optimistic revenue projections have required ad hoc adjustments in spending to meet budget deficit targets.** Typically, the authorities have, toward the end of the fiscal year, frozen spending authorizations across ministries below budgeted levels to meet fiscal targets. This has resulted in ad hoc fiscal adjustments that risk increases in arrears (pending bills)

and shortfalls in public investment spending. Because of these unrealistic revenue projections, budgets have not provided a transparent indication of the spending that the government will likely carry out in the fiscal year.

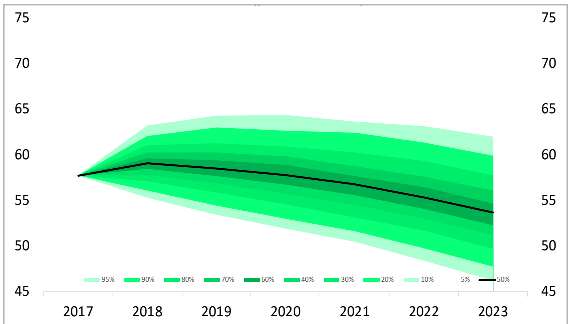
12. The fiscal deficit in 2016/17 was 9.2 percent of GDP, compared to a program target of 6.9 percent. This reflected mainly a combination of higher-than-programmed foreign-financed investment and lower tax revenues. Income taxes experienced the largest shortfall, reflecting the upward adjustment in PAYE tax bands, delays in the implementation of planned revenue administration measures, and reduced profitability in the financial sector. New spending pressures also emerged from the drought, the election, and the higher interest bill (the latter equivalent to 0.2 percent of GDP). These were only partially offset by cuts in domestically-financed investment and other current spending.

13. Revenue shortfalls have persisted over the course of FY2017/18, putting the authorities' consolidation plans at risk. Revenues through end-March 2018 were about 0.5 percent of GDP short of the revised budget target, mainly on the back of lower income tax, excise, and VAT revenues. The authorities have adopted a series of revenue administration measures, beginning in January 2018, such as the rollout of the Integrated Custom Management System and installation of scanners at customs ports to reduce revenue losses due to the under-declaration of imports. While these measures are expected to boost revenues in the medium term, staff projects shortfalls in FY2017/18 revenues relative to the March 2018 supplemental budget, primarily based on revenue outturns through March, and also partly due to the effect of the interest rate controls on corporate tax receipts. As such, further expenditure cuts will be needed to meet the June 2018 fiscal target.

Policy Discussions

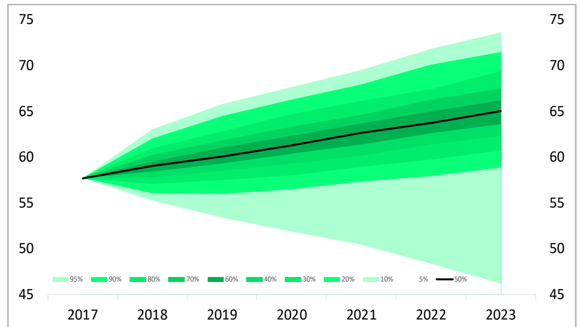
14. Staff and the authorities agreed that reducing the fiscal deficit over the medium term is essential to contain fiscal risks and support private sector growth. Reducing the fiscal deficit gradually toward the authorities' medium-term objective of 3 percent of GDP would reduce financing risks, put debt on a downward path, and avoid procyclical tightening in the event of a shock. Such a strategy is also in line with the East African Monetary Union's convergence criteria (a fiscal deficit of 3 percent of GDP by 2021). Staff also underscored that the composition of financing needs to be carefully calibrated to balance the risks from further non-concessional borrowing on the external market and risks of crowding out the private sector in the domestic market.

Kenya: Public Deft Fan Chart—Baseline
(Adjustment Scenario, Percent of GDP)



Note: The fan chart is based on simulations that draw from a multivariate distribution of historical shocks including on output (domestic and global), terms of trade, the exchange rate, and interest rates (both domestic and external).

Kenya: Public Debt Fan Chart—Alt. Scenario
(Unchanged Policies, Percent of GDP)



Note: The fan chart is based on simulations that draw from a multivariate distribution of historical shocks including on output (domestic and global), terms of trade, the exchange rate, and interest rates (both domestic and external).

15. The authorities' plan to reduce the deficit to 7.5 percent of GDP in 2017/18—and further to 5.7 percent in 2018/19—marks a good first step in implementing this strategy.[1] The strategy implies an adjustment in the primary balance of over 3 percent of GDP during 2017/18–2018/19 relative to the 2016/17 outcome. This strikes a careful balance between reducing the fiscal risks posed by high budget deficits and maintaining robust growth. Expiration of one-off spending (text table) would help to achieve the envisaged fiscal consolidation.

Kenya: Expiration of One-Off Spending, 2018/19
(percent of GDP)

	2018/19
Projected reduction in the overall deficit	1.5
Expiration of one-off spending	0.5
Elections	*0.4*
Drought	*0.2*
Residual consolidation (excl. one-offs)	1.0

16. Additional spending cuts, beyond those incorporated in the supplemental budget, are needed to achieve the 2017/18 fiscal target. The authorities agreed that if revenues disappoint, they would contain spending for the remainder of 2017/18 as needed to achieve the deficit target. Staff urged the authorities to focus the cuts on low-priority domestically-financed capital projects to avoid undue disruption to priority spending, and to contain spending commitments (rather than delaying payments) to ensure that the deficit target is met without incurring arrears.

17. The authorities have committed to a series of tax policy measures to boost revenues in 2018/19. The authorities are planning revenue measures that include: (i) removal of the VAT exemption on petroleum imports, which is set to expire in September (0.36 percent of GDP); (ii) expanding taxes on betting to cover both operator profits and winnings (0.41 percent of GDP); and (iii) removing various VAT and CIT exemptions (0.15 percent of GDP). The authorities expect these and additional planned measures to yield a total of 1.1 percent of GDP in additional revenues.

18. The draft income tax bill represents a positive step forward in Kenya's tax regime. The bill, which has been posted for public comment and is planned for introduction in FY2018/19, would

[1] At the time of the March 2018 staff report, the 2017/18 deficit target was 7.2 percent of GDP. The subsequent release in April 2018 of the national accounts statistics for 2017 had a significant downward revision of the GDP deflator and overall nominal GDP for the second half of 2017. This implies that the nominal fiscal deficit target of Ksh 623 billion is now equivalent to 7.5 percent of GDP.

increase the progressivity of the personal income tax, and have a positive revenue impact, by (1) adding a new personal income tax bracket of 35 percent for upper-income individuals; and (2) simplifying the corporate tax code along a number of lines.

19. **Staff indicated that additional measures will be needed for 2018/19 to meet the deficit target.** Staff welcome the measures described in paragraphs 17 and 18, which are incorporated into the baseline, but believe that the authorities' revenue projections are overly optimistic. The weak underlying performance of income and other taxes are likely to persist, partially offsetting the effects of the measures planned by the authorities. On this basis, staff projects that measures of an additional 0.6 percent of GDP will be needed to meet the deficit target. Further measures would also be required in case of lower yields from the measures described in paragraph 17 above. Staff also encourages the authorities to carry out a careful costing of any tax benefits that they plan to enact as part of the government's "Big Four" development plan (Box 2).

20. **There is scope for further improvement in the tax regime.** For the income tax, this could be achieved by closing remaining loopholes related to investment allowances and capital gains taxes. VAT exemptions also remain large; rationalization of these could yield roughly 2½–3 percent of GDP per year. The property tax remains largely unexploited, and will be needed to help support the devolution of spending responsibilities to county governments. The authorities should also consider improvements to the international taxation regime (see Box 3 and Selected Issues Paper).

21. **Staff encourages the authorities to monitor and prevent the accumulation of arrears, carefully evaluate fiscal risks related to PPPs, and mitigate the impact of the envisaged fiscal adjustment on the most vulnerable groups.** Staff welcomes the authorities' initiatives to move towards free secondary education, expand access to healthcare, and promote housing for low-income groups, which will help reduce inequality. The authorities should also carefully review fiscal risks associated with the large number of planned PPP projects as part of the Big Four, especially in the road sector.

Authorities' Views

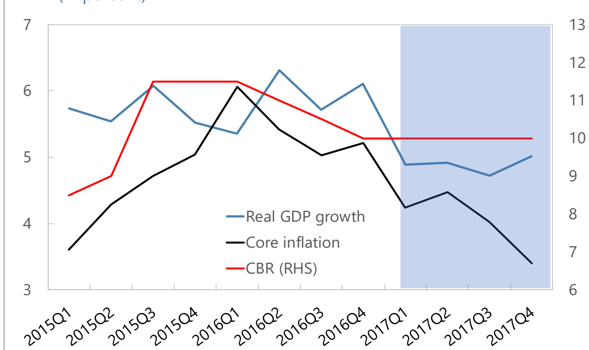
22. **The authorities agreed with staff on near term fiscal targets, but were more optimistic on revenues.** The authorities were confident that revenues would materialize as projected in the supplemental budget. As such, they saw less urgency than staff in identifying specific spending reductions to ensure that the fiscal target would be met. They thus saw less need for additional measures in FY2018/19 to meet the target. However, they agreed that if revenues disappoint, based on the outturn for April, they would freeze spending authorizations as needed to meet the target. They also believed that they would be able to slow down spending as needed without generating additional arrears.

B. Monetary and Exchange Rate Policies: Transitioning Toward a Modern, Forward-Looking Monetary Framework

Background

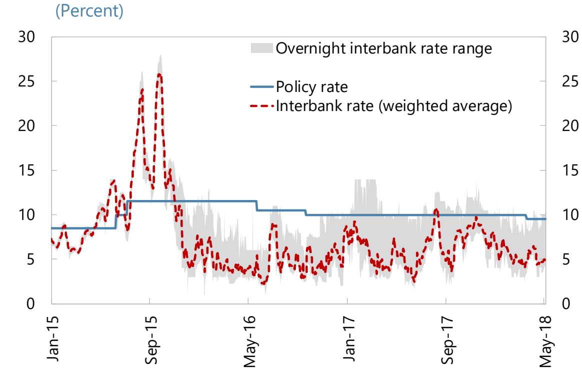
23. The Central Bank of Kenya's (CBK's) policy rate (CBR) has lost its signaling role as interest rate controls have weakened the link between the CBR and bank lending and deposit rates. Prior to introduction of interest rate controls, the CBK had been changing the CBR with respect to developments in inflation and growth. When core inflation moved above the mid-point of the inflation target range and/or growth accelerated above potential, the CBR was increased and lowered when the opposite happened to inflation and growth. Since the introduction of the controls, until March 2018 the CBK kept the CBR unchanged at 10.0 percent, despite lower growth and lower core inflation. A reduction in the CBR would lower the maximum interest rate that banks can charge under the interest rate caps. This, in turn, could ration a greater share of high risk/high return borrowers, tightening (rather than loosening) credit conditions. In March 2018, the CBK changed the CBR for the first time since controls were introduced, cutting the rate by 50 bps to signal its accommodative stance, but in doing so noting the potential for perverse outcomes. The impact, if any, of the cut on bank lending is not yet clear.

Kenya: Real GDP Growth, Core Inflation, and Policy Rate
(in percent)



Sources: Kenyan authorities and IMF staff calculations.

Kenya: Money Market, 2015-18
(Percent)

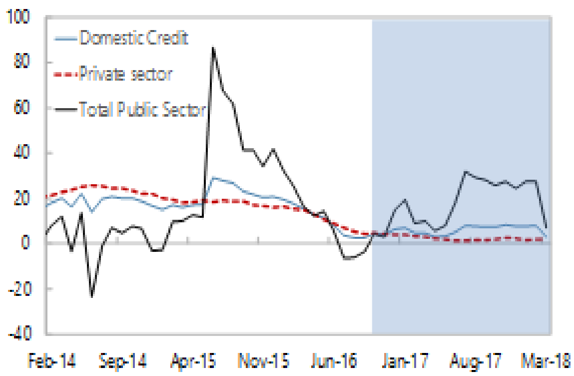


Sources: Central Bank of Kenya (CBK); and IMF staff calculations.

24. Interbank market volatility has hindered the monetary policy framework's effectiveness. The weighted average interest rate in the interbank market has ranged between 3 and 10 percent during 2017 and early 2018. The wide range has entailed significant day-to-day volatility, which appears to be driven by some combination of a small number of large banks dominating the market, remaining inefficiencies in the processing of large government transactions, and unsterilized FX interventions. The dispersion in interbank rates has remained elevated, with small banks facing much higher borrowing rates since three banks were closed in 2015–16 that led to a substantial increase in risk aversion.

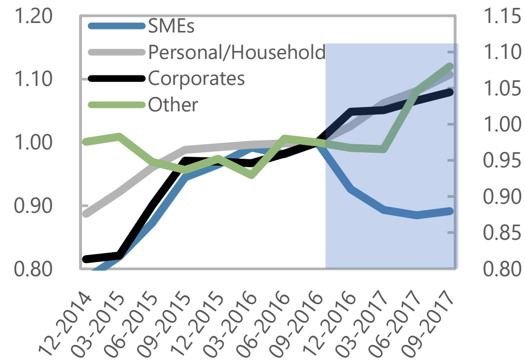
25. Private sector credit growth has fallen sharply. Private sector credit growth was 2 percent y/y in March 2018, compared to 4.1 percent at end-2016 and 16.0 percent at end-2015. While the slowdown in lending began before interest rate controls were adopted, their introduction has led to a further shift in bank lending from the private sector and toward the government, with the latter becoming increasingly reliant on banks for funding. This has been accompanied by a sharp decline in bank credit to SMEs, especially in trade and agriculture, reducing financial inclusion and growth (see Selected Issues Paper on Interest Rate Controls).

Kenya: Credit Growth by Sector
(y/y, in percent)



Sources: CBK, staff estimates

Kenya: Credit Outstanding by Borrower
(index, Sept. 2016=1)



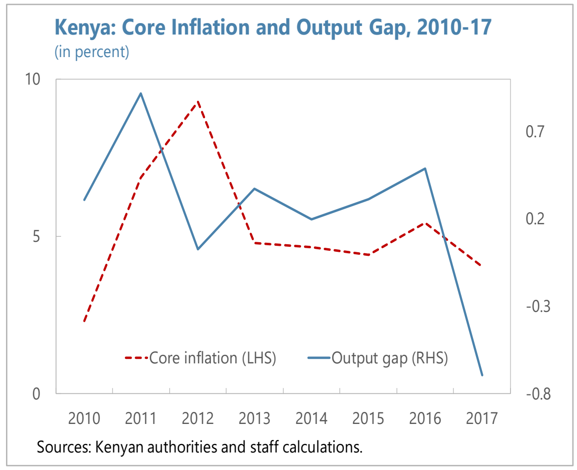
Sources: CBK, staff estimates

Policy Discussions

26. Abolishing or significantly modifying interest rate controls is key for transitioning to an interest-rate based monetary policy framework and enhancing Kenya's ability to respond to external shocks. The controls have delayed the CBK's adoption of an interest rate corridor. The latter is essential to re-establish the signaling role of the CBR and facilitate the CBK's communication on the stance of monetary policy. A first-best solution would be to remove the interest rate controls. Given the political difficulties of doing so, the authorities have committed to significantly modify interest rate controls if removal is not possible. This should be done by delinking the lending rate cap from the CBR; significantly increasing the lending rate cap with the aim of protecting consumers from predatory lending; and abolishing the floor on time deposit rates. Staff can agree with such an approach that includes all of these elements, as this would neutralize the negative impact of interest rate controls. The authorities have also committed to introduce a formal interest rate corridor for interbank rates around the policy rate as the cornerstone of the CBK's monetary policy framework. The corridor should be introduced shortly (two to three months) after the removal or significant modification of the controls, which should provide sufficient time to assess how banks have reacted to the removal of the controls and any operational changes that are needed to make the corridor effective.

27. Lower volatility in interbank interest rates would help ensure consistency with Kenya's interest-rate based monetary policy framework. The significant volatility in the interbank interest rate has adverse effects on bank lending rates, incentivizes banks to retain excess liquidity, and weakens the monetary policy transmission mechanism. To that end, the CBK should work to reduce interbank rate volatility, even before interest rate controls are removed or modified, by (1) sterilizing the liquidity impact of its foreign exchange interventions as needed; (2) improving liquidity forecasting, especially regarding large operations by the National Treasury; and (3) strengthening the horizontal repo market. Even with monetary policy transmission hampered by interest rate controls, greater interbank market stability will allow for a more efficient distribution of liquidity among banks, and help banks prepare for the post-controls era of monetary policy. To help further develop financial markets and increase transparency, the authorities should also consider publishing ex-post information on FX operations, such as volumes and number of participants, as do other frontier and emerging economies.

28. **An accommodative monetary policy seems appropriate.** Monetary conditions, as measured by the average interbank interest rate, are close to zero in real terms. With core inflation below the mid-point of the target range, fiscal consolidation in progress, and a negative output gap, the stance of monetary policy should remain accommodative. The CBK should stand ready to loosen liquidity conditions further, if possible, given interest rate controls, if growth and inflation remain subdued.



29. **There is also room for greater exchange rate flexibility.** The CBK engages in periodic FX interventions, typically unsterilized, to limit shilling movement. Given the CBK's credibility, well-anchored inflation expectations, and adequate reserve coverage, there is scope for greater exchange rate flexibility. This would underscore the exchange rate's role as a potential shock absorber (see Annex II).

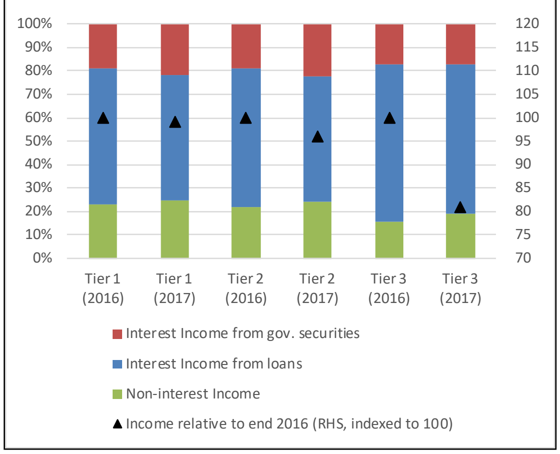
Authorities' Views

30. **The authorities agreed that interest rate controls and interbank market volatility are hampering monetary policy effectiveness.** However, they believe that the volatility issue cannot be resolved before interest rate controls are removed or significantly modified and the CBR signaling function strengthens. Their preferred strategy is to focus on reducing interbank market segmentation by improving the trading platform for government securities to increase access to liquidity for more banks. In their view, it is not necessary to sterilize FX interventions, given their relatively low volumes, and they saw liquidity forecasting, including for government transactions, as adequate. They agree that, after controls are modified, an interest rate corridor should be established, but believe a longer period (of six months) would be preferable, to observe any related financial stability issues related to the change in interest rate regime. The authorities underscored their adherence to a flexible exchange rate policy and that their FX interventions were undertaken to avoid excessive exchange rate volatility, which they viewed as important for achieving macroeconomic and financial stability.

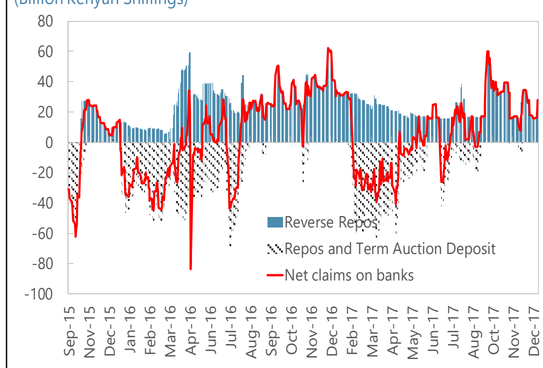
C. Financial Sector Policies: Maintaining Financial Stability

Background

Share of Bank Income By Source
(year end)



Kenya: CBK's Net Position vis-a-vis Banks, 2015-17
(Billion Kenyan Shillings)



Sources: Central Bank of Kenya; and IMF staff calculations.

31. Interest rate controls have reduced the profitability of banks. Commercial banks have been forced to adjust their deposit and lending facilities with the controls introduced in September 2016, significantly reducing their net interest income. To soften the impact on their earnings, banks have taken steps to reduce operating expenses, including by cutting staff and increasing fees. The significant drop in profitability is of particular concern for small banks, whose profits were already below the industry average and have been forced to adjust their deposit and lending facilities with the controls introduced in September 2016, significantly reducing their net interest income. Although the impact of interest rate controls on the banking sector's performance has largely fallen on smaller banks and so far, does not pose a systemic risk, with the system in aggregate remaining sound, they pose risks to financial stability if maintained for much longer.

32. NPLs have continued to increase and liquidity support by the CBK to banks remains relatively high. NPLs increased to 12.4 percent in April 2018, from 9.6 percent a year earlier. This reflects stricter NPL classifications by the CBK; the slowdown in credit growth, which affects NPL rates through the denominator factor; and the slowdown in economic growth. The outstanding amount of liquidity support to some small banks that remain cut-off from the interbank market—while down from peak levels and now focused on fewer banks—remains significant.

33. These pressures notwithstanding, banks and corporates appear relatively resilient to shocks in the corporate sector. Stress tests suggest that Kenya's large non-financial corporations, which have enjoyed strong growth and profitability in recent years, are resilient to shocks, and Kenya's banks are resilient to corporate sector shocks: Even under extreme shock scenarios, banks would experience an increase in NPLs but would not experience a severe deterioration of capital levels (see Selected Issues Paper on corporate vulnerability for further detail).

Policy discussions

34. Strengthening the bank supervision framework is critical for safeguarding financial stability. The authorities continue to strengthen the banking supervision framework. Capital and liquidity positions of commercial banks and microfinance institutions have been improving. Specialized on-site inspections of banks' ICT systems are being implemented, as well as International Financial Reporting Standards (IFRS) 9 standards (although the latter will be phased in over a five-year period). The CBK also recently issued a guidance note to banks related to Cyber Security. While the overall banking sector is healthy, two small government-owned banks (both representing about 3 percent of system assets, or about 0.3 percent of GDP) are not compliant with capital ratios and some other banks fall short of liquidity statutory minima. Staff encourages the CBK to continue to implement remedial plans for banks that are not compliant with capital and liquidity ratios, including requiring banks to present credible restructuring plans to restore prudential ratios in a time-bound manner.

35. The authorities are making progress in the resolution of the 3 banks that were intervened in 2015 and 2016. CBK and Kenya Deposit Insurance Corporation (KDIC) accepted an offer to acquire selected assets and deposits from Chase Bank. Dubai Bank is in the liquidation process and Imperial Bank is in a non-binding offer stage and the finalization of the transaction is expected by July 2018. The treatment of repurchase agreements in resolution, placed along with the rest of senior creditors according to the KDI Act, continues to create uncertainty for investors and curtail the development of the horizontal repo market. Moving forward, the authorities should move to address shortcomings in the bank resolution framework, including a complex legal regime and a lack of planning and coordination between relevant institutions that delays decision-making. The authorities should also consider amending the KDI Act to allow for netting off of repurchase agreements, which would, in turn, simplify the resolution of banks and ensure collateral enforceability.

36. The authorities are also making progress with Anti-Money Laundering/Combatting Financing of Terrorism (AML/CFT reforms). Kenya's financial supervisors are working toward developing risk-based AML/CFT supervisory tools and to enhance the operations and procedures of Kenya's financial intelligence unit, which should help to strengthen anti-corruption efforts. While reporting entities are being encouraged to undertake risk assessments for AML/CFT, Kenya has not yet carried out a national risk assessment, which would help to better understand AML/CFT risks. The authorities are working (with Fund TA) to generate the data necessary to assess AML/CFT risks in the sector.

Authorities' views

37. The authorities agree with the need to continue strengthening banking supervision and support the recapitalization plans of the two government-owned banks. With regard to further strengthening of banking supervision, the authorities pointed to work toward improving its regulatory and supervisory framework to support continuous surveillance of regulated entities and conduct vulnerability assessments of banks. On interest rate controls, the authorities highlighted the CBK's engagement with banks on reviewing their business models based on customer needs, strengthening information sharing on credit and transparency of its pricing, and strengthening the current banking sector consumer protection, legal, and regulatory framework.

D. Structural Reforms: Promoting Inclusive Growth and Improving Governance

Background

38. Kenya has made impressive progress in strengthening the business environment, although indicators suggest that there is scope for further improvement. Kenya has improved significantly its ranking in the World Bank Doing Business Indicators (moving up a combined 33 places to 80 during 2016–18), with noteworthy improvements on starting a business, protecting minority investors, and resolving insolvency. Kenya has also continued to move up the WEF competitiveness ranks, moving to 91/137 in 2017–18, compared with 106/144 in 2011–13. However, performance on corruption, as measured by indicators compiled by the Transparency International and the World Bank, suggests continued challenges.

Policy discussions

39. The authorities should undertake additional reforms aimed at promoting strong and inclusive growth, strengthening transparency, and improving institutions and governance:

- **Furthering regional and multilateral integration**. The implementation of the Africa Continental Free Trade Area (CFTA), ratified by Kenya on March 27, 2018 along with the Comesa-EAC-SADC Tripartite FTA (TFTA), are significant and welcome steps toward regional integration, and staff encourage the authorities to continue to move forward with both. Staff encourages the authorities to sign the Economic Partnership Agreement (EPA) with the European Union.
- **PFM reforms.** Additional public financial management (PFM) reforms are needed to strengthen expenditure control and debt management, increase transparency, and improve the efficiency of public investment. Specific measures, which are structural benchmarks under the program (see Letter of Intent Table 4), include: (1) clarification of counties' power to set taxes/user fees to increase revenue at the county level to reduce pressures on transfers to counties; (2) standardization of guidelines for project appraisal and selection to improve the efficiency of public investment; (3) automation of the release of funds through the exchequer account to prevent the accumulation of pending bills; and (4) operationalization of a centralized payment system to ensure better control of public expenditure. In addition, efforts to provide a medium-term focus to budgeting, including the setting of expenditure ceilings that are consistent with medium term fiscal targets and realistic revenue projections, are of high priority. These efforts could draw on recent technical assistance.
- **Improving fiscal rules.** There is scope to further clarify Kenya's fiscal rules. The Public Finance Management Act (PFMA) of 2012 and the PFM Regulations of 2015 provide important fiscal targets and rules to help guide fiscal policy. Additional clarification would be

helpful on the ceiling for the present value of public debt, in particular by indicating whether it applies to debt on a gross or net (of government deposits) basis. In addition, a description of the procedures and correction mechanisms to be followed in case the debt ceiling of 50 percent of GDP in NPV terms is breached would further strengthen the fiscal framework.

- **Strengthening macroeconomic statistics.** The quality of Kenya's macroeconomic statistics is broadly adequate for surveillance and for assessing program performance, and the authorities are taking further steps to strengthen data provision, in particular on government financial statistics. Nevertheless, further improvements are needed on balance of payments statistics, especially regarding the compilation of the International Investment Position (IIP) and financial account data. This should include dissemination of IIP data and revision of historical financial account data with the latest data available (see Informational Annex).

Authorities' views

40. The authorities noted the strong progress made recently on improving the business environment and their commitment to PFM reforms. They highlighted strong improvements in rankings across a variety of sub-categories of competitiveness, although they also noted that these indicators do not fully capture the improvements that have been made in reducing bottlenecks. They agreed that PFM reforms are a priority, as reflected in recent requests for technical assistance from the Fund. They also noted that they are working toward improving macroeconomic statistics.

PROGRAM PERFORMANCE AND MODALITIES

41. Since the March 2016 approval of the authorities' SBA/SCF, only the first review has been completed, on January 25, 2017. The performance criteria on the primary balance for end-December 2016 and end-June 2017 were missed due to revenue shortfalls and spending pressures, with the latter partly due to the drought (Letter of Intent Table 1). Understandings on corrective policies to address the slippage could not be reached due to the extended election period. The introduction of interest rate controls in September 2016 also weakened performance under the program. The implementation of structural benchmarks under the program has been partial (Letter of Intent Table 2), with only three of eight structural benchmarks met so far, partly due to the unexpectedly prolonged electoral cycle in 2017.

42. The SBA program was extended to September 14, 2018. The extension provides additional time for the authorities to bring the program back-on-track and reach new understandings with IMF staff on policies and measures that would enable the completion of the pending reviews under the SBA for Kenya. The authorities did not request an extension of the SCF as this type of arrangement can be approved up to a maximum of 24-months.

43. Establishment of new end-June 2018 and continuous quantitative performance criteria (QPCs), indicative targets, a monetary policy consultation clause (MPCC), and structural benchmarks (SBs) for end-August 2018, is being proposed. Since the governing performance criteria for the second review under the SBA (end-June 2017) are now considered outdated, establishment of new performance criteria and an MPCC for end-June 2018 and new Structural

Benchmarks is proposed. These new QPCs, MPCC, and SBs would help to return Kenya to a sustainable fiscal path in line with program objectives and allow the banking sector to better support economic growth. The proposed QPCs (Letter of Intent Table 3) include a floor on the primary deficit in line with the authorities' end-fiscal year target of an overall deficit of 7.5 percent of GDP. The deficit target reflects the nominal target as discussed in the March 2018 staff report (requesting an extension of the SBA). With final 2017 nominal GDP lower than expected—due to a lower-than-expected GDP deflator—the deficit as a share of GDP, which had been 7.2 percent in March, is now higher. QPCs also include a floor on net international reserves, a ceiling on the government's external payment arrears, and a ceiling on new debt contracted or guaranteed by the national government and the CBK—the last is consistent with the reclassification of Kenya's risk of debt distress from low to moderate and Kenya's significant links to international capital markets. There is also a monetary policy consultation clause should inflation go outside of the CBK's target band. The proposed SBs (Letter of Intent Table 4) include significantly amending interest rate controls to avoid their adverse impact; and several PFM reforms as discussed in paragraph 39 above.

44. Kenya's capacity to repay the Fund remains strong. Export growth is expected to continue the recovery seen in 2017, supported by tourism and continued regional and continental integration. This, along with the envisaged fiscal consolidation and adequate international reserve coverage, would contain the risk of debt distress. Failure to fully implement the envisaged fiscal adjustment or repeal or significantly modify interest rate controls, which would negatively impact economic growth, revenue performance, and monetary policy effectiveness, as well as an external shock that increased financing pressures or spurred capital outflows, would negatively affect this assessment. While the authorities intend to continue to treat the program as precautionary, obligations to the Fund (assuming full drawings under the program) relative to exports and GDP are manageable.

45. The downside risks to the program are delayed or partial fiscal consolidation, failure to eliminate or amend interest rate controls, and external shocks. While political stability has improved since November 2017, some fissures remain—if they were to widen again, political considerations could delay the planned fiscal consolidation. Revenue outturns below those expected per the authorities' plans could also threaten the program's success. Likewise, while there appears to be political momentum behind modification of interest rate controls, there is a risk that the controls will not be modified in a timely fashion or be significantly modified. Failure to make progress in this area could lead to a reduction in growth by about ½ percent per annum in 2018 and beyond. Finally, tightening global monetary conditions could increase the public sector's gross external financing requirements.

46. If downside risks materialize, policy measures could be needed to safeguard stability and debt sustainability. Kenya's first line of defense in the event of a shock should be to allow flexibility in the exchange rate. That, combined with the use of Kenya's ample FX reserves, could minimize volatility and potentially provide space to continue with the needed fiscal adjustment. As noted above, failure to remove or significantly modify interest rate controls would limit the authorities' ability to respond in case downside risks materialize.

OTHER ISSUES

47. Capacity development needs are being addressed through a tailored technical assistance program (see Annex IV). Recent assistance has included strengthening public investment management, improving revenue administration integrity, and further development the bank supervision framework. Going forward, Kenya's capacity-building strategy should focus on strengthening the authorities' approach to medium-term budgeting, improving public financial management, further enhancing bank supervisory capacity, and expanding government financial statistics coverage.

48. The authorities have made some progress on improving macroeconomic statistics, but significant gaps remain. The overall quality, timeliness, and coverage of macroeconomic statistics has improved in recent years, although staffing and capacity constraints remain a challenge. In particular, the authorities should move to extend coverage of government financial statistics to public corporations and to improve public debt reporting. They should also move to disseminate international investment position data and to improve trade statistics. (See Informational Annex for additional information.)

49. The CBK has implemented all the recommendations of the May 2015 safeguards assessment. Notably, the legal framework was amended in line with staff's advice and subsequently enacted. CBK Board members were appointed in accordance with the provisions of this law, and the Audit Committee subsequently reconstituted.

STAFF APPRAISAL

50. Kenya has enjoyed macroeconomic stability and healthy economic growth in recent years. This has been supported by the authorities' efforts to strengthen public infrastructure, improve the business environment, and enable a rapid increase in financial inclusion.

51. Safeguarding these gains requires timely action to reduce government budget deficits and eliminate or significantly modify interest rate controls. A fiscal effort that delivers the adjustment recommended above will return debt to a sustainable path and will support the authorities' plans for boosting inclusive growth, including via the Big Four development plan. Likewise, elimination or significant modification of interest rate controls will enable greater credit growth, especially to SMEs, boosting economic growth, increasing financial access, and better enabling the CBK to conduct monetary policy. Staff welcomes the authorities' commitment to implementing these policies in a timely fashion.

52. Additional measures will be needed to achieve the authorities' fiscal targets. The authorities' plan correctly focuses on raising revenues to help protect priority spending. Nevertheless, given underlying weaknesses in tax revenues, additional measures will be needed to complement those included in the supplemental budget for FY2017/18 and the draft budget for FY2018/19. Cutting expenditure is necessary for 2017/18, given the limited time for the adjustment. Additional revenue measures, beyond those planned by the authorities for FY2018/19, will be needed to achieve the deficit target of 5.7 percent of GDP. These measures should be based on an ambitious reform of the remaining exemptions in the corporate income tax and value added tax. Gradually increasing these revenues over time would help achieve the authorities' medium-term objective of a deficit target of 3 percent of GDP.

53. More realistic revenue projections are essential to improve the transparency of the budget and improve the quality of fiscal adjustment. Overly optimistic revenue projections have reduced the transparency of the budget and necessitated ad-hoc spending cuts to meet fiscal targets. As in the past, these risks generating arrears and can lead to disruptive cuts in spending late in the fiscal year. Efforts to provide a medium-term focus to budgeting, including the setting of expenditure ceilings that are consistent with medium term fiscal targets and realistic revenue projections, are also of high priority.

54. Continued improvements in other areas of public financial management will be critical. This should include further clarification of Kenya's fiscal rules. It should also include measures aimed at reducing pressures on transfers to counties, preventing the accumulation of arrears, and improving the efficiency of public investment and expenditure control. It is also critical to closely monitor the implementation of PPPs and new spending programs under the Big Four to ensure that potential fiscal risks are contained.

55. Interest rate controls should be removed but, if this is not possible, the modification of controls should fully address their adverse effects. Immediate elimination or modification is key to restarting bank lending, supporting inclusive economic growth, and enabling the CBK to effectively implement an interest-rate based monetary policy framework. These modifications should include delinking the lending rate cap from the CBR, significantly increasing the lending rate cap with the aim of protecting consumers from predatory lending, and abolishing the floor on time deposit rates.

56. Revitalizing efforts to modernize the inflation-targeting monetary policy framework are key. Doing so will allow the CBK to reestablish the CBR's signaling role. This will require establishing an interest rate corridor around the CBR, once the interest rate controls are eliminated or modified; taking additional steps to smooth volatility in the interbank market; and allowing greater shilling flexibility in response to external shocks.

57. Kenya's external position is broadly stable. Lower imports have driven a narrowing of the current account deficit despite REER appreciation. Analysis suggests that Kenya's external position is weaker than fundamentals and desirable policy settings (see Annex II). International reserves are adequate and the business environment is improving.

58. The CBK has taken important steps to strengthen financial sector supervision. It should maintain its efforts to strengthen the banking supervision framework and take action to ensure that all banks are compliant with prudential capital and liquidity ratios.

59. Staff welcomes the impressive progress made in strengthening the business environment. Such improvements are necessary to raise potential growth and improve Kenya's medium-term prospects. Here, too, the removal of interest rate controls will be important, as will efforts by the authorities to improve governance by strengthening PFM.

60. Staff urges the authorities to continue in their efforts to improve macroeconomic statistics and their dissemination. Some progress has been made in improving data quality since Kenya's last Article IV staff report (see Annex I). However, important gaps remain, particularly with regard to government finance and balance of payments statistics. The authorities are encouraged to implement the enhanced General Data Dissemination Standards by launching their National Summary Data Page without further delay.

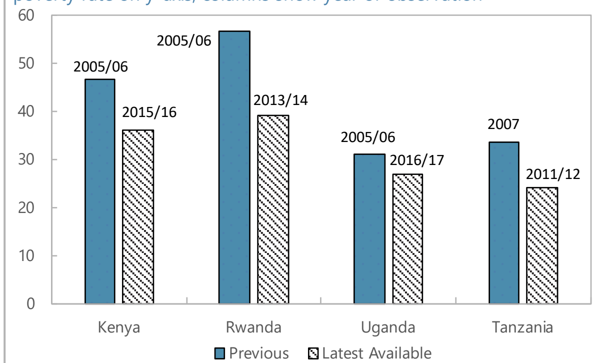
61. Staff supports the authorities' request for establishment of new QPCs and an MPCC under the SBA. The extension of the SBA until September 14, 2018 will give the authorities more time to work toward the objectives of the program, including meeting SBs by end August 2018, and reduce vulnerabilities. Staff recommends that the next Article IV consultation be held within 24 months in accordance with the Executive Board decision on consultation cycles for members with Fund arrangements.

Box 1. Poverty, Inequality, and Employment Developments

The recently released 2015/16 Household Budget Survey shows strong advances in poverty reduction over the past decade. The survey, published March 22, 2018, shows a significant reduction in Kenya's overall poverty incidence between 2005/06 and 2015/16, from 46.8 percent to 36.1 percent. This is broadly in line with trends in EAC peers over the past decade, although Kenya's poverty rate appears to remain well above that of Uganda and Tanzania. In line with this headline figure, Kenya's food poverty and extreme poverty rates fell by roughly similar margins, to 32.0 percent and 8.6 percent, respectively. The reduction in the overall poverty rate was driven by rural areas (where about two-thirds of Kenya's population lives), where the poverty rate fell from 52.5 to 40.1 percent. The urban poverty rate fell by a much smaller margin, but with a poverty rate of 29.4 percent urban areas remain much less poor than rural Kenya.

Poverty Rate

poverty rate on y-axis; columns show year of observation



Source: Country authorities.

The survey also suggests labor market improvements. Kenya's employment ratio (those with employment as a share of the working age population) improved slightly between 2009 and 2016, from 69.3 to 71.6 percent, with a similar increase among rural and urban areas (to 73.2 and 69.4, respectively). However, employment rates fell among younger age brackets (15–19 and 20–24), leaving youth employment particularly low at 27.6 percent.

Inequality and gender disparities remain prominent in Kenya. The household survey indicates that the top income quintile accounts for 59.4 percent of consumption expenditure, with this inequality even more pronounced in urban and semi-urban areas. The survey also finds that female-headed households are somewhat poorer than male-headed households (30.2 percent versus 26.0 percent), despite UNDP data showing some gradual reduction in gender inequality over the past decade. Likewise, while male labor force participation and unemployment rates stood at 79.2 percent and 5.2 percent, respectively, these rates were only 75.6 and 9.6 percent for women, with women comprising nearly two-thirds of Kenya's unemployed.

Box 2. The Big Four

President Kenyatta announced the "Big Four" program in December 2017, shortly following his inauguration. The stated goal of the program is to focus the government's economic development agenda for the next five years on the manufacturing sector, affordable housing, universal affordable health care, and food security.

The authorities are still in the process of identifying specific policies and corresponding financing needs over the next five years. However, responsibilities for each policy area have been assigned to relevant ministries. It is currently estimated that, for FY2018/19, about US$4–5 billion will be allocated for related projects, with about US$2.1 billion (about 2.3 percent of GDP) coming from the government. On the government side, most would involve reallocation of existing budgeted funds, although details are still not available.

Specific policies under consideration include:

- *Manufacturing:* The authorities seek to increase manufacturing's share of GDP from 9 to 15 percent by 2022. Policies could include reduction in the cost of off-peak power for heavy industries; creation of industrial parks and SEZs; and enforcement of local contracts for government projects and procurement.
- *Housing*: The authorities are considering creating a housing development fund to serve as a financing vehicle to use publicly-owned land to encourage the construction of low-cost housing. They are also considering creating a refinance company that would issue bonds in the local capital market. With the proceeds, the finance company would extend long-term loans to financial institutions secured against mortgages, which would help create a market for longer-maturity mortgages. The government also announced a lower tax rate for developers who build a certain number of housing units per year.
- *Health care*: The government seeks to provide universal health care, although the ultimate cost will depend on how generous the package of benefits will be. The government would also look to reform the governance of private insurance companies and increase the number of community health facilities.
- *Food security*: Policies would focus on large-scale production, improving smallholder productivity, and reducing the cost of food. The latter would be achieved by expanding the amount of land under production with the cooperation of the private sector via PPPs, better coordination of irrigation services, improving access to credit for the agriculture sector, and redesigning Kenya's food subsidy model to better target farmers' needs.

Development efforts targeting these four areas are welcome, but the authorities should carefully consider the design of policies to achieve these objectives. Policies geared toward boosting the manufacturing sector should seek to correct market failures or negative externalities and apply to industries as a whole. The authorities should seek to avoid "picking winners" and ideally leave the implementation and assessment of incentives to an independent body to ensure a level playing field. The authorities should also seek to ensure that any local content policies are in line with existing WTO agreements.

Box 3. Strengthening International Corporate Taxation in Kenya[1]

The overall parameters of Kenya's current international tax regime are quite sound, but several important steps could be taken to improve the regime going forward. This will be necessary to avoid the likely increase in leakage from the tax base that can be expected as a result of increasing cross-border inbound investment, and from constraints on cross border taxation arising from a widening tax treaty network.

A transparent treaty policy that uses cost-benefit analysis to assess the need for a treaty is essential to preserve the integrity of Kenya's treaty network. To restrict revenue leakage through payment of inter-group technical, management and professional service fees, future treaties should include a separate technical services article (following the Seychelles Treaty Article 13 model). To limit incentives for treaty shopping, a limitation of benefits (LOB) provision restricting use of a DTT to entities that have a sufficient economic nexus to justify the source country tax concessions given up by Kenya should be included. If Kenya were to adopt the Multilateral Legal Instrument an LOB provision would be added to existing treaties. Finally, many of Kenya's treaties do not include the necessary provisions to make effective the relatively recent additions to the ITA designed to permit taxation of indirect offshore transfers of interest in Kenyan immovable assets.

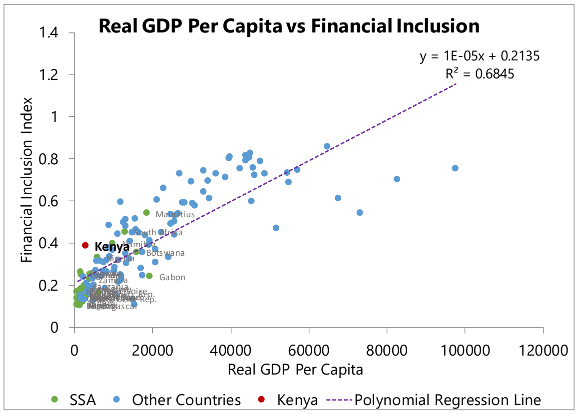
An ``earnings stripping'' rule could augment the current thin-capitalization rule to limit earning stripping via interest payment, by implementing a "fixed ratio" rule that limits net interest deductions claimed by a company to a fixed percentage of earnings before interest, taxes and depreciation (EBITDA). This ratio is most typically set at (a generous) 30 percent of applicable EBITDA. This type of rule avoids problems such as the need to define what constitutes debt or to combat the charging of an excessively high interest rate on related party debt.

There are also a number of improvements in transfer pricing policy that can be revenue enhancing, starting with using risk-based analysis to identify cases that are targets for enforcement. The draft income tax bill has addressed some of these issues, for example by introducing the profit split method in the Eighth Schedule, but more improvements are needed in the longer term and would need to be implemented outside the scope of the income tax bill.

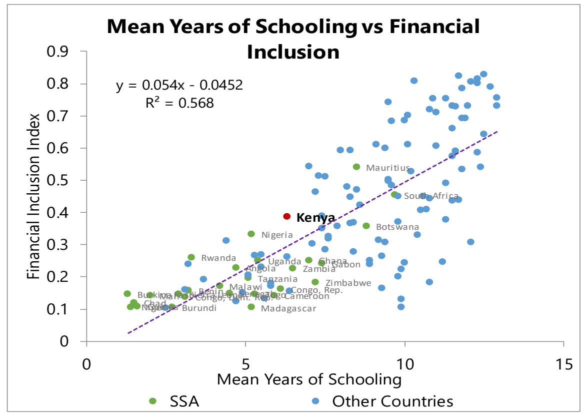
[1] See selected issues paper for additional detail.

Figure 1. Kenya: Financial Inclusion and Socio-Economic Conditions

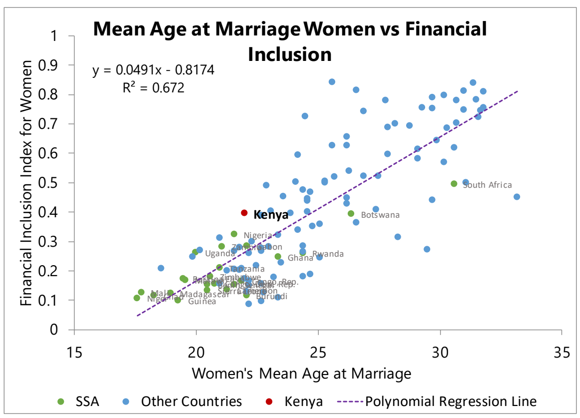
Kenya's level of financial inclusion is high relative to peers with similar per capita income,



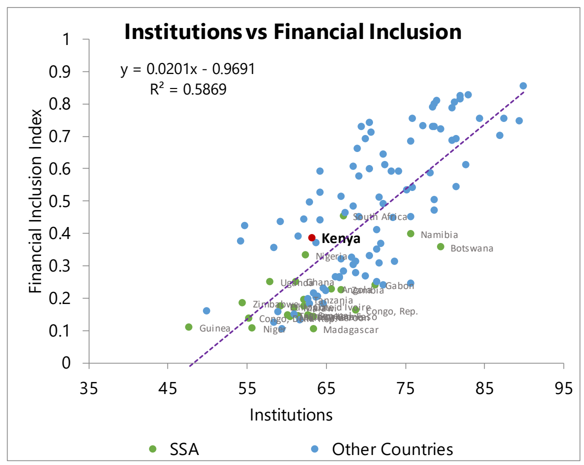
… relative to peers with similar level of education,



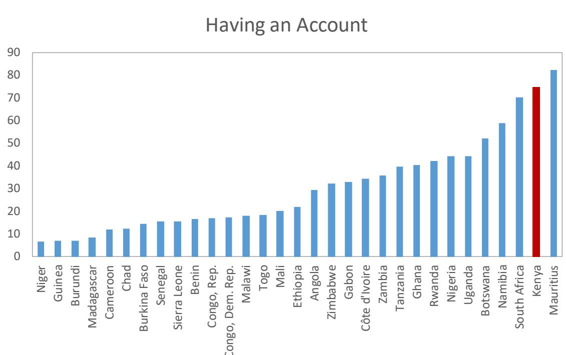
… relative to peers with similar mean age of women at marriage,



… and relative to peers with similar level of governance.



Kenya's financial inclusion is high in terms of not only access…



but also in terms of types of financial services.

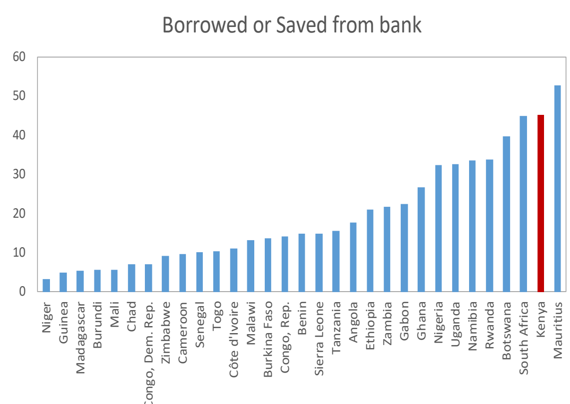
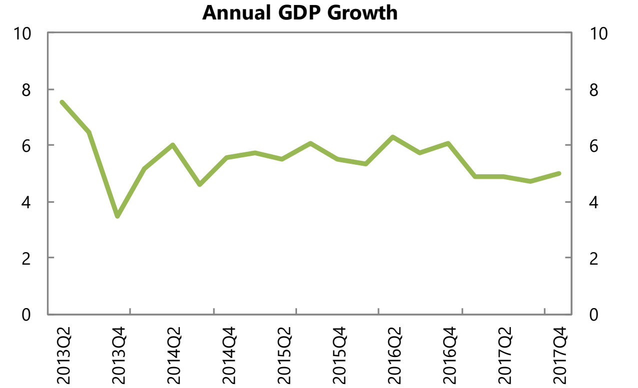
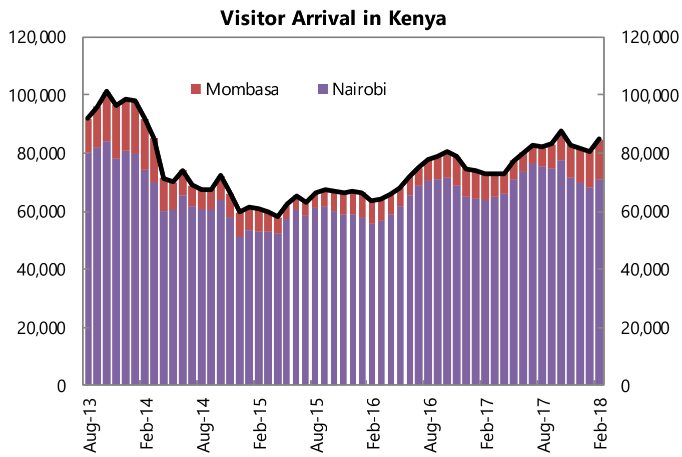


Figure 2. Kenya: Real Sector, 2013–17

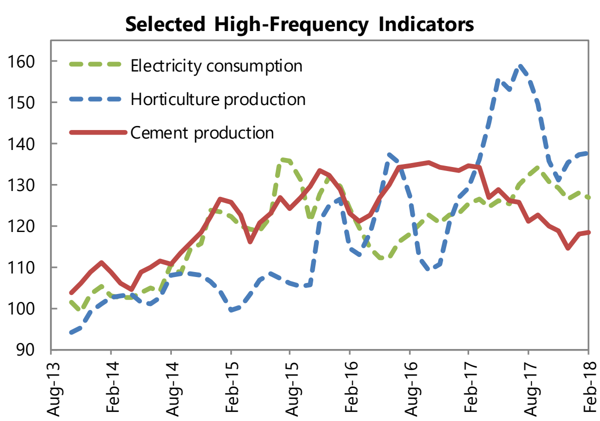
Growth has remained robust despite deceleration in 2017…



…with visitor arrivals recovering in late 2017…



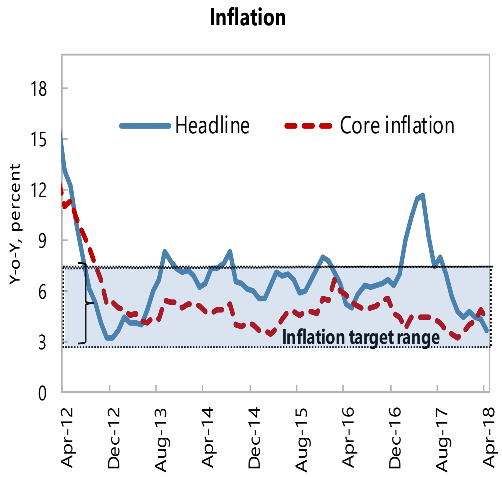
…and mixed signals from high-frequency indicators.



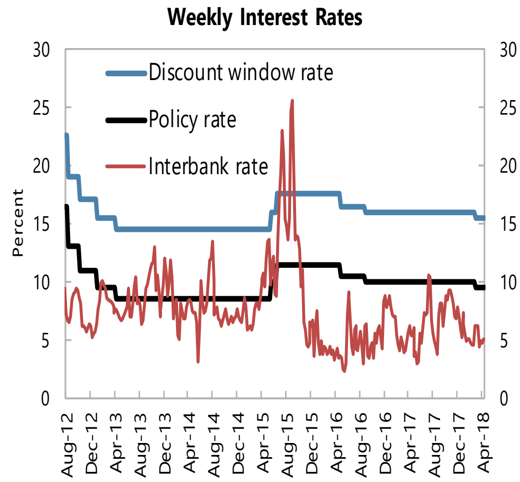
Sources: Kenyan authorities; and IMF staff calculations.

Figure 3. Kenya: Monetary Sector, 2012–18

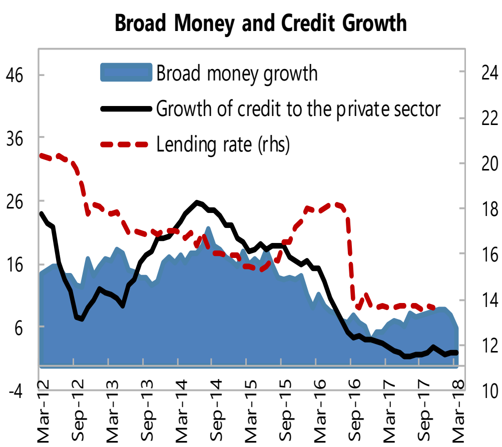
Inflation breached the target band in H1 2017, but fell within the band in July.



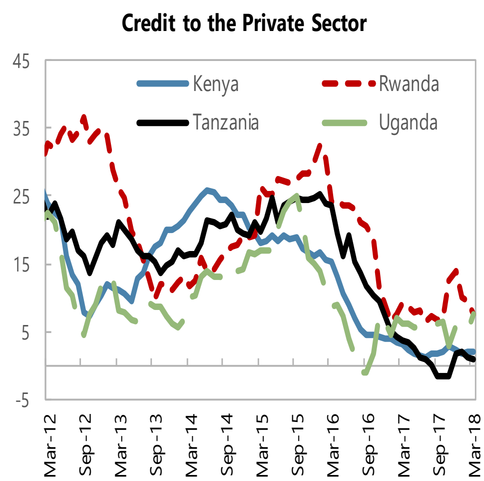
Money market rate deviations from the policy rate persist.



Credit growth has slowed significantly...

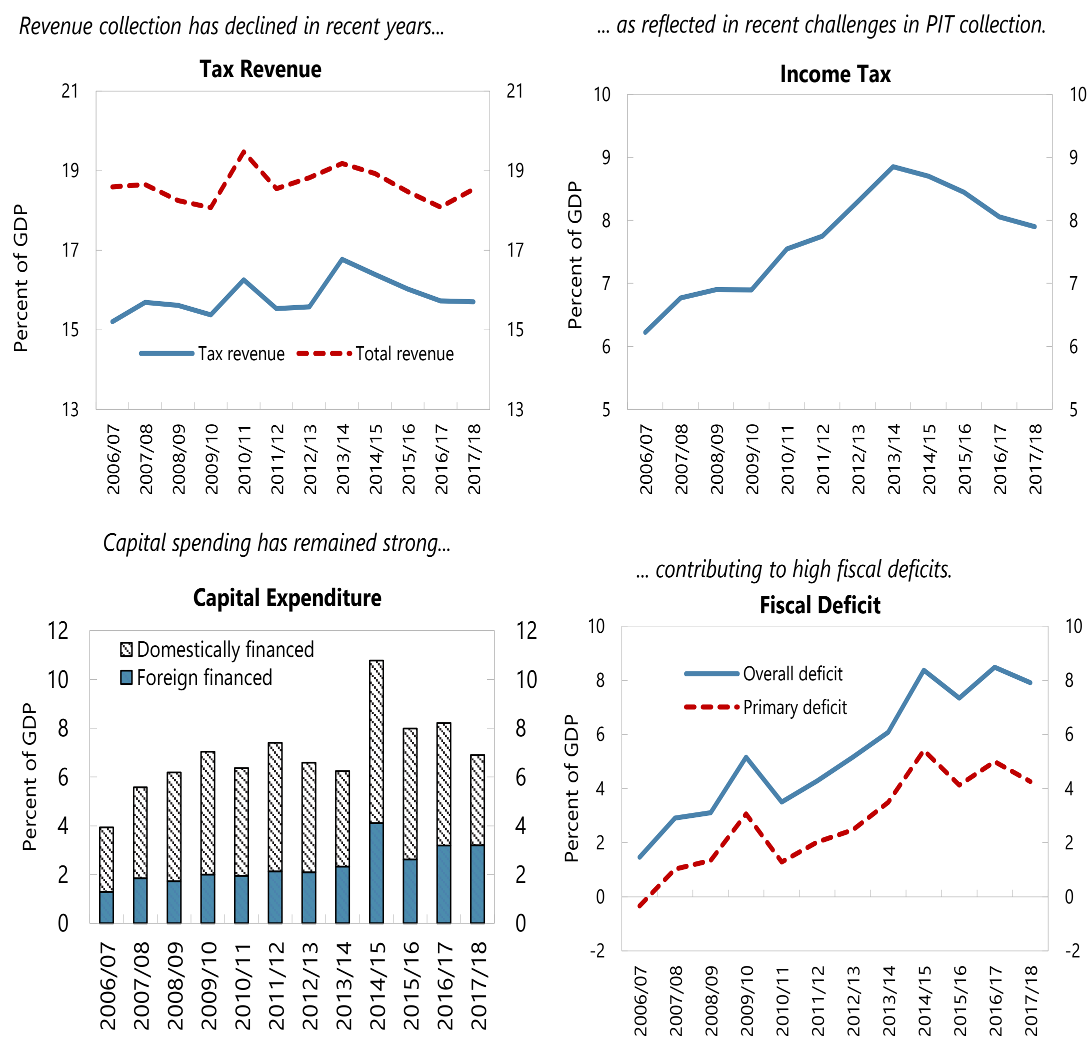


... in line with developments in other EAC countries.



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

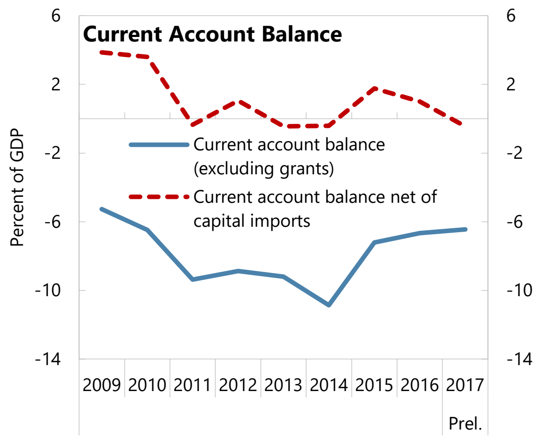
Figure 4. Kenya: Fiscal operations, 2006/07–16/17



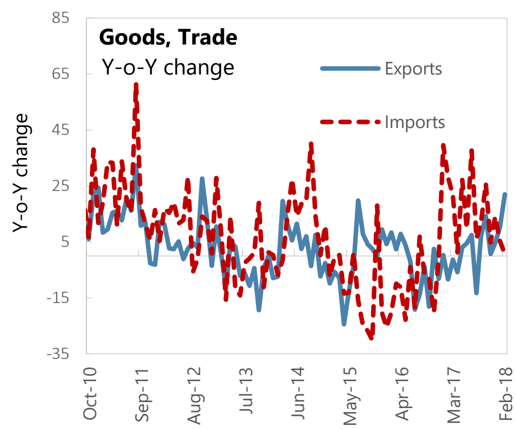
Source: Kenyan authorities; and IMF staff calculations.

Figure 5. Kenya: External Sector, 2009–17

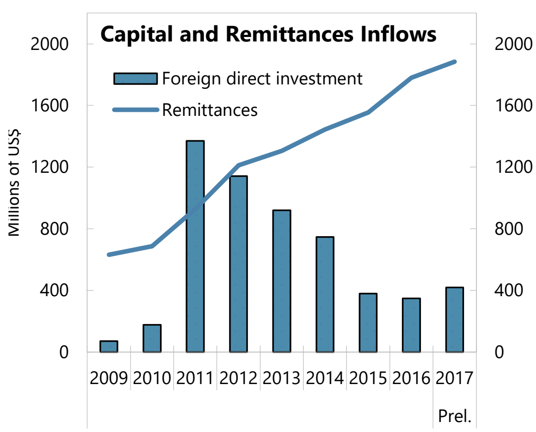
The current account balance has improved...



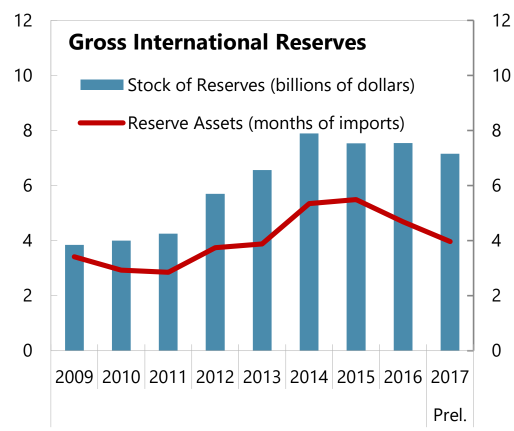
...despite a jump in imports in 2017.



Remittances remain strong but FDI has fallen.

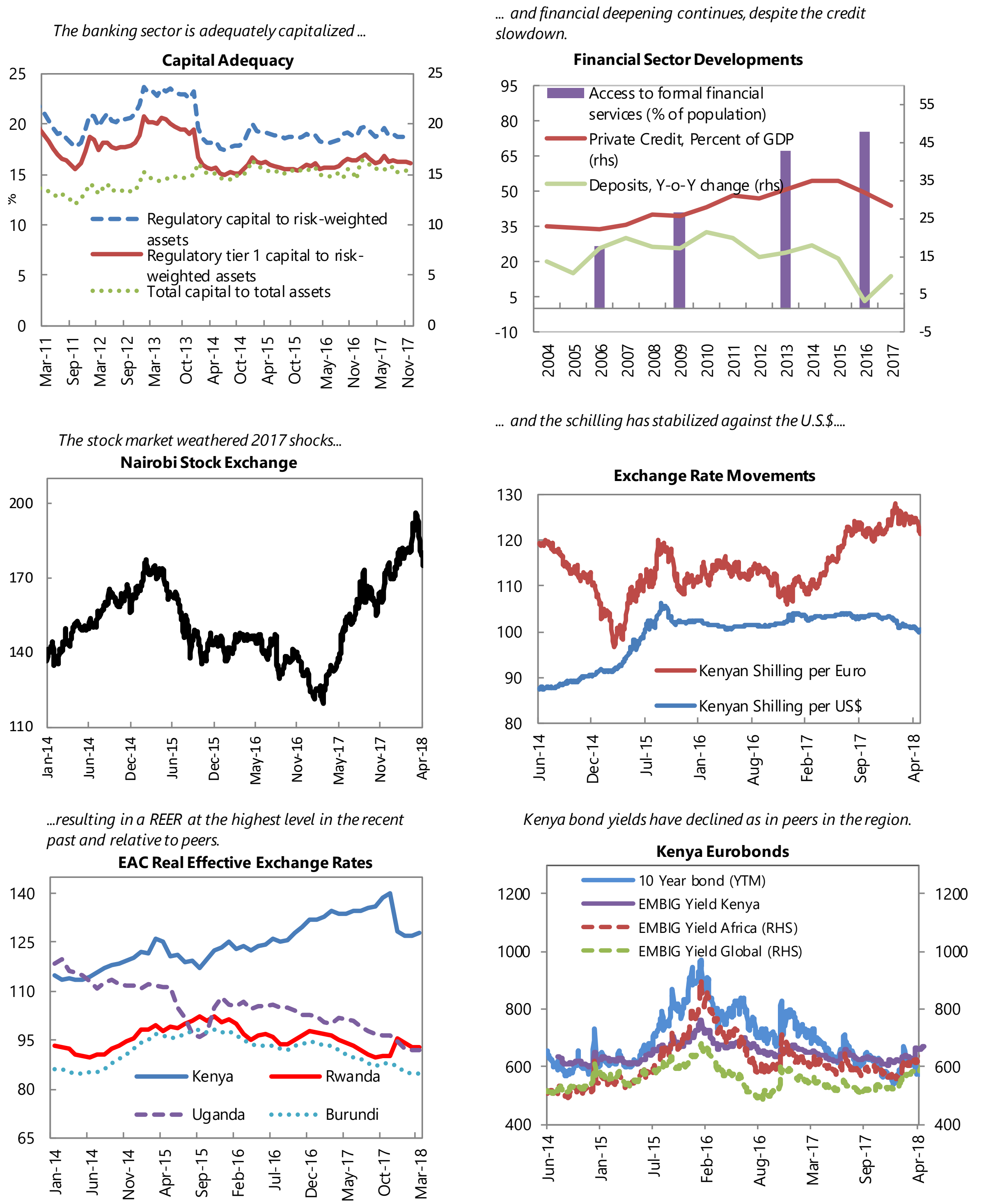


International reserves remain adequate.



Sources: Kenyan authorities; and IMF staff calculations.

Figure 6. Kenya: Financial Sector, 2014–17



Sources: Kenyan authorities; Bloomberg; and IMF staff calculations.

Table 1a. Kenya: Selected Economic Indicators, 2014/15–2021/22[1]

	2014/15	2015/16	2016/17		2017/18	2018/19	2019/20	2020/21	2021/22
	Act.	Act.	Prog.	Prel.	Proj.				
	(Annual percentage change, unless otherwise indicated)								
Output, prices, and exchange rate									
Real GDP	5.5	5.8	5.6	5.4	5.3	5.9	6.1	6.3	6.5
GDP deflator	9.1	9.0	5.9	5.2	5.1	4.7	4.4	5.2	5.1
CPI (period average)	6.6	6.5	6.4	8.1	5.2	5.5	5.0	5.0	5.0
CPI (end of period)	7.0	5.8	6.5	9.2	5.2	5.4	5.0	5.0	5.0
Core inflation (period average) [2]	4.4	5.4	5.0	4.0	3.9	4.8	4.8	5.2	5.5
Exports volume	6.0	1.7	7.4	3.4	12.8	12.5	9.2	8.6	8.1
Imports volume	3.2	-1.3	4.1	3.4	6.4	6.2	9.4	9.6	8.9
Exchange rate (Kenyan shilling/US$)	92.7	102.1	.	.	.	.	.	.	.
Real effective exchange rate (depreciation, -)	6.0	1.5	.	.	.	.	.	.	.
Money and credit									
Broad money (M3)	18.4	8.1	10.5	6.0	.	.	.	.	.
Reserve money	14.9	4.9	10.8	2.4	.	.	.	.	.
Credit to non-government sector	18.3	8.9	6.0	1.5	.	.	.	.	.
Policy rate	10.0	10.5	.	.	.	.	.	.	.
M3/GDP (percent)	43.8	41.1	40.9	38.9	.	.	.	.	.
NPLs (percent of total gross loans)	5.7	n.a.		.	.	.	.	.	.
	(Percent of GDP, unless otherwise indicated)								
Central government budget									
Total revenue and grants	19.4	18.8	21.0	18.9	19.9	20.8	20.8	20.8	20.7
Tax revenues	16.4	15.9	17.0	16.1	16.0	17.2	17.3	17.4	17.5
Non-tax revenues	2.5	2.4	3.4	2.4	3.4	3.1	3.0	2.9	2.7
Grants	0.5	0.4	0.5	0.3	0.5	0.5	0.5	0.5	0.5
Expenditure	28.0	26.5	27.9	27.9	28.0	27.4	26.2	25.9	25.2
Current	19.3	19.3	19.9	19.5	21.4	20.8	19.7	19.3	19.0
Capital	8.7	7.2	8.0	8.4	6.6	6.6	6.5	6.6	6.2
Unidentified measures	0.0	0.0	0.0	0.0	0.6	0.9	1.4	1.6	1.1
Primary balance	-5.4	-4.1	-3.8	-5.6	-3.2	-0.5	1.5	2.1	1.3
Overall balance	-8.4	-7.3	-6.9	-9.2	-7.5	-5.7	-4.0	-3.5	-3.5
Excluding SGR (phase 1) related spending	-6.3	-6.5	-6.0	-7.8	-6.7	-5.2	-3.6	-2.9	-3.5
Excluding grants	-8.8	-7.7	-7.5	-9.6	-8.0	-6.2	-4.5	-4.0	-4.0
Net domestic borrowing	4.3	3.3	4.3	4.1	4.1	1.8	3.8	3.9	3.5
Public debt [3]									
Public gross nominal debt	47.9	52.9	52.5	58.3	60.7	60.2	57.7	57.2	54.5
Public net nominal debt	43.7	47.0	49.4	52.6	55.5	56.1	55.8	55.3	52.6
of which : external public debt	23.6	26.0	26.1	30.4	31.2	32.5	30.6	28.5	25.6
Public gross debt, PV	43.5	45.5	48.8	53.0	58.0	60.2	58.4	55.6	53.7
Public net debt, PV	39.4	39.6	45.7	47.2	52.8	56.1	56.4	53.6	51.8
Gross domestic debt	24.3	27.0	26.4	28.0	29.5	27.8	27.1	28.7	28.9
Investment and saving									
Investment	19.9	24.3	20.9	17.4	17.0	18.5	19.5	20.3	20.2
General government	8.7	7.2	9.6	8.5	6.7	6.6	6.5	6.4	6.2
Nongovernment	11.2	17.1	11.3	8.9	10.3	11.8	13.1	13.8	14.1
Saving	10.0	20.0	15.4	12.0	10.3	12.0	13.4	14.1	14.0
General government	-0.4	-0.8	2.1	-0.8	-1.3	0.5	2.0	2.6	2.3
Nongovernment	10.4	20.8	13.3	12.8	11.6	11.5	11.4	11.5	11.7
External sector									
Exports (goods and services)	17.0	15.9	17.1	15.2	16.1	16.7	17.1	17.4	17.4
Imports (goods and services)	-31.3	-24.0	-25.6	-24.1	-25.9	-25.9	-26.0	-26.4	-26.5
Current account balance (including grants)	-9.9	-4.3	-5.5	-5.5	-6.7	-6.4	-6.2	-6.2	-6.3
Gross international reserves									
In billions of US$	7.2	8.3	8.9	8.6	8.9	9.1	9.9	10.5	11.4
In months of next year imports	5.3	5.7	5.3	5.0	4.7	4.5	4.4	4.3	4.3
Memorandum items:									
GDP at current market prices									
Billion of Kenyan shillings	5,849	6,734	7,435	7,556	8,305	9,260	10,255	11,249	12,827
US$ billion	62.7	67.4	72.0	73.0	79.2	86.8	93.8	101.6	110.7
GDP per capita (nominal US$)	1,439	1,504	1,562	1,583	1,671	1,782	1,875	1,976	2,096

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, 2015–22

	2015	2016	2017		2018	2019	2020	2021	2022
	Act.	Act.	Prog.	Prel.			Proj.		
	(Annual percentage change, unless otherwise indicated)								
Output, prices, and exchange rate									
Real GDP	5.7	5.9	5.3	4.9	5.7	6.0	6.2	6.5	6.5
GDP deflator	10.0	8.1	5.8	2.7	5.3	5.8	5.3	5.1	5.1
CPI (period average)	6.6	6.3	6.3	8.0	5.0	5.3	5.0	5.0	5.0
CPI (end of period)	8.0	6.3	5.9	4.5	5.5	5.1	5.0	5.0	5.0
Core inflation (period average) [1]	4.4	5.4	5.0	4.0	3.9	4.8	4.8	5.2	5.5
Exports volume	-6.8	2.0	7.8	7.8	17.6	12.0	10.6	9.4	9.6
Imports volume	0.0	-2.6	4.9	9.6	3.5	8.9	9.8	9.4	8.4
Exchange rate (Kenyan shilling/US$)	98.2	101.5	.	103.2	.	.	.	.	.
Real effective exchange rate (depreciation, -)	4.5	3.9	.	.	.	.	.	.	.
Money and credit									
Broad money (M3)	14.1	3.7	14.7	9.5	8.5	27.7	20.1	18.8	16.3
Reserve money	3.4	4.8	12.9	6.7	5.5	26.3	18.9	17.3	14.9
Credit to non-government sector	16.0	4.1	6.7	2.4	12.6	17.9	19.8	19.8	20.1
Policy rate	11.5	10	.	10	.	.	.	.	.
M3/GDP (percent)	42.4	38.4	40.9	39.1	38.1	43.4	46.6	49.4	51.4
NPLs (percent of total gross loans)	6.8	9.1	.	10.6	.	.	.		
	(Percent of GDP, unless otherwise indicated)								
Central government budget									
Total revenue and grants	19.1	18.7	21.1	19.9	20.7	21.0	20.7	20.7	20.7
Tax revenues	16.2	15.9	17.2	16.4	16.9	17.4	17.3	17.4	17.5
Non-tax revenues	2.5	2.4	3.3	3.0	3.3	3.0	2.9	2.8	2.7
Grants	0.5	0.4	0.6	0.4	0.5	0.5	0.5	0.5	0.5
Expenditure	27.2	27.0	27.6	28.6	28.2	27.0	25.9	25.6	25.2
Current	19.3	19.2	19.9	20.9	21.4	20.4	19.4	19.3	19.0
Capital	7.9	7.8	7.7	7.7	6.7	6.6	6.5	6.4	6.2
Unidentified measures	0.0	0.0	0.1	0.7	0.8	0.9	1.4	1.4	1.1
Primary balance	-4.7	-4.9	-3.2	-4.8	-2.6	-0.6	0.3	0.5	0.2
Excluding SGR (phase 1) related spending	-3.4	-3.8	-2.7	-3.7	-2.0	-0.2	0.7	0.6	0.4
Overall balance	-8.1	-8.3	-6.4	-8.7	-7.4	-6.0	-5.2	-3.5	-3.5
Excluding grants	-8.6	-8.7	-7.0	-9.2	-7.9	-6.5	-5.7	-4.0	-4.0
Net domestic borrowing	3.7	3.7	3.7	4.2	2.9	2.9	3.8	3.7	3.5
Public debt [2]									
Public gross nominal debt	51.4	53.2	54.7	58.0	63.2	62.9	60.0	57.5	56.3
Public net nominal debt	46.3	47.9	52.1	52.4	58.5	59.9	58.1	55.6	54.4
of which : external public debt	25.7	26.4	28.3	28.5	34.1	35.2	32.3	28.8	27.5
Public gross debt, PV	40.4	50.6	49.0	55.4	60.6	59.9	56.9	54.3	53.1
Public net debt, PV	35.3	45.3	46.4	49.8	55.8	56.9	54.9	52.4	51.2
Gross domestic debt	25.7	26.8	26.4	29.5	29.1	27.6	27.8	28.7	28.8
Investment and saving									
Investment	16.7	16.1	19.9	17.2	17.8	19.1	20.0	20.3	20.2
General government	7.9	7.8	9.5	7.7	6.7	6.6	6.5	6.3	6.1
Nongovernment	8.8	8.3	10.4	9.5	11.1	12.6	13.6	14.1	14.1
Saving	10.0	11.0	14.2	10.3	11.1	12.8	14.0	14.1	13.9
General government	-0.6	-0.8	2.3	-1.1	-0.4	1.3	2.3	2.4	2.3
Nongovernment	10.6	11.8	11.8	11.4	11.5	11.5	11.7	11.6	11.7
External sector									
Exports (goods and services)	16.6	14.5	16.4	15.7	16.5	16.9	17.3	17.4	17.4
Imports (goods and services)	-27.7	-23.2	-24.5	-25.8	-25.9	-25.9	-26.2	-26.5	-26.5
Current account balance (including grants)	-6.7	-5.2	-5.7	-6.8	-6.6	-6.3	-6.1	-6.3	-6.3
Gross international reserves									
In billions of US$	7.5	7.5	8.5	7.1	8.0	9.2	10.2	11.0	11.8
In months of next year imports	5.5	4.7	4.8	4.0	4.1	4.3	4.4	4.3	4.3
Memorandum items:									
GDP at current market prices									
Billions of Kenyan shillings	6,284	7,194	7,784	7,749	8,631	9,678	10,823	12,108	13,546
US$ billion	64.0	70.9	75.1	75.1	83.3	90.3	97.4	105.9	115.6
GDP per capita (nominal US$)	1,448	1,559	1,607	1,606	1,735	1,829	1,920	2,032	2,160

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, 2016/17—2020/21[1]

(Billions of Kenyan Schilling)

	2016/17	2017/18		2018/19			2019/20	2020/21
	Prel.	Supp II	Proj.	Supp II	Draft Budget	Proj.	Proj.	
Revenues and grants	1,426.9	1,702.6	1,655.3	1,959.3	1,970.4	1,924.4	2,133.6	2,336.6
Revenue	1,400.6	1,659.6	1,612.3	1,908.8	1,923.3	1,877.4	2,080.8	2,281.6
Tax revenue	1,219.5	1,370.1	1,327.5	1,639.1	1,639.1	1,593.1	1,778.0	1,958.6
Income tax	625.1	709.3	673.8	836.6	836.6	798.7	888.9	979.9
Personal income	334.9	379.9	365.4	447.6	447.6	412.1	461.5	506.2
Corporate income	290.1	329.4	308.3	388.9	388.9	386.6	427.5	473.8
Import duty (net)	89.9	103.4	99.7	119.4	119.4	112.8	127.6	145.9
Excise duty	165.5	179.4	179.4	219.0	219.0	210.0	233.8	251.0
Value-added tax	339.0	378.0	374.6	464.2	464.2	471.6	527.7	581.8
Domestic	192.9	218.6	214.6	257.3	257.3	251.6	280.0	308.7
Imports	125.9	159.4	159.9	206.9	206.9	220.1	247.7	273.1
Nontax revenue	181.1	289.5	284.8	269.8	284.2	284.2	302.8	322.9
Investment income	28.5	31.6	31.6	24.6	24.6	24.6	27.4	30.3
Other	57.8	88.0	83.3	79.7	79.7	79.7	88.7	97.8
Ministerial and Departmental Fees (AIA)	75.9	148.8	148.8	140.7	155.2	155.2	161.1	166.4
Railway Levy	18.9	21.2	21.2	24.7	24.7	24.7	25.6	28.4
Grants	26.3	43.0	43.0	50.5	47.0	47.0	52.7	55.0
Project grants	19.1	36.9	36.9	44.4	40.0	40.0	46.6	48.9
Program grants	6.8	6.1	6.1	6.1	7.1	7.1	6.1	6.1
AMISON	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure and net lending	2,110.0	2,330.0	2,327.5	2,520.9	2,533.1	2,533.1	2,687.6	2,915.8
Recurrent expenditure	1,470.1	1,773.6	1,774.0	1,908.0	1,923.0	1,923.0	2,023.9	2,175.0
Transfer to counties	305.0	331.7	331.7	372.7	374.6	374.6	372.2	381.9
Interest payments	271.2	305.1	305.1	399.6	400.0	400.0	423.3	450.7
Domestic interest	212.9	215.2	215.2	286.9	285.6	285.6	288.4	315.0
Foreign interest due	58.4	89.8	89.8	112.7	114.4	114.4	134.9	135.8
Wages and benefits (civil service)	336.6	392.8	392.8	444.2	444.2	444.2	484.4	524.6
Civil service reform	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Pensions and Other Consolidated Fund Services	64.0	76.2	76.2	106.4	105.9	105.9	133.5	149.9
Defense and NSIS	130.2	138.8	138.8	125.5	126.8	126.8	126.5	138.3
Other	363.0	529.1	529.4	454.6	466.5	466.5	479.0	524.6
Development and net lending	639.9	556.3	553.6	612.9	610.2	610.2	663.7	740.8
Domestically financed	385.1	317.5	313.2	353.7	355.9	355.9	375.2	425.1
Foreign financed	246.4	236.4	237.9	252.2	247.2	247.2	281.1	306.7
of which: SGR project	111.4	58.0	69.0	50.0	50.0	50.0	68.3	136.5
Net lending	2.4	2.4	2.4	2.4	2.4	2.4	1.6	2.5
Overall Balance (incl. grants)	-683.1	-627.4	-672.3	-561.6	-562.7	-608.7	-554.0	-579.2
Adjustments to cash basis	-14.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Unidentified measures (deficit reducing)	0.0	0.0	49.3	0.0	0.0	80.9	140.3	183.1
Overall balance including measures (cash basis, incl. grants)	-697.3	-627.4	-622.9	-561.6	-562.7	-527.8	-413.7	-396.1
Statistical discrepency	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.0
Financing	697.3	627.4	622.9	561.6	562.7	527.8	413.7	396.1
Net foreign financing	385.7	354.6	281.5	281.2	282.5	360.1	9.1	12.9
Disbursements	421.7	504.9	506.4	531.5	532.8	532.8	365.5	316.8
Project loans	117.2	140.2	140.2	181.9	181.3	181.3	187.9	218.9
Program loans	6.8	7.0	7.0	2.5	2.5	2.5	1.5	1.5
Commercial borrowing [2]	186.3	290.2	290.2	297.1	298.9	298.9	107.8	28.1
Standard Gauge Railway	111.4	67.5	69.0	50.0	50.0	50.0	68.3	136.5
Phase 1	111.4	58.0	59.5	0.0	0.0	0.0	0.0	0.0
Phase 2	0.0	9.5	9.5	50.0	50.0	50.0	68.3	136.5
Repayments due	-35.9	-150.3	-224.9	-250.3	-250.3	-172.7	-356.3	-303.9
Net domestic financing	311.5	272.8	341.4	280.4	280.3	167.7	404.6	383.2
Memorandum items:								
Nominal GDP	7,556.0	8,553.9	8,305.5	9,790.8	9,726.6	9,259.7	10,254.7	11,248.6
Primary balance incl. grants	-426.0	-322.3	-317.8	-162.0	-162.8	-127.8	9.6	54.7
Total gross public debt, gross	4,407.0	…	5,042.3	…	…	5,578.0	5,918.6	6,437.5
of which: external debt 3	2,294.7	…	2,588.7	…	…	3,006.6	3,139.7	3,206.1
of which: domestic debt	2,112.3	…	2,453.7	…	…	2,571.4	2,778.9	3,231.5
Total net public debt [4]	3,972.5	…	4,607.9	…	…	5,193.5	5,718.0	6,220.1

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, 2016/17–2020/21[1]

	2016/17		2017/18		2018/19			2019/20	2020/21
	Prog.	Prel.	Supp II	Proj.	Supp II	Draft Budget	Proj.	Proj.	
	(in percent of GDP, unless otherwise indicated)								
Revenues and grants	21.0	18.9	20.5	19.9	21.2	21.3	20.8	20.8	20.8
Revenue	20.4	18.5	20.0	19.4	20.6	20.8	20.3	20.3	20.3
Tax revenue	17.0	16.1	16.5	16.0	17.7	17.7	17.2	17.3	17.4
Income tax	8.9	8.3	8.5	8.1	9.0	9.0	8.6	8.7	8.7
Personal income	4.9	4.4	4.6	4.4	4.8	4.8	4.5	4.5	4.5
Corporate income	4.0	3.8	4.0	3.7	4.2	4.2	4.2	4.2	4.2
Import duty (net)	1.2	1.2	1.2	1.2	1.3	1.3	1.2	1.2	1.3
Excise duty	2.4	2.2	2.2	2.2	2.4	2.4	2.3	2.3	2.2
Value-added tax	4.6	4.5	4.6	4.5	5.0	5.0	5.1	5.1	5.2
Nontax revenue	3.4	2.4	3.5	3.4	2.9	3.1	3.1	3.0	2.9
Investment income	0.4	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3
Other	1.0	0.8	1.1	1.0	0.9	0.9	0.9	0.9	0.9
Grants	0.5	0.3	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Expenditure and net lending	27.9	27.9	28.1	28.0	27.2	27.4	27.4	26.2	25.9
Recurrent expenditure	19.7	19.5	21.4	21.4	20.6	20.8	20.8	19.7	19.3
Transfer to counties	3.8	4.0	4.0	4.0	4.0	4.0	4.0	3.6	3.4
Interest payments	3.1	3.6	3.7	3.7	4.3	4.3	4.3	4.1	4.0
Domestic interest	2.3	2.8	2.6	2.6	3.1	3.1	3.1	2.8	2.8
Foreign interest due	0.8	0.8	1.1	1.1	1.2	1.2	1.2	1.3	1.2
Wages and benefits (civil service)	4.6	4.5	4.7	4.7	4.8	4.8	4.8	4.7	4.7
Pensions and Other Consolidated Fund Services	0.8	0.8	0.9	0.9	1.1	1.1	1.1	1.3	1.3
Defense and NSIS	1.7	1.7	1.7	1.7	1.4	1.4	1.4	1.2	1.2
Other	5.6	4.8	6.4	6.4	4.9	5.0	5.0	4.7	4.7
Development and net lending	8.0	8.5	6.7	6.7	6.6	6.6	6.6	6.5	6.6
Domestically financed	5.4	5.1	3.8	3.8	3.8	3.8	3.8	3.7	3.8
Foreign financed	2.6	3.3	2.8	2.9	2.7	2.7	2.7	2.7	2.7
of which: SGR project	1.0	1.5	0.7	0.8	0.5	0.5	0.5	0.7	1.2
Overall Balance (incl. grants)	-6.9	-9.0	-7.6	-8.1	-6.1	-6.1	-6.6	-5.4	-5.1
Adjustments to cash basis	0.0	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance (cash basis, incl. grants)	-6.9	-9.2	0.0	-8.1	-6.1	-6.1	-6.6	-5.4	-5.1
Unidentified measures (deficit reducing)	0.0	0.0	0.0	0.6	0.0	0.0	0.9	1.4	1.6
Overall balance incl. measures and grants (cash basis)	-6.9	-9.2	-7.6	-7.5	-6.1	-6.1	-5.7	-4.0	-3.5
Statistical discrepency	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	6.9	9.2	7.6	7.5	6.1	6.1	5.7	4.0	3.5
Net foreign financing	2.6	5.1	4.3	3.4	3.0	3.1	3.9	0.1	0.1
Disbursements	4.3	5.6	6.1	6.1	5.7	5.8	5.8	3.6	2.8
Project loans	1.2	1.6	1.7	1.7	2.0	2.0	2.0	1.8	1.9
Program loans	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Commercial borrowing [2]	2.1	2.5	3.5	3.5	3.2	3.2	3.2	1.1	0.3
Standard Gauge Railway	1.0	1.5	0.8	0.8	0.5	0.5	0.5	0.7	1.2
Phase 1	1.0	1.5	0.7	0.7	0.0	0.0	0.0	0.0	0.0
Phase 2	0.0	0.0	0.1	0.1	0.5	0.5	0.5	0.7	1.2
Repayments due	-1.7	-0.5	-1.8	-2.7	-2.7	-2.7	-1.9	-3.5	-2.7
Net domestic financing	4.3	4.1	3.3	4.1	3.0	3.0	1.8	3.9	3.4
Memorandum items:									
Primary balance incl. grants (Central government)	-3.8	-5.6	-3.9	-3.8	-1.7	-1.8	-1.4	0.1	0.5
Total gross public debt, gross	52.5	58.3	…	60.7	…	…	60.2	57.7	57.2
of which: external debt [3]	26.1	30.4	…	31.2	…	…	32.5	30.6	28.5
of which: domestic debt	26.4	28.0	…	29.5	…	…	27.8	27.1	28.7
Total gross public debt, PV	48.8	53.0	…	58.0	…	…	60.2	58.4	55.6
Total net public debt [4]	n.a.	52.6	…	55.5	…	…	56.1	55.8	55.3

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, December 2015 – December 2018

	Dec-15	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
	Act.	Act.	Act	Act	Act	Act	Proj.	Proj.	Proj.	Proj.
	(In billions of Kenyan shillings, unless otherwise indicated)									
Central Bank of Kenya (CBK)										
Net foreign assets	621	622	698	738	695	627	803	759	724	687
(in millions of US dollars) [1 2]	6,073	6,065	6,775	7,119	6,728	6,075	7,674	8,177	7,723	7,330
Net domestic assets	-229	-210	-283	-339	-270	-188	-385	-319	-252	-224
Net domestic credit	-65	-67	-132	-152	-101	-35	-220	-165	-86	-54
Government (net)	-44	-114	-117	-179	-168	-67	-257	-144	-144	-144
Commercial banks (net)	-22	43	-18	24	63	28	33	-24	55	87
Other items (net)	-164	-143	-151	-187	-169	-153	-165	-153	-165	-169
Reserve money	392	411	415	400	425	439	418	441	473	463
Currency outside banks	191	209	201	207	209	225	214	181	194	190
Bank reserves	201	202	214	193	216	214	204	260	279	273
Banks										
Net foreign assets	-130	-126	-95	-94	-79	-92	-104	-105	-109	-113
(in millions of US dollars)	-1,270	-1,234	-921	-908	-766	-892	-995	-1,020	-1,045	-1,070
Reserves	201	202	214	193	216	214	204	260	279	273
Credit to CBK	22	-43	18	-24	-63	-28	-33	24	-55	-87
Net domestic assets	2,353	2,497	2,482	2,619	2,673	2,688	2,717	2,709	2,982	2,959
Net domestic credit	2,834	3,084	3,066	3,178	3,234	3,262	3,300	3,294	3,565	3,542
Government (net)	569	707	701	825	842	824	882	826	875	940
Other public sector	82	105	106	107	114	111	113	113	113	113
Private sector	2,183	2,272	2,260	2,246	2,278	2,327	2,305	2,354	2,577	2,489
Other items (net)	-481	-587	-584	-559	-561	-574	-583	-585	-583	-583
Total deposits	2,446	2,529	2,620	2,694	2,746	2,781	2,783	2,888	3,097	3,033
Monetary survey										
Net foreign assets	491	495	603	644	616	535	699	654	615	574
(in millions of US dollars)	4,804	4,832	5,854	6,211	5,962	5,183	6,679	6,339	5,872	5,457
Net domestic assets	2,175	2,269	2,244	2,292	2,375	2,493	2,316	2,475	2,740	2,712
Net domestic credit	2,794	2,973	2,953	3,002	3,070	3,198	3,046	3,195	3,470	3,445
Government (net)	525	593	583	646	674	757	625	546	616	708
Other public sector	82	105	106	107	114	111	113	113	113	113
Private	2,186	2,276	2,263	2,249	2,282	2,330	2,309	2,536	2,741	2,624
Other items (net)	-619	-704	-709	-710	-695	-705	-730	-720	-729	-732
M1	1,023	1,310	1,317	1,391	1,383	1,397	1,373	1,436	1,467	1,492
Money and quasi-money (M2)	2,253	2,360	2,412	2,481	2,515	2,538	2,547	2,665	2,721	2,769
M2 plus resident foreign currency deposits (M3)	2,667	2,765	2,847	2,936	2,990	3,028	3,016	3,129	3,355	3,286
M3 plus nonbank holdings of government debt (L)	3,399	3,709	3,817	3,935	4,016	4,101	4,139	4,295	4,605	4,511
Memorandum items										
(growth in percent yoy, excluding multipliers and velocity)										
M2	12.8	4.8	5.7	5.4	7.5	7.5	5.6	7.4	8.2	9.1
M3	14.1	3.7	6.4	6.0	7.8	9.5	5.9	6.6	12.2	8.5
Deposits	14.5	3.4	6.1	5.4	7.5	10.0	6.2	7.2	12.8	9.1
Reserve money	3.4	4.8	3.2	2.4	8.1	6.7	0.8	10.3	11.3	5.5
Net domestic credit	20.8	6.4	4.6	5.2	7.4	7.6	3.2	6.4	13.0	7.7
Government (net)	38.4	12.9	7.1	15.3	28.4	27.7	7.1	-15.5	-8.7	-6.5
Private	16.0	4.1	3.0	1.5	1.7	2.4	2.0	12.8	20.1	12.6
Net domestic assets of the banking sector	17.2	4.3	1.8	3.9	8.9	9.9	3.2	8.0	15.4	8.8
NDA growth (as percent of the base period M3)	10.8	2.8	1.2	2.4	5.3	6.0	1.9	4.6	9.1	5.3
Multiplier (Average M2/RM)	5.8	5.8	5.9	5.9	5.9	5.9	6.0	6.0	5.9	6.0
Multiplier (Average M3/RM)	6.9	6.9	6.9	7.0	7.0	7.0	7.1	7.1	7.1	7.1
Velocity (GDP/M2)	2.9	3.1	3.1	3.2	3.1	3.1	3.1	3.1	3.1	3.1
Velocity (GDP/M3)	2.5	2.6	2.7	2.7	2.7	2.6	2.7	2.7	2.5	2.6
Nominal GDP	16.3	14.5	15.7	12.2	9.1	7.7	7.8	9.9	10.5	11.4

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, 2015–21

(Millions of U.S. dollars, unless otherwise indicated)

	2015	2016	2017	2018	2019	2020	2021
	Act.	Prel.	Est.		Proj.		
Current account	-4,299	-3,653	-5,124	-5,541	-5,696	-5,905	-6,639
Trade balance	-8,395	-7,890	-9,612	-10,529	-10,959	-11,771	-12,854
Goods: exports, f.o.b.	5,997	5,747	6,615	7,726	8,720	9,736	10,754
Coffee	212	213	214	242	298	355	388
Tea	1,247	1,226	1,639	1,847	2,073	2,294	2,508
Horticulture	760	910	1,009	1,183	1,311	1,447	1,582
Other	3,778	3,398	3,752	4,454	5,038	5,639	6,275
Goods: imports, f.o.b.	14,392	13,637	16,227	18,256	19,678	21,507	23,608
Oil products	2,500	2,087	2,699	3,487	3,516	3,633	3,859
Other	11,892	11,550	13,528	14,768	16,162	17,873	19,749
Capital imports	5,432	4,365	4,754	5,163	5,709	6,379	7,106
Services balance	1,321	1,691	2,045	2,626	2,834	3,054	3,186
Services, credit	4,649	4,528	5,160	5,989	6,498	7,075	7,682
Transportation	1,956	1,786	2,214	2,734	3,061	3,386	3,706
Travel	726	824	978	1,163	1,231	1,339	1,457
Services, debit	3,329	2,837	3,115	3,363	3,663	4,021	4,496
Transportation	1,434	947	1,127	1,268	1,435	1,646	1,898
Goods and services balance	-7,075	-6,199	-7,567	-7,903	-8,124	-8,718	-9,668
Primary income, balance	-686	-684	-896	-1,187	-1,362	-1,257	-1,338
Credit	493	433	480	445	641	823	772
Debit	1,179	1,117	1,376	1,632	2,003	2,080	2,111
Secondary income, balance	3,461	3,230	3,339	3,549	3,790	4,069	4,367
Credit	3,525	3,281	3,389	3,602	3,846	4,129	4,430
Remittances	1,573	1,745	1,875	2,020	2,177	2,342	2,518
Debit	63	51	50	53	56	60	63
Capital account	263	206	259	570	400	458	458
Financial account	-3,918	-4,250	-4,589	-5,982	-6,645	-6,559	-7,091
Foreign direct investment	-379	-348	-426	-576	-621	-671	-721
Direct investment, assets	243	158	156	101	109	139	135
Direct investment, liabilities	621	505	581	677	731	811	856
Portfolio investment	155	383	-445	-2,596	-176	-263	-237
Portfolio investment, assets	191	423	444	487	522	558	602
Portfolio investment, liabilities	36	40	889	3,083	698	820	840
Equity and investment fund shares	11	23	123	328	541	562	583
Debt securities	25	17	765	2,755	157	259	257
Financial derivatives	0	0	0	0	0	0	0
Other investment	-3,695	-4,285	-3,718	-2,810	-5,847	-5,625	-6,133
Other investment, assets	502	-193	101	137	15	85	79
Other investment, liabilities	4,197	4,093	3,820	2,947	5,863	5,710	6,212
Net errors and omissions	-242	-764	0	0	0	0	0
Overall balance	-360	39	-277	1,011	1,349	1,112	910
Reserves and related items	-296	106	-277	1,011	1,349	1,112	910
Reserve assets (gross)	-361	38	-396	867	1,194	976	783
Use of Fund credit and loans to the Fund (net)	-66	-67	-119	-144	-155	-136	-127
Disbursements	0	0	0	0	0	0	0
Repayments	66	67	119	144	155	136	127
Memorandum items:							
Gross official reserves (end of period)	7,534	7,546	7,150	8,017	9,211	10,188	10,970
(in months of next year's imports)	5.5	4.7	4.0	4.1	4.3	4.4	4.3
(in months of 3-year-rolling average imports) 1/	4.8	5.0	4.8	5.0	5.2	5.2	5.1
(in percent of M3)	28.3	27.3	23.6	24.4	21.9	20.2	18.3
WEO oil price (APSP; US$)	50.8	42.8	52.8	65.2	61.3	58.5	57.0
Terms of trade 2/	3.2	-1.8	-2.9	-6.9	1.5	1.1	0.4

Sources: Kenyan authorities and IMF staff estimates and projections.
1/ CBK definition of reserve cover: in months of imports of goods and services over the previous 36 months (annualized rolling average).
2/ Percentage change, goods and services.

Table 4b. Kenya: Balance of Payments, 2015–21
(Percent of GDP)

	2015	2016	2017	2018	2019	2020	2021
	Act.	Prel.	Est.		Proj.		
Current account	-6.7	-5.2	-6.8	-6.6	-6.3	-6.1	-6.3
Trade balance	-13.1	-11.1	-12.8	-12.6	-12.1	-12.1	-12.1
Goods: exports, f.o.b.	9.4	8.1	8.8	9.3	9.7	10.0	10.2
Coffee	0.3	0.3	0.3	0.3	0.3	0.4	0.4
Tea	1.9	1.7	2.2	2.2	2.3	2.4	2.4
Horticulture	1.2	1.3	1.3	1.4	1.5	1.5	1.5
Other	5.9	4.8	5.0	5.3	5.6	5.8	5.9
Goods: imports, f.o.b.	22.5	19.2	21.6	21.9	21.8	22.1	22.3
Oil products	3.9	2.9	3.6	4.2	3.9	3.7	3.6
Other	18.6	16.3	18.0	17.7	17.9	18.4	18.7
Capital imports	8.5	6.2	6.3	6.2	6.3	6.5	6.7
Services balance	2.1	2.4	2.7	3.2	3.1	3.1	3.0
Services, credit	7.3	6.4	6.9	7.2	7.2	7.3	7.3
Transportation	3.1	2.5	2.9	3.3	3.4	3.5	3.5
Travel	1.1	1.2	1.3	1.4	1.4	1.4	1.4
Services, debit	5.2	4.0	4.2	4.0	4.1	4.1	4.2
Transportation	2.2	1.3	1.5	1.5	1.6	1.7	1.8
Goods and services balance	-11.1	-8.7	-10.1	-9.5	-9.0	-9.0	-9.1
Primary income, balance	-1.1	-1.0	-1.2	-1.4	-1.5	-1.3	-1.3
Credit	0.8	0.6	0.6	0.5	0.7	0.8	0.7
Debit	1.8	1.6	1.8	2.0	2.2	2.1	2.0
Secondary income, balance	5.4	4.6	4.4	4.3	4.2	4.2	4.1
Credit	5.5	4.6	4.5	4.3	4.3	4.2	4.2
Remittances	2.5	2.5	2.5	2.4	2.4	2.4	2.4
Debit	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Capital account	0.4	0.3	0.3	0.7	0.4	0.5	0.4
Financial account	-6.1	-6.0	-6.1	-7.2	-7.4	-6.7	-6.7
Foreign direct investment	-0.6	-0.5	-0.6	-0.7	-0.7	-0.7	-0.7
Direct investment, assets	0.4	0.2	0.2	0.1	0.1	0.1	0.1
Direct investment, liabilities	1.0	0.7	0.8	0.8	0.8	0.8	0.8
Portfolio investment	0.2	0.5	-0.6	-3.1	-0.2	-0.3	-0.2
Portfolio investment, assets	0.3	0.6	0.6	0.6	0.6	0.6	0.6
Portfolio investment, liabilities	0.1	0.1	1.2	3.7	0.8	0.8	0.8
Equity and investment fund shares	0.0	0.0	0.2	0.4	0.6	0.6	0.6
Debt securities	0.0	0.0	1.0	3.3	0.2	0.3	0.2
Financial derivatives	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment	-5.8	-6.0	-5.0	-3.4	-6.5	-5.8	-5.8
Other investment, assets	0.8	-0.3	0.1	0.2	0.0	0.1	0.1
Other investment, liabilities	6.6	5.8	5.1	3.5	6.5	5.9	5.9
Net errors and omissions	-0.4	-1.1	0.0	0.0	0.0	0.0	0.0
Overall balance	-0.6	0.1	-0.4	1.2	1.5	1.1	0.9
Reserves and related items	-0.5	0.1	-0.4	1.2	1.5	1.1	0.9
Reserve assets (gross)	-0.6	0.1	-0.5	1.0	1.3	1.0	0.7
Use of Fund credit and loans to the Fund (net)	-0.1	-0.1	-0.2	-0.2	-0.2	-0.1	-0.1
Disbursements	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repayments	0.1	0.1	0.2	0.2	0.2	0.1	0.1
Memorandum items:							
Gross official reserves (end of period)	11.8	10.6	9.5	9.6	10.2	10.5	10.4
Exports of goods and nonfactor services	16.6	14.5	15.7	16.5	16.9	17.3	17.4
Imports of goods and nonfactor services	27.7	23.2	25.8	25.9	25.9	26.2	26.5

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	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17
					(Percent)						
Capital adequacy											
Regulatory capital to risk-weighted assets	20.8	19.4	21.9	23.2	19.2	18.8	18.7	19.4	19.6	18.8	18.5
Regulatory tier 1 capital to risk-weighted assets	18.7	17.3	18.9	19.4	15.9	15.7	16.3	16.6	16.8	16.2	16.0
Total capital to total assets	13.2	13.2	14.2	14.9	15.6	15.5	14.5	16.0	15.5	15.3	15.3
Asset quality											
Non-performing loans to total gross loans[1]	6.2	4.4	4.5	5.0	5.4	6.8	9.1	9.6	9.9	10.4	10.6
Bank provisions to NPLs	75.3	82.2	80.9	70.7	65.0	57.8	54.8	53.8	60.2	54.5	53.2
Non-performing loans net of provisions to capital	6.4	3.5	3.5	5.8	7.4	11.0	17.6	17.0	15.2	18.4	19.5
Earning assets to total assets	88.8	87.8	87.4	88.9	88.2	89.0	90.3	90.2	91.6	90.6	90.8
Earning and profitability											
Return on assets (ROA)	3.7	3.3	3.8	3.6	3.4	2.9	3.1	2.9	2.8	2.6	2.7
Return on equity (ROE)	30.7	32.2	34.2	28.9	26.5	23.8	24.8	22.2	22.3	20.6	20.8
Interest margin to gross income	34.7	38.6	32.7	37.2	36.0	34.0	33.8	30.0	29.2	29.1	29.1
Non-interest expenses to gross income	48.2	44.6	37.8	41.7	40.9	41.3	42.8	43.1	43.9	44.9	45.2
Liquidity											
Liquid assets to total assets	38.4	33.3	35.2	34.3	32.7	27.8	33.1	33.7	35.4	35.9	34.6
Liquid assets to short-term liabilities	44.5	37.0	41.9	38.6	37.7	38.1	41.4	43.8	44.7	45.4	43.7
liquid assets to total deposits	51.0	43.8	46.8	47.0	45.2	38.5	46.6	46.9	48.6	49.6	47.4
Total loans to total deposits	72.5	77.4	76.9	80.4	83.7	81.9	87.3	86.0	82.7	81.1	82.9
Sensitivity to market risk											
Net open position in foreign exchange to capital	4.3	3.3	2.6	2.2	4.3	3.5	4.0	3.2	3.8	3.7	4.5
Interest bearing assets to interest bearing liabilities	117.8	115.4	116.2	121.6	122.1	123.2	127.3	125.6	125.8	125.2	124.4
FX currency denominated assets to total assets	10.6	11.8	13.2	13.7	15.4	16.7	16.4	15.4	16.1	15.8	16.8
FX currency denominated liabilities to total liabilities	17.1	21.5	20.9	22.9	22.6	24.3	22.3	22.5	23.2	22.7	23.5
Spread between lending and deposit rate	9.3	8.4	10.3	8.9	8.0	7.3	7.7	6.2	6.4	6.2	6.4

Source: Central Bank of Kenya.

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

Annex I. Implementation of Past Fund Advice

The 2014 Article IV consultation made the following recommendations.

- **Maintain a strong foreign exchange reserves position with a flexible exchange rate to cushion the impact of potential shocks**. Gross reserves have risen from US$6.6 billion at end-2015Q3 to US$9.3 billion or 4.8 months of imports as of end-March 2018. Reflecting limited movement of the shilling relative to the US$, MCM's 2018 report on exchange rate arrangement to be published in February 2018 will reclassify Kenya's shilling from "floating" to "other managed arrangement."

- **Maintain a prudent fiscal stance consistent with Kenya's medium-term debt target while pursuing a shift in the composition of expenditure towards development priorities.** This included controlling the wage bill, improving the quality and efficiency of public spending, and mobilizing tax revenue. The government has increased the share of spending allocated to public investment (albeit less than originally targeted), has announced a revision of the salary scales for public servants in line with recommendations from the Salary and Remunerations Commission, and is taking steps to improve tax administration.

- **Effectively implement devolution to promote inclusive growth and improve social conditions, and mitigate the associated fiscal risks**. Disadvantaged counties have experience a significant increase in government spending and service delivery. The 2015 amendments to PFM regulations established limits on both the stock of gross debt and debt service for counties (up to 20 percent and 15 percent of each county's last audited revenues, respectively), require annual publication of county financial accounts, and specify financial and criminal penalties for violation of the PFM regulations.

- **Improve cash management: the development of a Treasury Single Account**. Improvements in cash management will allow for the introduction of a centralized payment unit in July 2018, while the capabilities of the Integrated Financial Management and Information System (IFMIS) will be more effectively exploited.

- **Put in place effective management of newly-discovered oil and gas**. The government is working with the World Bank and FAD in implementing the framework for natural resource management and rolling out capacity building in the context of the Kenya Petroleum Technical Assistance Project.

- **Enhance bank supervision.** Recent steps include: (i) stricter enforcement of transparency guidelines requiring banks to disclose their main shareholders and the volume of lending to insiders (directors, board members and employees); (ii) enhanced monitoring of capital adequacy levels through the initiation of the internal capital adequacy assessment process (ICAAP); (iii) hiring of additional staff in the area of compliance to support supervisory capacity; and (iv) stricter enforcement of regulations regarding the classification of non-performing loans. However, some small banks have been in non-compliance with prudential ratios for an extended period of time, and progress in resolving three banks intervened in recent years has been slow.

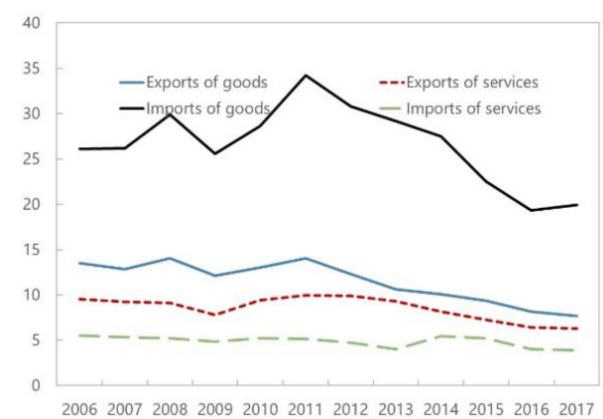
- **Accelerate regional integration**. Kenya has continued making progress in implementing EAC agreements, with compliance reaching 90 percent on recognition of certificates of origin (second to Burundi), an important non-tariff barrier expected to be removed in the transition to a common market (well above Rwanda, Tanzania, and Uganda).
- **Improve data quality**. The Balance of Payments has been upgraded in line with the BPM6. The work on the Foreign Investment Survey will start in May 2018, and is expected to be completed by October 2018. The first estimate of the International Investment Position can be started after that, and is expected to be finalized by end-2018. Both the FIS and the IIP will cover 2016 and 2017.

Annex II. Kenya: External Stability Assessment

A. Recent External Developments

1. The narrowing in the current account deficit has been driven by lower imports, while the REER has continued to appreciate. Goods imports have declined from 33.5 percent of GDP in 2011 to 21.6 percent of GDP in 2017, more than offsetting the decline in exports. Despite relative stability in the nominal effective exchange rate, the real effective exchange rate has continued to appreciate, rising by 5.7 percent in 2017 compared to 2016.

Trade, Percent of GDP



Source: KNBS

NEER and REER, 2010=100

Source: IMF, Information Notice System.

B. Exchange Rate Assessment

2. The EBA-lite methodology for the exchange rate suggests that the external position is weaker than fundamentals. The current account approach shows that the current account deficit (both actual and cyclically adjusted) are above the norm (the CA gap is -2.5 percent), suggesting an overvaluation of about 17.5 percent of the real exchange rate. This can only marginally be explained by the policy gap. The REER approach also shows a similar-size of overvaluation, equivalent to about 18.0 percent. Again, the policy gap is marginal. Given the continued appreciation of the real exchange rate, the external position is assessed to be weaker than fundamentals. Regarding the last approach, the external sustainability approach, it was not possible to use it as the international investment position data is not yet produced by the authorities.

Current account approach	Percent of GDP	REER approach	
CA – Actual	-6.8%	ln(REER) – Actual	4.88
CA – Cyclically Adjusted	-7.1%		
CA – Norm	-4.3%	ln(REER) – Norm	4.70
CA – Fitted	-4.9%	ln(REER) – Fitted	4.69
Policy Gap	-0.5%	Policy Gap	-0.01
Residual (Actual – Fitted)	-1.8%	Residual (Actual – Fitted)	0.18
CA Gap	-2.5%		
REER Gap	**17.5%**	**REER Gap**	**18.0%**

C. Reserve Adequacy

3. **International reserves are above the level suggested by the Fund's approach for assessing reserve adequacy in credit-constrained economies.** The optimum level of reserves for Kenya is calculated by measuring the benefit of holding reserves less the cost of holding reserves. The benefits are the lower probability of a crisis and the reduction in the severity of a crisis, while the cost is measured on the basis of Kenya's external funding costs. The model suggests that the optimal level of reserves for Kenya is 3.5 months of imports, while current holdings (as of March 2018) are 4.8 months of imports. Reserve coverage is projected to stabilize at about 4.4 months of imports over the medium term, which is appropriate for Kenya in light of the heightened uncertainty in the global economy and the risk of capital flow volatility.

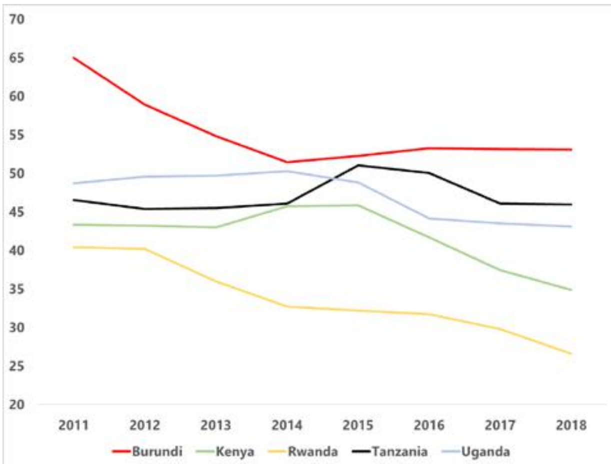
D. Competitiveness Measures

4. **Kenya has performed well compared to peers and over time in improving conditions for competitiveness.** Kenya has continued to implement reforms which have improved their ranking in the World Bank Doing Business Indicators. In 2018, Kenya's rank moved up an impressive 12 places to 80. It is worth highlighting that Kenya's ranking in getting credit is a key strength, although the introduction of interest rate controls restrains access to credit, particularly for SMEs, and there is room for improvement in other areas. Kenya has also continued to move up the WEF competitiveness rankings, moving to 91/137 in 2017–18, compared with 106/144 in 2011–13.[1]

[1] In line with the Use of Third-Party Indicators in Fund Reports from 2017, we present scores for several indicators in a cross-country context. The World Bank's Doing Business indicators are partly, and the World Economic Forum's Global Competitiveness Index is entirely based on survey data. The World Bank started to publish the Doing Business indicators in 2003, they publish them every year, and today they cover 190 countries. The Global Competitiveness Report has been published annually since 2004, and provides information on 137 economies currently.

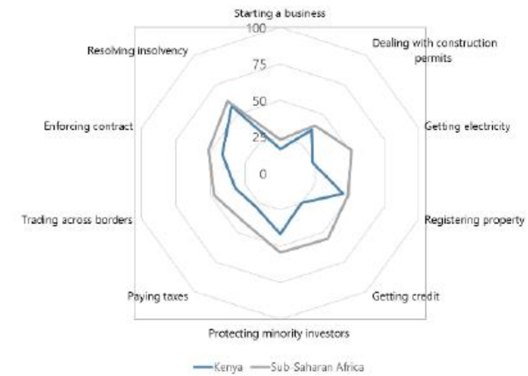
Competitiveness Indicators

Distance to the frontier (DTF) in Kenya and EAC, between 0 and 100



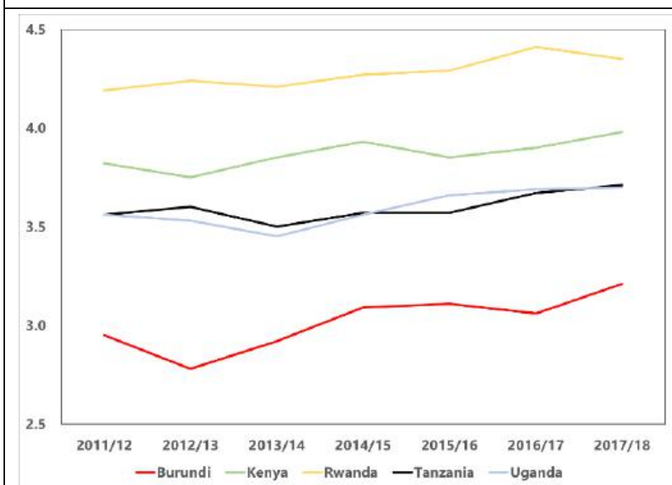
Source: World Bank Doing Business 2018. Note: The chart shows 100-DTF; the smaller the value, the closer the country is to the frontier.

2018 distance to the frontier (DTF) by subcategories in Kenya and Sub-Saharan Africa, between 0 and 100



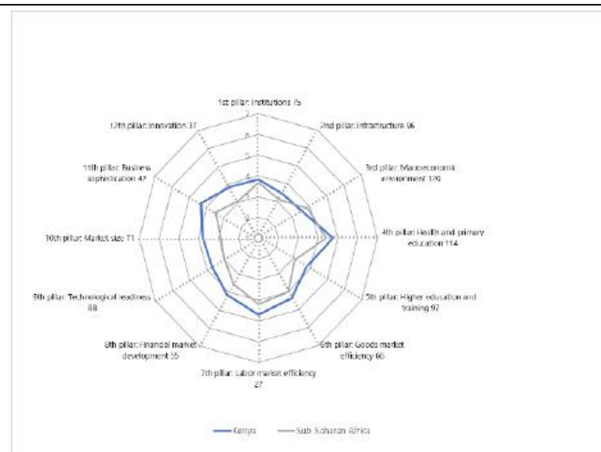
Source: World Bank Doing Business 2018. Note: The chart shows 100-DTF; the smaller the value, the closer the country is to the frontier.

Global Competitiveness Index in Kenya and EAC, between 1 and 7



Source: World Economic Forum Global Competitiveness Report 2017–18. Note: measured on a 1–7 scale, with 7 being the most desirable outcome.

2017–18 Global Competitiveness Index by subcategories in Kenya and Sub-Saharan Africa, between 1 and 7



Source: World Economic Forum Global Competitiveness Report 2017–18. Note: measured on a 1-7 scale, with 7 being the most desirable outcome.

Annex III. Risk Assessment Matrix*

Source of Risks	Likelihood /Time Horizon	Expected Impact on Economy	Policy Response
		Potential Domestic Shocks	
Delay in removal of interest rate controls.	Medium **Short to Medium Term**	**High.** This could have adverse effects on financial stability and access to credit, especially for high-risk borrowers. This would dampen growth and reduce financial inclusion. It would also delay the modernization of the monetary policy framework.	* Strengthen bank supervision to maintain financial sector stability; * Continue prudent monetary and fiscal policies and structural reforms to maintain growth
A return of drought.	Medium **Short Term**	**High.** This would lead to slower growth, an increase in food inflation, pressures on public spending and the current account, and adversely affect vulnerable households.	* Guard against second-round effects on inflation; * Use targeted programs to vulnerable groups and reprioritize spending;
Political risks.	Medium **Short to Medium Term**	Medium. Continued dispute of election results by the opposition could lead to a prolonged period of uncertainty, delayed implementation of reforms, and pressure on government spending.	* Remain committed to fiscal targets and reforms under the program.
Deterioration in security situation.	Medium **Short to Medium Term**	**High.** This would adversely affect the tourism sector, foreign direct investment and portfolio inflows. Consequently, it could adversely affect the growth.	* Reprioritize fiscal spending to accommodate security needs; and * Maintain policies to improve macro fundamentals (e.g., structural and governance reforms). * Strengthen AML/CFT framework to help curtail financing of terrorism.
		Potential External Shocks	
Retreat from cross-border integration.	Medium **Short to Medium Term**	Medium. This would adversely impact (i) the current account of the balance of payments by reducing tourism and exports; and (ii) the financial account of the balance of payments by reducing foreign direct investment and portfolio inflows.	* Maintain exchange rate flexibility; * Accelerate reforms to address structural weakness affecting competitiveness.
Policy and geopolitical uncertainties: • Policy uncertainty. Two-sided risks to US growth; uncertainty associated with negotiating post-Brexit arrangements and NAFA; and evolving political processes, including elections in several large economies	Medium **Short to Medium Term** **High** **Short to medium Term**	Medium. This would adversely impact (i) the current account of the balance of payments by reducing tourism and exports; and (ii) the financial account of the balance of payments by reducing foreign direct investment and portfolio inflows.	* Maintain exchange rate flexibility; * Accelerate reforms to address structural weakness affecting competitiveness.

Source of Risks	Likelihood /Time Horizon	Expected Impact on Economy	Policy Response
• Intensification of the risks of fragmentation/ security dislocation in part of the Middle East, Africa, and Europe.			
Financial conditions: • Tighter global financial conditions. • Further pressure on traditional bank business models.	**High** **Short to Medium Term** **Medium** **Medium Term**	Medium. This would adversely impact (i) the financial account of the balance of payments, by reducing capital inflows; (ii) the banking sector and credit growth by reducing funding for the banking sector; (iii) the corporate sector by reducing foreign direct investment; and (iv) fiscal external financing by raising terms of Eurobond issuances.	* Maintain exchange rate flexibility; * Address bottlenecks in the banking sector and further strengthen financial sector supervision. * Maintain policies to improve macroeconomic fundamentals and regulatory environment that are conducive to growth in small- and medium-sized businesses.
Weaker-than-expected global growth: • Structurally weak growth in key advanced economies. • Significant U.S. slowdown and its spillovers. • Significant China slowdown and its spillovers.	**High** **Medium Term** **Medium** **Medium Term** **Low/ Medium** **Short to Medium Term**	Medium. This would adversely impact (i) the current account of the balance of payments by reducing tourism and exports; and (ii) the financial account of the balance of payments by reducing foreign direct investment and portfolio inflows.	* Maintain exchange rate flexibility; * Accelerate reforms to address structural weakness affecting competitiveness.
Lower energy prices.	**Low** **Short to Medium Term**	**Low.** Lower energy prices would be a positive shock for Kenya in the near term, but a lack of investment in the oil sector could adversely affect medium-term growth.	* Maintain exchange rate flexibility;
Cyber-attacks	**Medium** **Short to Medium Term**	**Medium.** Such attacks can trigger financial instability or widely disrupt socio-economic activities.	* Continue reforms to strengthen cyber security capabilities at both government and private sector level.

* The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. "Short term" and "medium term" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Annex IV. Capacity Development Strategy for FY 2019

The authorities are engaged in an SBA with the Fund. They see IMF TA as a way to support the economic and financial policies under the program. As such, capacity development program for Kenya, including related technical assistance delivery, is a key component of program and surveillance priorities.

Overall Assessment of Capacity Development

1. **As a lower-middle-income country, Kenya faces some capacity development needs**. These are being addressed in part through tailored technical assistance. Key areas of focus are public financial management; revenue administration; upgrading the bank and non-bank supervisory frameworks; and improving government finance and national accounts statistics.

2. **Program engagement has contributed in the past to building capacity in Kenya, although the lengthy delay in program reviews following the completion of the first review under the SBA/SCF in January 2017**[1] may have somewhat reduced the effectiveness of program engagement for TA absorption. Key achievements include:

- Development of plans to strengthen the National Treasury's public investment project database and the related improvement of budgeting, accounting, and reporting;
- Expanded coverage of the Treasury Single Account (TSA) and training on cash management processes;
- Improved integrity of the Kenya Revenue Administration's (KRA's) taxpayer registration database and the development of a medium-term revenue administration strategy;
- The development of training programs for the Central Bank of Kenya on risk-based supervision and ICAAP reviews.

TA implementation has been at times challenged by recipient capacity constraints.

Forward-Looking Priorities

3. **The TA strategy for Kenya should focus on medium-term budgeting, public financial management, revenue administration, financial supervision and regulation, strengthening macroeconomic and government finance statistics, and improving the AML/CFT framework.** In particular,

- Strengthening the authorities' approach to medium-term budgeting by revising the process by developing realistic budget baselines and setting credible expenditure ceilings.
- Further improving public financial management, particularly with regard to public investment management, TSA coverage, and financial reporting.

[1] The SCF expired in March 2018. The SBA was extended in March 2018 for 6 months.

- Assisting the authorities with strengthening and implementing risk-based supervision.
- Expanding government financial statistics coverage to the general government and public corporations.

4. For FY 2019, key priorities and objectives include:

Priorities	Objectives
Public Financial Management	Support IPSAS implementation to improve annual financial reporting
Revenue Administration	Complete revenue administration gap assessment
Regulatory and Prudential Framework	Implement risk-based supervision for insurance companies
Financial Stability	Strengthen the macroprudential policy framework
AML/CFT	Continue the implementation of AML/CFT reforms

Risks to capacity development include capacity constraints from rate rates of turnover and restraints on staffing levels. These risks could be mitigated adapting the TA provided to the relevant capacity context and planning for follow-up missions as needed.

Authorities' Views

5. The authorities agree with the path of the capacity development strategy for Kenya. They consider the strategy and objectives as appropriate to Kenya's capacity development needs, absorption capacity, and in the context of their broader macroeconomic program.

Appendix I. Letter of Intent

Nairobi, Kenya
May 25, 2018

Ms. Christine Lagarde
Managing Director
International Monetary Fund
700 19th St, NW
Washington, DC 20431

Dear Ms. Lagarde,

1. Economic conditions in Kenya have continued to improve since the 6-month extension of our precautionary Stand-By Arrangement (SBA) on March 12, 2018. In particular, GDP growth accelerated to 5.0 percent in the fourth quarter of 2017, from 4.7 percent in the first nine months of the year, and confidence indicators point to a continued strong momentum in 2018. This reflects a recovery from the effects of the protracted presidential election process and improving weather conditions. In addition, inflation remains low (3.7 percent in April), the exchange rate has been stable, and gross international reserves reached an all-time high of US$9.1billion at end-April (equivalent to 6.11 months of imports).

2. The economy grew by 4.9 per cent in 2017 supported by activities in the non-agricultural sector——mainly the services sub-sector——that offset the lower performance in the agricultural sector. The growth reflected increased performance in the information and communication, tourism, wholesale and retail, and transport and storage sectors. The impact of the extensive drought, coupled with the election-related expenditures, contributed to missing (i) the performance criteria on the primary fiscal balance for end-December 2016 and end-June 2017, and (ii) the monetary policy consultation clause for June 2017 (Table 1). The introduction of interest rate controls in September 2016, which were aimed at addressing the high cost of credit, has had somewhat unintended adverse consequences on credit growth and monetary policy effectiveness. In addition, there have been some delays in implementing some of the structural benchmarks under the program (Table 2). To bring the program back on track, we are taking steps to help achieve our program objectives, especially to maintain public debt sustainability, avoid the adverse impact of interest rate controls, and continue reforms to strengthen public financial management and modernize the monetary policy framework.

- On fiscal policy, we have introduced specific revenue administration measures that have helped improve revenue collection in the second half of 2017/18. In addition, since revenues remain below target, we issued in May 2018 a circular on expenditure controls to limit spending for the remainder of 2017/18, especially for lower-priority domestically-financed investment projects, with a view to contain the overall deficit to KSh623 billion. We are also monitoring commitments by spending units to ensure no increase in spending arrears (pending bills of 90 days or more). Consistent with the commitment in our letter of intent of March 6, we have submitted to Parliament the budget estimates for 2018/19 that targets a deficit of 5.7 percent of GDP, and will submit the supporting Finance Bill, 2018 to Parliament that will contain revenue raising measures, including removal of some tax exemptions and further improvements in tax administration. In additional, we shall present to Parliament, a modern new Income Tax Bill that overhauls the existing Income Tax Act.

- On interest rate controls, we plan to submit together with the Finance Bill 2018, a proposal that aims to refocus the controls on consumer protection and avoid their adverse impact on the economy, especially ensuring that they no longer block lending and access to finance, or hinder the conduct of monetary policy.
- On structural reforms, we are taking steps to deepen financial sector reforms, improve the transparency and efficiency of public spending, and strengthen public debt management.

3. We propose a set of quantitative performance criteria, an Monetary Policy Consultation Clause, and indicative targets for end-June 2018 (Table 3), and resetting some of the structural benchmarks for end-August 2018 (Table 4). These will serve as a basis for completing delayed reviews under the precautionary SBA, together with a macroeconomic framework and conservative revenue projections for 2018/19 and over the medium term to be agreed with Fund staff, that reflect forward looking policies to be specified in a follow-up letter of intent at the time of the next SBA review. The follow-up letter of intent will be presented to the Executive Board before the expiration of the SBA program on September 14, 2018. We authorize the publication of this letter of intent, the attached technical memorandum of understanding, and the related staff report.

Sincerely yours,

/s/

Henry Rotich, EGH
Cabinet Secretary
The National Treasury and Planning

/s/

Patrick Njoroge
Governor
Central Bank of Kenya

Table 1. Kenya: Performance Against Quantitative Performance Criteria and Indicative Targets

(Billions of Kenyan shillings; unless otherwise indicated)

	Performance Criteria (PC)/Indicative targets (IT)											
	2016				2017							
	End-Dec (PC)				End-Mar (IT)				End-Jun (PC)			
	Prog.	Adj. Prog.	Act.	Met / Not Met	Prog.	Adj. Prog.	Prel.	Met / Not Met	Prog.	Adj. Prog.	Prel.	Met / Not Met
Quantitative performance criteria [1]												
Fiscal targets												
Primary budget balance of the national government (-=deficit, floor) [2, 3]	-100.0	-111.2	-131.1	Not met	-169.5	-189.8	-219.0	Not met	-211.5	-240.6	-300.5	Not met
Monetary targets [4, 5]												
Stock of central bank net international reserves (floor, in millions of US$) [6, 7]	6,283	5,633	6,599	Met	6,266	6,456	7,195	Met	7,230	7,384	7,512	Met
Public debt target												
National government external payment arrears (ceiling, millions of US$) [8]	0	0	0.0	Met	0	0	0	Met	0	0	0	Met
Contracting or guaranteeing of new non-concessional external debt (US$ million)	…	…	…	…	…	…	…	…	…	…	…	…
Monetary policy consultation clause												
Upper band	7.5	7.5	…		7.5	7.5	…		7.5	7.5	…	
Center inflation target [9]	5.0	5.0	6.5	Met	5.0	5.0	10.3	Not met	5.0	5.0	10.8	Not met
Lower band	2.5	2.5	…		2.5	2.5	…		2.5	2.5	…	
Indicative targets												
Stock of net domestic assets of the central bank (ceiling)	-165	-99	-279	Met	-193	-232	-355	Met	-289	-321	-391	Met
Priority social expenditures of the national government (floor) [3]	10.5	…	…	…	30.0	30.0	…	…	57.4	57.4	…	…
Stock of all guarantees issued by the national government (ceiling) [3]	50	…	…	…	50	50	…	…	50	50	…	…
Change in the stock of national government domestic bills pending for 90 days or more [3]	…	…	…	…	0	0	…	…	0	0	…	…
Memorandum items:												
Maximum upward adjustment of the primary deficit ceiling owing to excess in concessional loans relative to program projections [3]	27.1	27.1	11.2	…	30.0	30.0	20.3	…	39.6	39.6	29.1	…
Programmed project loans [3, 10]	56.8	56.8	57	…	85.7	85.7	85.7	…	96.0	96.0	96.0	…
Budgeted project loans [3, 10]	83.9	83.9	68	…	115.7	115.7	106.0	…	135.6	135.6	125.1	…
Programmed external commercial debt (millions of US$) [3]	750	750	100	…	750	750	1,130	…	1,500	1,500	1,809	…
Program grants [3]	2.7	2.7	…	…	3.5	3.5	…	…	6.1	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: Performance Against Structural Benchmarks

Complete a study on tax expenditures, in order to identify their size, type, evolution over time, and the category of taxation to which they apply (IMF Country Report No. 17/25, MEFP ¶12).	End-January 2017	Met
Adopt Cabinet guidelines on the selection, appraisal, and funding for major investments projects (IMF Country Report No. 17/25 MEFP ¶14).	End-March 2017	Not met. Review of recommendations from an AFRITAC East TA mission is on-going and a Task Force has been appointed to prepare the guidelines for approval.
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. 17/25, MEFP ¶12).	End-March 2017	Not met. Draft legislation (Bill) and Policy have been developed reflecting recommendations from an IMF FAD TA mission. The draft Policy and Bill have been presented to Council of Governors for their comments. Upon inclusion of the comments, the two policy documents will be submitted to Cabinet for Approval and subsequently to Parliament.
Automate the release of funds from the exchequer account, first through the current system of MDA accounts (IMF Country Report No. 17/25, MEFP ¶14)	End-March 2017	Not met. While MDAs are making payment requests electronically in the system, transfers from Exchequer Accounts to MDAs is still done manually. Legal issues remain regarding the validity of digital signatures.
Publish consolidated financial statements for the budgetary central government (i.e., the MDAs, their development projects, and the Consolidated Fund Accounts) (IMF Country Report No. 17/25, MEFP ¶14).	End-March 2017	Met
Set up an integrated Public Investment Management (PIM) system for tracking projects through the project cycle (IMF Country Report No. 17/25, MEFP ¶14)	End-June 2017	Met. A PIM unit has been set up, its head has been appointed and Officers transferred to the new Unit based on the various TA from the IMF East Afritac. It is currently under the Directorate of Budget, Fiscal and Economic Affairs.
Make operational a Centralized Payment System to ensure better control of public expenditure (IMF Country Report No. 17/25, MEFP ¶14).	End-June 2017	Not met. Payments still pass through MDAs which in turn make payments within 24 hours after receiving funds. Legal issues remain regarding interpretation of Consolidated Fund Services, Exchequer and The Treasury Single Account (TSA).
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 (IMF Country Report No. 17/25, MEFP ¶20).	End-June 2017	Met

Table 3. Proposed Quantitative Performance Criteria and Indicative Targets for June 2018

(in billions of Kenyan shillings; unless otherwise indicated)

	2017 End-Dec Act.	2018 End-Jun (PC) Proj.
Quantitative performance criteria [1]		
Fiscal targets		
Primary budget balance of the national government (-=deficit, floor) [2, 3]	-54.4	-259.8
Monetary targets [4, 5]		
Stock of central bank net international reserves (floor, US$ million) [6, 7]	5,789	7,710
Public debt target		
National government external payment arrears (ceiling, millions of US$) [8]	0	0
Contracting or guaranteeing of new public debt (ceiling, KES billion) [3]	508	1,220
Monetary policy consultation clause		
Upper band	…	7.5
Center inflation target [9]	5.0	5.0
Lower band	…	2.5
Indicative targets		
Stock of net domestic assets of the central bank (ceiling)	-153.1	-301
Priority social expenditures of the national government (floor) [3]	64.7	81.5
Stock of all guarantees issued by the national government (ceiling) [3]	…	…
Change in the stock of national government domestic bills pending for 90 days or more [3]		
Memorandum items:		
Maximum upward adjustment of the primary deficit ceiling owing to excess in concessional loans relative to program projections [3]	…	0.0
Programmed project loans [3]	39.4	138.7
Budgeted project loans [3]		138.7
Programmed external commercial debt (US$ million) [3]	106.8	2,881
Program grants [3]	2.7	6.1

[1] Performance criteria for end-June and end-December 2018, and indicative target for end-September 2018.
[2] The primary budget balance of the national government and related adjusters are defined, respectively, in paragraph 6 and paragraph 7 of the TMU.
[3] All targets are cumulative flows from July 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 17 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-March 2018 (see TMU ¶9).
[8] Continuous.
[9] Compliance will be evaluated based on the 12-month inflation average of the latest three months.

Table 4. Kenya: Proposed Structural Benchmarks

Measure	Target Date	Macro Criticality
Modify interest rate controls while protecting consumers from predatory lending.	End-August 2018	To enable banks to resume providing credit to the economy and support growth, and to improve the effectiveness of monetary policy.
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.	End-August 2018	To reduce pressures on transfers to counties while maintaining a business-friendly tax system
Adoption by Cabinet of standardized guidelines for project appraisal and selection.	End-August 2018	To improve the efficiency of public investments
Automate the release of funds from the exchequer account, first through the current system of MDA accounts.	End-August 2018	To prevent the accumulation of pending bills
Make operational a Centralized Payment System to ensure better control of public expenditure.	End-August 2018	To strengthen expenditure control

Attachment. Technical Memorandum of Understanding

Nairobi, Kenya, May 25, 2018

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 Stand-By Arrangement.

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 June 30, 2018 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 SGR I (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**);
- Contracting or guaranteeing of new debt by the national government and the CBK (**ceiling**);
- monetary policy consultation clause (**band**).

4. The program sets indicative targets for June 30, 2018 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**);
- 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 SGR I, adjusted for cash basis.

6. For program purposes, the **national government primary balance** 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 SGR I; 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, 2017.

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** of the national government 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.

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 SGR I) 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)

	2018
	Jun.
Program Amount [1]	6.1

Source: Authorities' data.

[1] For FY2017/18 cumulative from July 1, 2017.

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)

	2018
	Jun.
Program grants	60.55
External commercial debt	2,880.82

Source: Kenyan authorities.

[1] Cumulative from July 1, 2017.

9. **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 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 March 29, 2018)

Currency	Kenyan Shillings per currency unit	US Dollars per currency unit
US Dollar	100.74	1.00
STG Pound	142.15	1.41
Japanese Yen	0.95	106.3
Canadian Dollars	78.17	1.29
Euro	124.60	1.24
Swiss Franc	105.53	0.95
Swedish Kronor	12.12	8.32
Danish Kronor	16.69	6.04
Chinese Yuan	15.99	6.30
Australian Dollars	77.32	1.30
SDR	146.84	0.69

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. External debt is defined on a residency basis.

11. The performance criterion on the national government external payment arrears is defined as a cumulative flow in gross terms from July 1, 2017 and applies on a continuous basis.

V. CONTRACTING OR GUARANTEEING OF NEW PUBLIC DEBT (CEILING)

12. A performance criterion (ceiling) applies to the nominal value of new debt (external and domestic) contracted or guaranteed by the national government and the CBK. For debt with original maturity of one year or less, new debt would be measured as the change in the outstanding stock

over the specified period. The ceiling does not apply to the use of Fund resources, operations related to external debt restructuring; or normal import related credits. Public debt issued in foreign currency shall be valued in in local currency using the program exchange rates.

13. For the purposes of this TMU, the definition of debt is set out in paragraph 8 of the Guidelines on Public Debt Conditionality in Fund Arrangements (Executive Board's Decision No.15688-(14/107). The definition also refers to commitments contracted or guaranteed for which value has not been received. The definition of debt is as follows:

- For the purpose of these guidelines, the term "debt" will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of financial and nonfinancial assets (including currency) or services, and 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:
  - (i) loans, i.e., advances of money to the obligor by the lender made on the basis of an 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);
  - (ii) suppliers' credits, i.e., 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
  - (iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the 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.

14. Under the definition of debt set out above, arrears, penalties, and judicially awarded damages arising from the 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 (e.g., payment on delivery) will not give rise to debt.

VI. MONETARY POLICY CONSULTATION CLAUSE

15. 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 the end-June 2018 test date, 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.

TMU Table 4. Inflation Consultation Band

	2018 Apr.- Jun. Target
Upper band	7.5
Center point	*5.0*
Lower band	2.5

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

16. **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.

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

VIII. INDICATIVE TARGET ON NATIONAL GOVERNMENT DOMESTIC PENDING BILLS

18. 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.

IX. INDICATIVE TARGET ON PRIORITY SOCIAL SPENDING

19. 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

X. INDICATIVE TARGET ON GUARANTEES ISSUED BY THE NATIONAL GOVERNMENT

20. 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.

XI. DATA REPORTING

21. 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 non-concessional 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. Public debt			
Stock of Treasury Bills	Quarterly	Within 45 days after the end of the quarter.	NT
Total new issuance of Treasury Bonds	Quarterly	Within 45 days after the end of the quarter.	NT
Total new other domestic debt contracted or guaranteed	Quarterly	Within 45 days after the end of the quarter.	NT and CBK
Total new contracted external project loans	Quarterly	Within 45 days after the end of the quarter.	NT
Total other new contracted or guaranteed external concessional debt	Quarterly	Within 45 days after the end of the quarter.	NT and CBK
Total new Eurobond issuances	Quarterly	Within 45 days after the end of the quarter.	NT
Total new other non-concessional external debt contracted or guaranteed	Quarterly	Within 45 days after the end of the quarter.	NT and CBK
3. 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)

Information	Frequency	Reporting Deadline	Responsible Entity
4. 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
5. 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
6. 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 non-concessional medium- and long-term external debt contracted or guaranteed by the national government and CBK	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 15 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

INTERNATIONAL MONETARY FUND

KENYA

May 31, 2018

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION AND ESTABLISHMENT OF PERFORMANCE CRITERIA FOR THE SECOND REVIEW UNDER STAND-BY ARRANGEMENT —DEBT SUSTAINABILITY ANALYSIS[1]

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

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

Kenya's risk of external debt distress has increased from low to moderate. This reflects the breach of three external debt indicators—external debt service-to-export ratio, external debt service-to-revenue ratio, and the present value of external debt to export ratio—for an extended period of time under the most extreme shock. The first indicator is also breached under the baseline scenario, pointing to rising refinancing risks, although such a breach is temporary and marginal. It is related to a bullet Eurobond repayment, against the background of Kenya's continued access to international markets and a comfortable level of official foreign reserves. While public debt has risen in recent years, overall public–sector debt dynamics continue to be sustainable, with most new debt financing infrastructure to address bottlenecks and boost sustainable growth. However, reducing the fiscal deficit over the medium term, restricting borrowing to finance projects with high social and economic returns, and lengthening the maturity of non-concessional borrowing are essential to limit and eventually reverse the rise in public debt ratios, and reduce refinancing risks. 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 2014–16: 3.75). 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[2]

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 both external and domestic debt 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. The debt coverage excludes legacy debts of the pre-devolution county governments (whose size is modest), and non-guaranteed debt of state-owned enterprises.

2. **Kenya's overall public debt has increased in the past two years.** Gross public debt increased from 51.4 percent of GDP at end-2015 and 53.2 percent of GDP at end-2016 to about 58.0 percent at end-2017. About 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-2017 was US$21.4 billion, equivalent to 28.5 percent of GDP.

- As of June 2017, multilateral creditors accounted for a bit more than 40 percent of external credit to Kenya as the share of debt from commercial creditors has increased. Of Kenya's bilateral debt, about two-thirds is owed to Paris Club members, while the remaining one-third is mainly semi-concessional loans from China to finance construction of the Standard Gauge Railway project (SGR).

- Kenya's commercial financing has several 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.[3] Then 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. Payment for nearly 90 percent of this syndicated loan was extended to April 2018 reflecting delays in the issuance of a planned Eurobond due to the protracted election period. More recently, in February 2018, Kenya raised an additional US$2 billion in a new sovereign bond issue; the bond has been issued in two equal tranches of 10 years at a coupon of 7.25 percent and 30 years at a coupon of 8.25 percent. At the same time, the maturity of the syndicated loan was extended to seven years.

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[2] Data cited in this section come from the National Treasury's Monthly Bulletin and Quarterly Economic and Budgetary Reviews.

[3] 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

	2013		2014		2015		2016	
	Billion US$	Share	Billion US$	Share	Billion US$	Share	Billion US$	Share
Multilateral creditors	6.47	60.5	7.07	49.2	7.30	46.4	7.62	40.0
Bilateral creditors	2.84	26.6	3.86	26.9	4.29	27.3	6.26	32.9
Commercial creditors	0.69	6.5	2.82	19.6	3.58	22.7	4.47	23.5
Others (supplier credits)	0.18	1.7	0.18	1.3	0.16	1.0	0.15	0.8
Total (excluding guarantees)	10.18	95.2	13.93	96.9	15.33	97.4	18.50	97.2
Publicly guaranteed debt	0.51	4.8	0.44	3.1	0.41	2.6	0.54	2.8
Total (including guarantees)	10.69	100.0	14.37	100.0	15.74	100.0	19.04	100.0

Source: Kenyan National Treasury.

4. **Kenya's gross domestic public debt was KSh2,210 billion (29.5 percent of GDP) at end-2017.** Domestic debt is issued mostly in the form of Treasury bonds (67 percent of domestic debt) and Treasury bills (32 percent). Commercial banks hold 54 percent of the domestic debt and nonbanks (pension and trust funds, insurance companies and others) hold 42 percent. The Central Bank of Kenya and non-residents officially hold the rest, although it is likely that non-residents hold a greater share than the data suggests as the commercial banking sector serves as a conduit for non-residents to gain exposure to Kenyan domestic debt. The average maturity profile of Kenya's outstanding government domestic debt remained at 5 years as at end December 2016.

UNDERLYING ASSUMPTIONS

5. **This DSA is based on the following macroeconomic assumptions:**

- Real GDP growth in the baseline was weaker in 2017 relative to 2016 outturn, reflecting mainly headwinds from a severe drought that dampened agriculture output and hydropower generation, a prolonged presidential election, which led to a wait-and-see attitude by investors as business sentiment slumped, and sluggish private sector credit growth, which, in part, has been adversely impacted by the interest rate cap. Growth is expected to recover in the medium to long term, predicated on the dissipation of two of the headwinds experienced in 2017 (adverse weather, and political uncertainty), the strengthening of global economy, and the completion of flagship infrastructure projects that are helping to address some critical supply-side bottlenecks. Further, ongoing structural reform efforts to improve the business environment, and unlock the potential in four key priority areas identified by the Government (agriculture, manufacturing, affordable housing and universal health coverage) will be supportive of growth in the medium to long term.

- The primary fiscal deficit was 5.6 percent in FY2016/17, and is projected to be brought down in the medium to longer term, consistent with the East African Community (EAC) Monetary Union criteria of an overall fiscal deficit (including grants) of 3 percent of GDP.[4] Medium-term fiscal consolidation is expected to be underpinned by both expenditure and revenue measures. On expenditure, supported by the completion of some major flagship projects (SGR phase 1) and efforts to crowd-in private capital to finance some major infrastructure projects through PPPs will slow the pace of government spending, particularly the growth of development expenditures. Further the absence of one-off expenditures related to the elections and drought assistance will support fiscal consolidation over the medium term. On revenues, policy measures to rationalize exemptions, the new income tax bill (that seeks inter alia to broaden the tax base), administrative measures (including electronic tracking of cargo), and the projected pick-up in GDP growth should support a more robust recovery in revenues over the medium term.

- The current account deficit is estimated to have widened to 6.8 percent of GDP in 2017, mainly due to higher food and fuel imports because of the drought and rising global oil prices. Going forward, staff projects the current account deficit to start declining in 2018, supported by a rebound in exports (thanks to a broad-based recovery in the global economy, improved weather conditions, ongoing recovery in tourism following the lifting of travel warnings) and a slowdown in import growth as the pace of development expenditure (which has a high import intensity) slows.

Kenya: Selected Macroeconomic Assumptions

	2015	2016	2017	2018	2019	Long-term 1/
Real GDP Growth						
Current DSA	5.7	5.9	4.9	5.7	6.0	6.0
Previous DSA (December 2016)	5.8	5.5	6.0	6.2	6.5	6.5
Primary Fiscal Deficit (percent of GDP)						
Current DSA	4.7	4.9	4.8	2.6	0.5	0.9
Previous DSA (December 2016)	4.5	3.4	1.1	-0.5	-0.7	0.8
Non-interest Current Account (percent of GDP)						
Current DSA	5.3	3.7	5.1	4.8	4.1	2.5
Previous DSA (December 2016)	3.6	4.5	3.0	2.8	2.4	4.8

Source: IMF staff estimates.
1/ For current DSA, average 2023-37. For previous DSA, average 2022-36.

UNDERLYING ASSUMPTIONS

6. **External solvency debt indicators remain below their policy-dependent debt burden thresholds under the DSA baseline scenario throughout the projection period (Figure 1).** The present value (PV) of public and publicly guaranteed (PPG) external debt as a share of GDP is expected to rise to 31.4 percent in 2018 from 25.9 percent in 2017; this is higher than projected in the previous DSA. The PV of

[4] 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.

PPG external debt then gradually declines over time, remaining well below the 50 percent indicative threshold. The PV of external debt-to-exports and debt-to-revenue both remain below the indicative thresholds of 200 percent and 300 percent, respectively, over the entire projection period.

7. **However, the liquidity indicators temporarily and marginally breach their thresholds under the baseline scenario.** The debt service-to-exports ratio exceeds its threshold over two years by an average of 0.9 percentage points per year while the debt service-to-revenue ratio touches its threshold in one year. These reflect, in the case of both, the contracting of syndicated loans in the second half of FY2017/18 and, in the case of the former, worse-than-expected export performance in 2017.

8. **Under the standard stress tests there are longer breaches in the PV of debt to exports ratio, the debt service-to-exports ratio and the debt service-to-revenue ratio relative to the threshold.** Specifically, under the most extreme stress scenario, the PV of debt-to-exports breaches the threshold for 10 years by an average of more than 53 percentage points (Figure 1 and Table 2). Furthermore, the most extreme stress scenarios of the debt service-to-exports and debt service-to-revenue ratios also exceed the indicative thresholds.

9. **Staff has increased the risk of external debt distress from low to moderate.** This reflects the breach of three external debt indicators: external debt service-to-export ratio, external debt service-to-revenue ratio, and the PV of external debt to export ratio. While the first indicator is also breached under the baseline scenario, such a breach is only for a short period of time and is marginal, and is related to a bullet Eurobond repayment, against the background of Kenya's continued access to international markets and a comfortable level of official foreign reserves. The authorities should thus seek to reduce reliance on non-concessional borrowing to keep financing costs low. The authorities are also encouraged to refinance loans at a longer maturity to limit refinancing risks. In addition, continued commitment to fiscal consolidation will be key to maintaining debt sustainability.

PUBLIC DEBT SUSTAINABILITY ANALYSIS

10. **Under the baseline, total public debt as a share of GDP will peak in 2018 and then gradually decline over the medium term.** In 2018 public sector debt is projected to rise to 63.2 percent, from 58.0 percent in 2017 and 53.2 percent in 2016 (due to a ramping up of infrastructure projects). Looking forward, the primary deficit is expected to be 2.6 percent of GDP in 2018 (due to both revenue and spending measures) and to decline to about zero in 2020–22, resulting in a decline in debt to 56.3 percent of GDP in 2022. In PV terms, the debt peaks at 60.6 percent of GDP in 2018 and falls thereafter. The PV of public debt-to-revenue ratio would ease from 299.6 percent in 2018 to 261.5 percent in 2022 (Table 3).

11. **Total public debt as a share of GDP remains well below the low-income DSA public debt benchmark.** Under the baseline, debt remains below the benchmark of 74 percent of GDP in PV terms, while the path of the debt-to-revenue and debt service-to-revenue ratios are projected to decline in the longer term. This benchmark is 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 modest) as well as non-guaranteed debt of state-owned enterprises.

12. The alternative scenarios indicate that the PV of debt-to-GDP could breach its benchmark over the long term. Namely, under a standard scenario that keeps the primary balance unchanged from its 2017 level (corresponding to -4.8 percent of GDP) throughout the projection period (i.e., over 20 years), the PV of public debt-to-GDP would remain on a steady upwards trajectory and breaches the 74 percent benchmark in 2022. In addition, fixing the primary deficit at the 2017 level results in a significant increase in the debt-to-revenue ratio, rising above 400 percent in 2027.

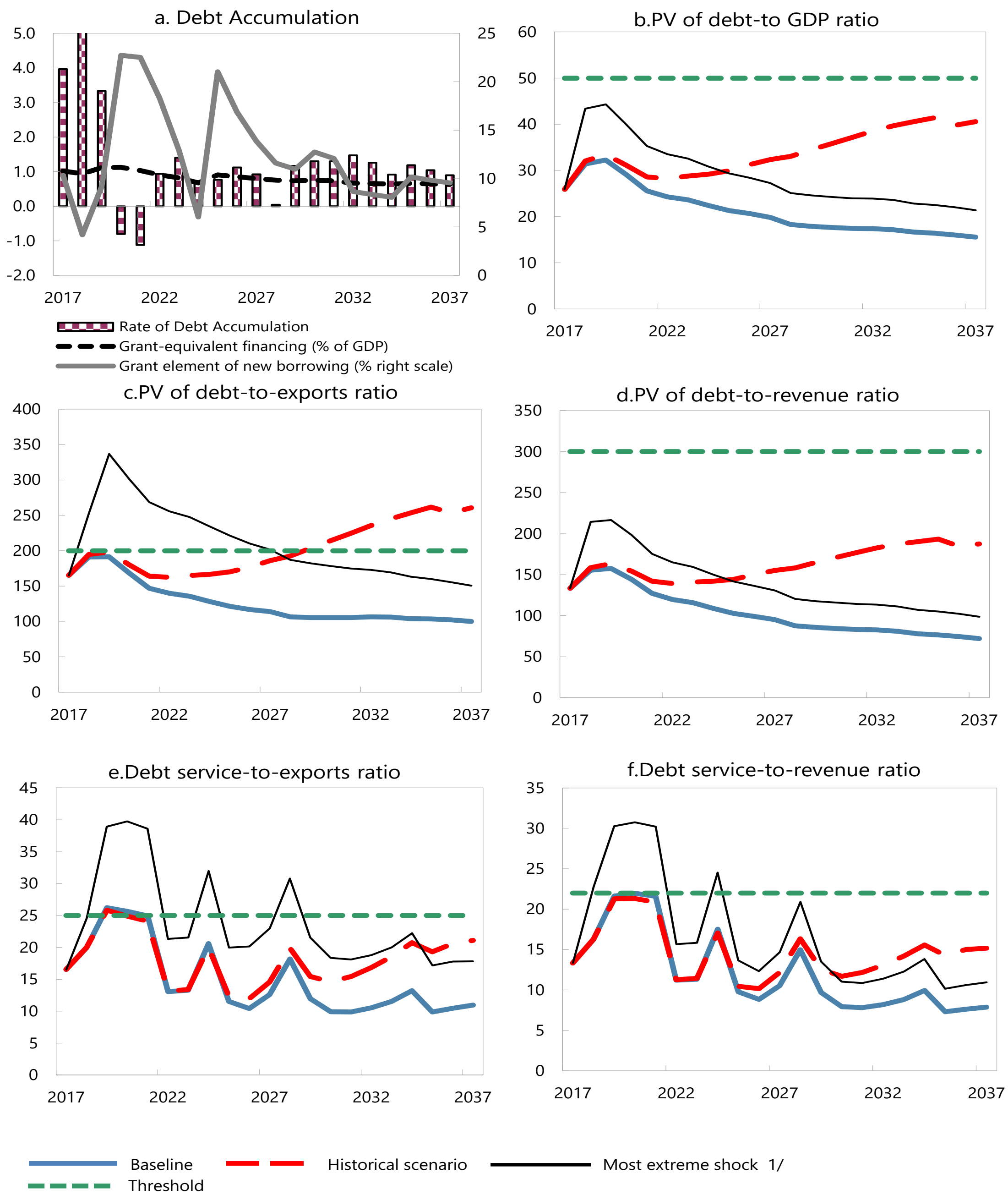
13. Further, under an extreme exchange rate shock scenario, insolvency indicators remain below thresholds. Even assuming a one-time depreciation of 30 percent taking place in 2018, the PV of debt-to-GDP would remain below its threshold. However, such a shock would bring overall public debt only about 1 percentage point of GDP away from its benchmark. Similar to the external public DSA, we note here again the vulnerability of public debt to a severe exchange rate shock.

MAIN FINDINGS AND CONCLUSIONS

14. This DSA finds that Kenya's risk of external debt distress has increased from low to moderate due to rising refinancing risks and narrower safety margins. There are breaches for three external debt indicators relative to the indicative thresholds by a significant amount and for an extended period of time under the most extreme shock. While there are breaches for one external debt indicator under the baseline scenario, such a breach is moderate in magnitude and not long lasting. In addition, the authorities are strengthening their debt management capacity to manage and prepare for large repayments on commercial borrowing. As part of this strategy, it is expected that the authorities will, over the next year, refinance loans to longer maturities. 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, while non-concessional borrowing should be limited to finance those projects with high social and economic returns. Looking ahead, such planned investment in infrastructure will be critical to raise growth and export potential, both of which will support Kenya's external debt sustainability.

15. Overall public-sector debt dynamics continue to be sustainable, although delivering on the fiscal consolidation envisaged under the program is essential to reduce risks. While the overall fiscal balance in 2016/17 was larger than projected in the previous DSA in December 2016, this was in part due to a higher execution of foreign-financed investment projects that are expected to raise growth in output and exports in the longer term. Going forward, 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 for debt, and debt indicators are below the relevant public debt benchmark in the baseline and stress scenarios. Standard stress-testing scenarios show that if the primary deficit were to remain at current levels, public debt would remain on an upward path. This highlights the need to follow through on the intended medium-term fiscal consolidation.

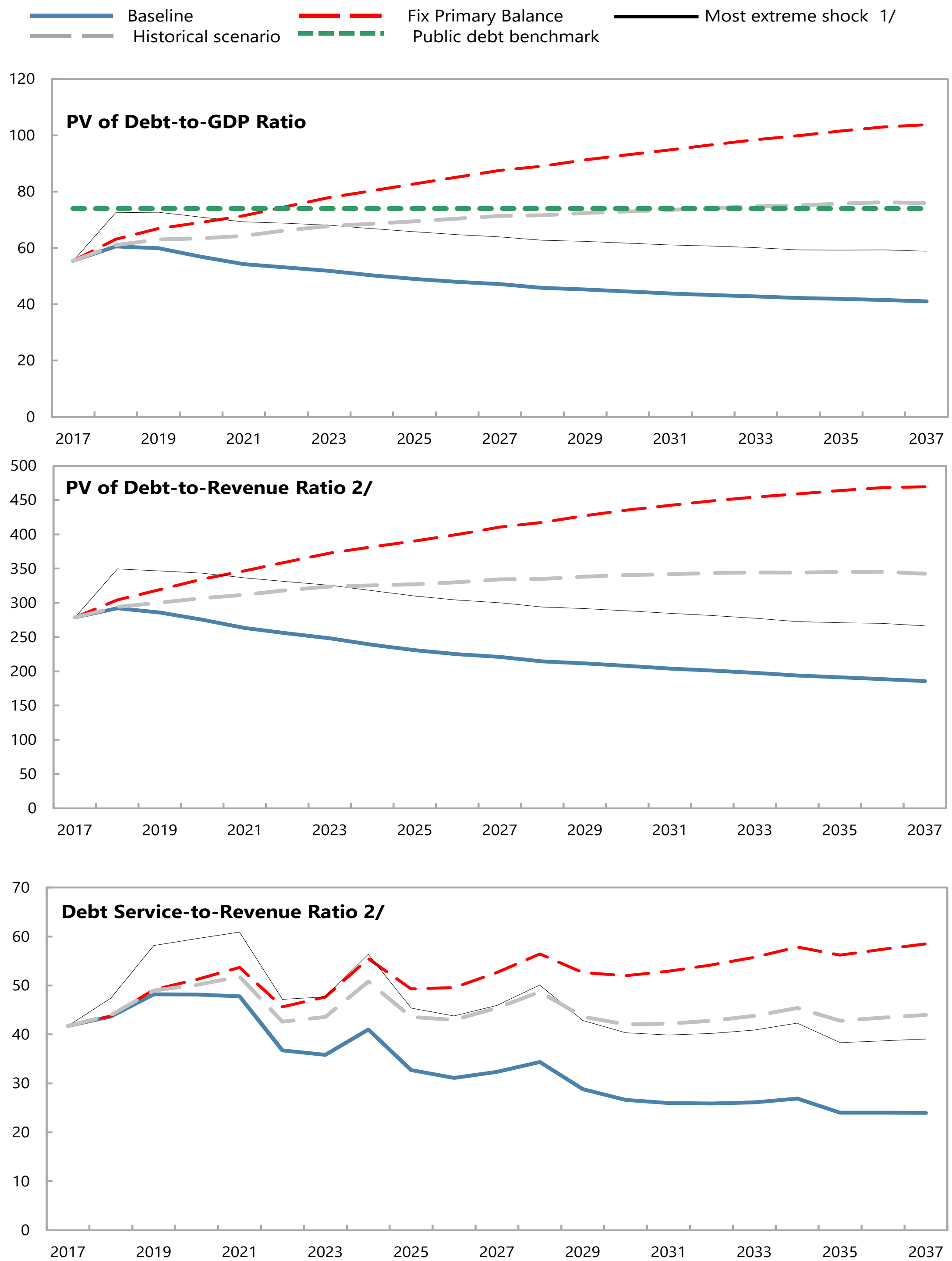
Figure 1. Kenya: Indicators of Public and Publicly Guaranteed External Debt Under Alternatives Scenarios, 2017–37 1/



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 2027. 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, 2017–37 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 2027.
2/ Revenues are defined inclusive of grants.

Table 1. Kenya: External Debt Sustainability Framework, Baseline Scenario, 2014–37 [1/]

(Percent of GDP, unless otherwise indicated)

	Actual			Historical [6/] Average	Standard [6/] Deviation	Projections									
	2014	2015	2016			2017	2018	2019	2020	2021	2022	2017-2022 Average	2027	2037	2023-2037 Average
External debt (nominal) 1/	**36.6**	**41.6**	**43.5**			**46.6**	**49.0**	**52.5**	**53.6**	**54.1**	**54.3**		**56.0**	**51.0**	
of which: public and publicly guaranteed (PPG)	23.5	25.7	26.4			28.5	34.1	35.2	32.3	28.8	27.5		23.0	18.3	
Change in external debt	7.3	5.0	1.9			3.1	2.4	3.6	1.1	0.5	0.2		0.2	1.1	
Identified net debt-creating flows	6.1	4.7	0.7			4.3	3.6	2.9	2.4	2.4	2.4		1.2	1.0	
Non-interest current account deficit	**9.0**	**5.3**	**3.7**	**5.9**	**2.2**	**5.1**	**4.8**	**4.1**	**3.8**	**4.0**	**4.0**		**2.6**	**2.1**	2.5
Deficit in balance of goods and services	14.7	11.1	8.7			10.1	9.5	9.0	9.0	9.1	9.1		7.7	7.4	
Exports	18.3	16.6	14.5			15.7	16.5	16.9	17.3	17.4	17.4		17.4	15.6	
Imports	33.0	27.7	23.2			25.8	25.9	25.9	26.2	26.5	26.5		25.1	22.9	
Net current transfers (negative = inflow)	-5.7	-5.4	-4.6	-5.8	0.6	-4.4	-4.3	-4.2	-4.2	-4.1	-4.1		-4.0	-4.4	-4.1
of which: official	-0.1	-0.1	0.0			0.0	-0.1	0.0	0.0	0.0	0.0		0.0	0.0	
Other current account flows (negative = net inflow)	0.0	-0.4	-0.5			-0.5	-0.4	-0.7	-1.0	-1.1	-1.0		-1.1	-0.8	
Net FDI (negative = inflow)	**-1.2**	**-0.6**	**-0.5**	**-1.2**	**1.1**	**-0.6**	**-0.7**	**-0.7**	**-0.7**	**-0.7**	**-0.7**		**-0.6**	**-0.6**	-0.6
Endogenous debt dynamics 2/	**-1.6**	**0.0**	**-2.5**			**-0.3**	**-0.5**	**-0.5**	**-0.7**	**-0.9**	**-0.9**		**-0.7**	**-0.5**	
Contribution from nominal interest rate	1.4	1.5	1.5			1.7	1.9	2.2	2.3	2.3	2.3		2.3	2.2	
Contribution from real GDP growth	-1.4	-2.0	-2.2			-2.0	-2.4	-2.7	-3.0	-3.2	-3.2		-3.1	-2.8	
Contribution from price and exchange rate changes	-1.6	0.5	-1.8			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	**1.1**	**0.3**	**1.2**			**-1.2**	**-1.1**	**0.6**	**-1.3**	**-2.0**	**-2.2**		**-1.0**	**0.1**	
of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	40.8			44.0	46.3	49.6	50.4	50.9	51.1		52.9	48.3	
In percent of exports	...	...	281.7			280.3	281.2	294.0	292.1	292.0	293.4		303.4	310.2	
PV of PPG external debt	**...**	**...**	**23.7**			**25.9**	**31.4**	**32.3**	**29.1**	**25.6**	**24.3**		**19.9**	**15.6**	
In percent of exports	**...**	**...**	**163.8**			**165.4**	**191.1**	**191.4**	**168.5**	**146.9**	**139.6**		**114.0**	**100.1**	
In percent of government revenues	**...**	**...**	**129.5**			**133.5**	**155.6**	**157.8**	**144.3**	**127.2**	**119.7**		**95.2**	**72.0**	
Debt service-to-exports ratio (in percent)	**68.8**	**50.8**	**60.7**			**59.2**	**39.6**	**75.8**	**85.1**	**87.0**	**64.5**		**66.1**	**74.0**	
PPG debt service-to-exports ratio (in percent)	**16.3**	**7.6**	**9.0**			**16.5**	**19.9**	**26.2**	**25.6**	**24.9**	**13.1**		**12.6**	**10.9**	
PPG debt service-to-revenue ratio (in percent)	**15.5**	**6.8**	**7.1**			**13.3**	**16.2**	**21.6**	**22.0**	**21.6**	**11.2**		**10.5**	**7.9**	
Total gross financing need (Billions of U.S. dollars)	14.6	11.8	14.2			18.5	18.6	23.7	29.6	37.3	40.9		71.9	148.2	
Non-interest current account deficit that stabilizes debt ratio	1.7	0.3	1.8			2.0	2.4	0.5	2.7	3.5	3.8		2.3	1.1	
Key macroeconomic assumptions															
Real GDP growth (in percent)	5.4	5.7	5.9	5.2	2.2	4.9	5.7	6.0	6.2	6.5	6.5	6.0	6.0	6.0	6.0
GDP deflator in US dollar terms (change in percent)	5.9	-1.5	4.6	5.3	6.3	1.0	5.0	2.2	1.6	2.1	2.6	2.4	2.6	2.6	2.6
Effective interest rate (percent) 5/	5.3	4.1	4.0	3.2	1.2	4.2	4.4	5.0	4.8	4.7	4.6	4.6	4.6	4.8	4.6
Growth of exports of G&S (US dollar terms, in percent)	2.5	-5.4	-3.5	6.2	11.5	14.6	16.5	10.9	10.5	9.7	9.2	11.9	7.3	7.9	8.0
Growth of imports of G&S (US dollar terms, in percent)	10.9	-12.7	-7.0	8.2	14.4	17.4	11.8	8.0	9.4	10.1	8.9	10.9	7.7	7.9	7.7
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	10.3	4.2	9.2	22.7	22.5	18.3	14.5	13.9	9.5	11.5
Government revenues (excluding grants, in percent of GDP)	19.3	18.7	18.3			19.4	20.2	20.4	20.2	20.1	20.3		20.9	21.6	21.0
Aid flows (in Billions of US dollars) 7/	0.3	0.3	0.3			1.1	1.7	1.5	1.3	1.3	1.3		1.9	3.6	
of which: Grants	0.3	0.3	0.3			0.3	0.4	0.5	0.5	0.5	0.6		0.8	1.8	
of which: Concessional loans	...	...	...			0.8	1.2	1.0	0.9	0.8	0.8		1.1	1.8	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			1.0	0.9	1.1	1.1	1.0	0.9		0.8	0.6	0.7
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			17.0	9.0	15.8	34.5	35.3	32.3		27.5	26.0	25.7
Memorandum items:															
Nominal GDP (Billions of US dollars)	61.4	64.0	70.9			75.1	83.3	90.3	97.4	105.9	115.6		175.9	408.4	
Nominal dollar GDP growth	11.5	4.2	10.7			5.9	11.0	8.3	7.9	8.7	9.2	8.5	8.8	8.8	8.8
PV of PPG external debt (in Billions of US dollars)			16.7			19.5	25.8	28.6	27.9	26.8	27.8		34.5	62.9	
(PVt-PVt-1)/GDPt-1 (in percent)						4.0	8.4	3.3	-0.8	-1.1	0.9	2.5	0.9	0.9	1.0
Gross workers' remittances (Billions of US dollars)	1.4	1.6	1.7			1.9	2.0	2.2	2.3	2.5	2.7		4.1	10.3	
PV of PPG external debt (in percent of GDP + remittances)	...	...	23.2			25.3	30.7	31.5	28.4	25.0	23.7		19.4	15.2	
PV of PPG external debt (in percent of exports + remittances)	...	...	140.0			142.7	166.5	167.4	147.9	129.3	123.1		100.5	86.1	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	7.7			14.3	17.4	22.9	22.5	21.9	11.5		11.1	9.4	

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, 2017–37

(Percent)

	Projections							
	2017	2018	2019	2020	2021	2022	**2027**	2037
PV of debt-to GDP ratio								
Baseline	26	31	32	29	26	24	**20**	16
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	26	32	33	31	29	28	**32**	41
A2. New public sector loans on less favorable terms in 2017-2037 2	26	33	35	33	30	29	**27**	25
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	26	32	33	30	27	25	**21**	16
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	26	34	39	36	32	31	**24**	16
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	26	33	35	31	28	26	**21**	17
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	26	31	31	28	24	23	**19**	15
B5. Combination of B1-B4 using one-half standard deviation shocks	26	34	38	34	30	29	**23**	17
B6. One-time 30 percent nominal depreciation relative to the baseline in 2018 5/	26	43	44	40	35	34	**27**	21
PV of debt-to-exports ratio								
Baseline	165	191	191	169	147	140	**114**	100
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	165	195	198	180	164	162	**186**	261
A2. New public sector loans on less favorable terms in 2017-2037 2	165	202	209	189	171	166	**154**	164
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	165	188	188	165	145	137	**112**	98
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	165	253	337	301	269	256	**202**	150
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	165	188	188	165	145	137	**112**	98
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	165	186	182	160	140	133	**109**	97
B5. Combination of B1-B4 using one-half standard deviation shocks	165	227	269	239	211	201	**161**	130
B6. One-time 30 percent nominal depreciation relative to the baseline in 2018 5/	165	188	188	165	145	137	**112**	98
PV of debt-to-revenue ratio								
Baseline	133	156	158	144	127	120	**95**	72
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	133	159	164	154	142	139	**155**	187
A2. New public sector loans on less favorable terms in 2017-2037 2	133	164	172	162	148	142	**129**	118
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	133	157	163	150	132	125	**99**	75
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	133	168	192	179	161	152	**117**	75
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	133	162	169	155	137	129	**102**	77
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	133	151	150	137	121	114	**91**	70
B5. Combination of B1-B4 using one-half standard deviation shocks	133	166	184	170	152	143	**111**	77
B6. One-time 30 percent nominal depreciation relative to the baseline in 2018 5/	133	214	217	198	176	165	**131**	99

Table 2. Kenya: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2017–37 (concluded)

(Percent)

Debt service-to-exports ratio								
Baseline	17	20	26	26	25	13	**13**	11
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	17	20	26	25	24	13	**15**	21
A2. New public sector loans on less favorable terms in 2017-2037 2	17	20	17	14	14	13	**14**	14
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	17	20	26	26	25	13	**13**	11
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	17	25	39	40	39	21	**23**	18
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	17	20	26	26	25	13	**13**	11
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	17	20	26	25	25	13	**12**	11
B5. Combination of B1-B4 using one-half standard deviation shocks	17	23	34	34	33	18	**18**	15
B6. One-time 30 percent nominal depreciation relative to the baseline in 2018 5/	17	20	26	26	25	13	**13**	11
Debt service-to-revenue ratio								
Baseline	13	16	22	22	22	11	**11**	8
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2017-2037 1/	13	16	21	21	21	11	**12**	15
A2. New public sector loans on less favorable terms in 2017-2037 2	13	16	14	12	12	11	**12**	10
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2018-2019	13	17	23	23	23	12	**11**	8
B2. Export value growth at historical average minus one standard deviation in 2018-2019 3/	13	16	22	24	23	13	**13**	9
B3. US dollar GDP deflator at historical average minus one standard deviation in 2018-2019	13	17	24	24	24	12	**11**	9
B4. Net non-debt creating flows at historical average minus one standard deviation in 2018-2019 4/	13	16	22	22	21	11	**10**	8
B5. Combination of B1-B4 using one-half standard deviation shocks	13	17	23	24	24	13	**13**	9
B6. One-time 30 percent nominal depreciation relative to the baseline in 2018 5/	13	23	30	31	30	16	**15**	11
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	6	6	6	6	6	6	**6**	6

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 the shock (implicitly 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, 2014–37

(Percent of GDP, unless otherwise indicated)

	Actual					Estimate	Projections								
	2014	2015	2016	Average 5/	Standard Deviation 5/	2017	2018	2019	2020	2021	2022	2017-22 Average	2027	2037	2023-37 Average
Public sector debt 1/	48.6	51.4	53.2			58.0	63.2	62.9	60.0	57.5	56.3		50.2	43.7	
of which: foreign-currency denominated	23.5	25.7	26.4			28.5	34.1	35.2	32.3	28.8	27.5		23.0	18.3	
Change in public sector debt	4.6	2.9	1.8			4.8	5.3	-0.4	-2.8	-2.6	-1.2		-0.8	-0.5	
Identified debt-creating flows	2.9	3.7	1.8			5.1	1.2	-0.8	-1.8	-2.2	-2.0		-1.2	-0.1	
Primary deficit	4.6	4.7	4.9	2.7	1.6	4.8	2.6	0.5	-0.4	-0.4	-0.1	1.2	0.7	1.8	0.9
Revenue and grants	19.8	19.1	18.7			19.9	20.7	21.0	20.7	20.6	20.8		21.3	22.1	
of which: grants	0.5	0.5	0.4			0.4	0.5	0.5	0.5	0.5	0.5		0.5	0.4	
Primary (noninterest) expenditure	24.3	23.9	23.6			25.1	24.1	22.6	21.8	21.6	21.6		22.2	23.9	
Unidentified Measures						0.3	0.8	1.1	1.5	1.3	0.9		0.2	0.0	
Automatic debt dynamics	-1.7	-1.1	-3.1			0.0	-1.3	-1.2	-1.4	-1.8	-1.9		-1.9	-1.9	
Contribution from interest rate/growth differential	-1.5	-2.0	-1.6			0.0	-1.0	-1.3	-1.5	-1.6	-1.7		-1.6	-1.7	
of which: contribution from average real interest rate	0.8	0.7	1.3			2.5	2.1	2.3	2.2	2.0	1.8		1.3	0.8	
of which: contribution from real GDP growth	-2.2	-2.6	-2.9			-2.5	-3.1	-3.6	-3.7	-3.6	-3.5		-2.9	-2.5	
Contribution from real exchange rate depreciation	-0.2	0.9	-1.5			0.0	-0.3	0.1	0.1	-0.2	-0.2		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			0.3	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		...	...	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.3	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	1.7	-0.8	0.0			-0.4	4.0	0.4	-1.0	-0.4	0.8		0.4	-0.4	
Other Sustainability Indicators															
PV of public sector debt	...	...	50.6			55.4	60.6	59.9	56.9	54.3	53.1		47.1	41.0	
of which: foreign-currency denominated	...	...	23.7			25.9	31.4	32.3	29.1	25.6	24.3		19.9	15.6	
of which: external	...	...	23.7			25.9	31.4	32.3	29.1	25.6	24.3		19.9	15.6	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	18.9	17.4	18.3			20.6	19.6	18.4	17.0	16.9	15.3		14.9	13.9	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	270.1			278.6	292.0	285.7	275.3	263.4	255.5		221.0	185.7	
PV of public sector debt-to-revenue ratio (in percent)	...	...	275.9			285.0	299.6	292.9	282.1	269.7	261.5		226.0	189.6	
of which: external 3/	...	...	129.5			133.5	155.6	157.8	144.3	127.2	119.7		95.2	72.0	
Debt service-to-revenue and grants ratio (in percent) 4/	39.6	32.5	35.5			41.7	43.7	48.2	48.1	47.8	36.7		32.3	24.0	
Debt service-to-revenue ratio (in percent) 4/	40.6	33.3	36.3			42.7	44.8	49.4	49.3	48.9	37.6		33.1	24.5	
Primary deficit that stabilizes the debt-to-GDP ratio	0.0	1.9	3.1			0.1	-2.7	0.8	2.5	2.2	1.1		1.5	2.2	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	5.4	5.7	5.9	5.2	2.2	4.9	5.7	6.0	6.2	6.5	6.5	6.0	6.0	6.0	6.0
Average nominal interest rate on forex debt (in percent)	2.4	2.6	3.1	1.8	0.7	3.7	4.6	4.6	4.2	4.0	4.0	4.2	3.9	4.3	4.1
Average real interest rate on domestic debt (in percent)	2.8	1.4	3.5	2.0	3.8	8.2	5.4	5.3	5.7	5.4	4.5	5.7	2.9	1.4	2.5
Real exchange rate depreciation (in percent, + indicates depreciation)	-1.2	3.9	-6.2	-2.6	7.5	0.1	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	8.1	10.0	8.1	8.9	3.6	2.7	5.3	5.8	5.3	5.1	5.1	4.9	5.1	5.1	5.1
Growth of real primary spending (deflated by GDP deflator, in percent)	12.8	3.6	4.8	2.2	4.1	11.3	1.6	-0.6	2.4	5.5	6.8	4.5	6.6	6.5	6.7
Grant element of new external borrowing (in percent)	...	...	...	...	...	10.3	4.2	9.2	22.7	22.5	18.3	14.5	13.9	9.5	...

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, 2017–37
(Percent)

	Projections							
	2017	2018	2019	2020	2021	2022	2027	2037
PV of Debt-to-GDP Ratio								
Baseline	55	61	60	57	54	53	47	41
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	55	61	63	63	64	66	71	76
A2. Primary balance is unchanged from 2017	55	63	67	69	71	75	88	104
A3. Permanently lower GDP growth 1/	55	62	63	61	61	61	60	68
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2018-2019	55	63	67	66	66	66	65	66
B2. Primary balance is at historical average minus one standard deviations in 2018-2019	55	62	65	64	62	61	56	49
B3. Combination of B1-B2 using one half standard deviation shocks	55	62	66	65	64	64	61	59
B4. One-time 30 percent real depreciation in 2018	55	73	73	71	69	69	64	59
B5. 10 percent of GDP increase in other debt-creating flows in 2018	55	71	71	69	68	67	60	52
PV of Debt-to-Revenue Ratio 2/								
Baseline	279	292	286	275	263	255	221	186
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	279	294	300	307	312	318	334	342
A2. Primary balance is unchanged from 2017	279	304	319	335	347	360	410	470
A3. Permanently lower GDP growth 1/	279	297	298	298	294	293	283	308
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2018-2019	279	306	318	320	318	318	307	298
B2. Primary balance is at historical average minus one standard deviations in 2018-2019	279	300	311	308	301	296	262	220
B3. Combination of B1-B2 using one half standard deviation shocks	279	301	313	313	309	307	287	266
B4. One-time 30 percent real depreciation in 2018	279	350	347	343	336	331	300	266
B5. 10 percent of GDP increase in other debt-creating flows in 2018	279	342	340	336	328	322	283	235
Debt Service-to-Revenue Ratio 2/								
Baseline	42	44	48	48	48	37	32	24
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	42	44	49	50	52	43	45	44
A2. Primary balance is unchanged from 2017	42	44	49	51	54	46	53	58
A3. Permanently lower GDP growth 1/	42	44	49	50	51	40	39	38
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2018-2019	42	45	51	52	53	43	42	38
B2. Primary balance is at historical average minus one standard deviations in 2018-2019	42	44	49	50	51	41	37	29
B3. Combination of B1-B2 using one half standard deviation shocks	42	44	50	51	52	42	40	34
B4. One-time 30 percent real depreciation in 2018	42	47	58	60	61	47	46	39
B5. 10 percent of GDP increase in other debt-creating flows in 2018	42	44	52	55	55	45	40	31

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.

INTERNATIONAL MONETARY FUND

KENYA

May 31, 2018

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION AND ESTABLISHMENT OF PERFORMANCE CRITERIA FOR THE SECOND REVIEW UNDER THE STAND-BY ARRANGEMENT—INFORMATIONAL ANNEX

Prepared By

The African Department
(In Consultation with Other Departments)

CONTENTS

RELATIONS WITH THE FUND

(As of March 31, 2018)

Membership Status: Joined: February 03, 1964; Article VIII

General Resources Account:	**SDR Million**	**Percent Quota**
Quota	542.8	100.00
Fund holdings of currency (Exchange Rate)	529.49	97.55
Reserve Tranche Position	13.40	2.47

SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	259.65	100.00
Holdings	18.24	7.02

Outstanding Purchases and Loans:	**SDR Million**	**Percent Quota**
ESF RAC Loan	40.71	7.50
ECF Arrangements	423.79	78.08

Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Mar 14, 2016	Sep 14, 2018	709.26	0.00
SCF [1]	Mar 14, 2016	Mar 13, 2018	354.63	0.00
Stand-By	Feb 02, 2015	Mar 14, 2016	352.82	0.00

Projected Payments to Fund [2] (SDR Million, based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2018	2019	2020	2021	2022
Principal	92.41	111.27	97.70	91.19	50.34
Charges/Interest	1.53	2.07	2.06	2.06	2.06
Total	**93.94**	**113.35**	**99.76**	**93.25**	**52.40**

Implementation of HIPC Initiative: Not Applicable

Implementation of Multilateral Debt Relief Initiative (MDRI): Not Applicable

Implementation of Post-Catastrophe Debt Relief (PCDR): Not Applicable

[1] Formerly PRGF.

[2] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Safeguards Assessments:

An update safeguards assessment of the Central Bank of Kenya (CBK) was completed in May 2015 with respect to the SBA/SCF approved on February 2, 2015. The assessment found that the CBK continues to maintain effective operational controls. In line with an IMF program structural benchmark, the CBK submitted a new central bank Act to parliament that broadly addresses issues identified in previous safeguards assessments and strengthens the bank's autonomy. The governance gap was also addressed following the appointment of new non-executive Board members.

Exchange Rate Arrangement:

Kenya's currency is the Kenyan Shilling. Kenya's de jure exchange rate arrangement is free floating and its de facto exchange rate arrangement is classified as stabilized. The official exchange rate, which is set at the previous day's average market rate, applies only to government and government-guaranteed external debt-service payments and to government imports for which there is a specific budget allocation. On April 18, 2018, the exchange rate was KSh100.4028 =US$1.00.

Kenya accepted the obligations of Article VIII, Sections 2, 3, and 4 of the IMF Articles of Agreement with effect from June 30, 1994, and maintains an exchange system free of restrictions on payments and transfers for current international transactions, other than restrictions notified to the Fund under Decision No. 144 (52/51).

Article IV Consultation:

The last Article IV consultation with Kenya concluded on September 22, 2014. The next Article IV consultation with Kenya is expected to take place on a 24-month cycle,

FSAP Participation:

A joint IMF/WB mission assessed Kenya's financial sector as part of the Financial Sector Assessment Program (FSAP) update during September 2009. The staff report on the Financial Sector Stability Assessment was issued to the Executive Board concurrently with the 2009 Article IV Consultation Staff Report.

Technical Assistance:

Technical assistance activities provided to Kenya since 2015 are listed in next page.

Resident Representative:
Mr. Jan Mikkelsen, since August 2017.

Technical Assistance, 2015–18

	Year of Delivery
Fiscal Affairs Department (FAD)	
Revenue administration (extractive industries)	2018
Public Investment Management assessment	2018
Strengthening the medium-term approach to budgeting	2018
Revenue administration gap analysis	2017–18
Cash management and Treasury Single Account	2017
AFRITAC East: Improving coverage/quality of fiscal reporting	2017
Improving the integrity of the taxpayer database	2017
Workshop on fiscal decentralization and public investment management	2017
Improving monitoring and evaluation of public investments	2017
International corporate taxation	2017
Tax administration	2016
AFRITAC East: Improving the coverage and quality of fiscal reporting	2016
AFRITAC East: Developing a framework for public investment management	2016
AFRITAC East: Debt sustainability analysis and fiscal risk reporting	2016
AFRITAC East: Framework and guidelines for monitoring and managing compliance	2016
Natural resource management	2016
Monetary and Capital Markets Department (MCM)	
Training on risk-based supervision for market intermediaries	2017
Supervisory review process training	2017
Central Bank Procurement and Governance	2017
AFRITAC East: Developing an integrated supervisory framework	2016
Bank supervision and regulations	2016
AFRITAC East: Assessment of financial market infrastructure and payments	2016
AFRITAC East: Developing an in-house training program on consolidated supervision	2016
AFRITAC East: Several medium-term debt management strategy	2016
AFRITAC East: Several missions on consolidated supervision	2015–16
Joint AFRITAC East and MCM: TA needs assessment	2015–16
Bank stress testing	2015
Legal Department (LEG)	
AML/CFT supervision and FIU	2016
FIU/CMA AML/CFT structures and tools	2016
Review of AML/CFT and Project assessment documents	2015
Tax legislation	2015
Natural Resources Law	2015
Statistics Department (STA)	
Government finance statistics	2017–18
AFRITAC East: Several missions on National Accounts	2017–16
Statistical data management	2017
e-GDDS	2017
AFRITAC East: Price Statistics (XMPIs, PPI, construction, consumer)	2017–16
Monetary and financial statistics	2017
Balance of payments statistics	2016
Balance of payments statistics- IIP development	2016
AFRITAC East: Support GFDM2001/14 implementation migration plan	2016–15
AFRITAC East: Mission on Quarterly National Accounts	2015
AFRITAC East: EAC GFS	2015

STATISTICAL ISSUES

(as of May 1, 2018):

I. Assessment of Data Adequacy for Surveillance

General: Data provision is broadly adequate for surveillance and program monitoring, although it has some shortcomings because of capacity constraints. Although the overall quality, timeliness and coverage of macroeconomic statistics have improved over the past few years, further improvements in the methodology of compiling real, fiscal, and external sector statistics would be desirable to facilitate enhanced design and monitoring of economic policies.

National Accounts: The Kenya National Bureau of Statistics (KNBS) has made significant efforts to enhance national statistics compilation. The East AFRITAC statistics advisor assisted with improving and rebasing the annual and quarterly national accounts estimates at current and constant (from 2001 to 2009) prices, and developing 2009 supply and use tables (SUTs) to better anchor the annual GDP estimates, along with other methodological changes. Improved source data and the balancing of economic flows via the SUTs resulted in improved coverage and more robust estimates. Rebased GDP and revised GDP for 2006–13 were published in September 2014. The difference between old and new base was 20.5 percent. SUT for 2009 for Kenya were published in the Economic Survey 2014 report (April 2014). The SUT provided a basis for development of the Input-Output Tables (IOT) and the Social Accounting Matrix (SAM), which were published in the Economic survey 2015 (April 2015). The KNBS is participating in the Quarterly National Accounts (QNA) Statistics Module of the IMF-U.K. Department for International Development (DFID). However, the 2009 base year will soon become outdated. The authorities are currently developing a time series with a contemporary base year (2016) and expect to release these data by December 2019. The authorities also publish a quarterly GDP time series in both current and constant prices. Inadequate staff resources continue to be a challenge to implementation of improvements identified during technical assistance.

Price Statistics: The CPI for Kenya is compiled using weights derived from the 2005/06 Kenya Integrated Household Budget Survey (KIHBS) and therefore unlikely to be representative of current expenditure patterns. The KNBS should prioritize the updating of the CPI using expenditures from the 2015/16 KIHBS.

Government Finance Statistics (GFS): East AFRITAC (AFE) collaborates closely with the EAC Secretariat through a capacity building program to support efforts to improve compilation and dissemination of government finance statistics (GFS) and Public-Sector Debt Statistics (PSDS) based on the Government Finance Statistics Manual 2014 (GFSM 2014) to achieve the fiscal data requirements associated with the East African Monetary Union (EAMU) Protocol. A series of AFE GFS and PSDS TA missions are taking place to further support efforts to improve fiscal data.

While GFS is reported at General Government (GG) level, future work will aim to reduce discrepancies, improve stock data, and the quality of GG data. The authorities committed to compiling and disseminating high-frequency Budgetary Central Government (BCG) data by end-2018. Process of extending coverage to public corporations is in initial stages. Quarterly Public-Sector Debt is disseminated for certain elements of BCG, but data is reported at face value and not nominal value.

Monetary and Financial Statistics: Monetary and financial statistics are compiled broadly in line with the *Monetary and Financial Statistics Manual*. The CBK reports monetary and financial statistics monthly, using Standardized Report Forms (SRFs) for the central bank and other depository

corporations (ODCs), and monetary data based on these SRFs are published in the *International Financial Statistics*. The CBK has recently made progress: in expanding the coverage of ODCs data to include savings and credit cooperatives (SACCOs) and microfinance banks; and in developing other financial corporations (OFCs) data which comprises of insurance corporations and pension funds – those data are submitted for STA's review.
Financial sector surveillance: Kenya does not participate in the IMF's Coordinated Direct Investment Survey (CDIS) and the Coordinated Portfolio Investment Survey (CPIS). The CBK reports Financial Soundness Indicators (FSIs) on a quarterly basis which include 11 cored and 11 encouraged indicators for deposit takers. Data on the household debt to gross domestic product ratio is also reported. However, FSIs on other financial corporations and nonfinancial corporations are not reported.
External sector statistics: The KNBS compiles annual balance of payments statistics in Kenyan shillings that are regularly reported to STA. In addition, the Central Bank of Kenya (CBK) compiles a complete set of annual balance of payments statistics in U.S. dollars, which are reported to AFR and used for programming and surveillance purposes. The two datasets are not entirely consistent, and Fund staff has strongly encouraged the authorities to reconcile them. Although the overall quality of trade data may be reasonably good, data for other current account and many financial account transactions are rather weak and there is a need to lower large errors and omissions. The financial account is largely drawn from the International Transactions Reporting System (ITRS), which suffers from a large and growing element of unclassified inflows and outflows that might well include settlements of current account transactions. The last TA mission on ESS, conducted in October 2016, assisted the KNBS in developing a preliminary IIP statement. However, no IIP data have been disseminated yet. The mission also reviewed the 2016 FIS. Past data should be revised with the latest FIS results as they involve a broader coverage of statistical units than the other data sources such as the ITRS. The KNBS identified priority actions to harmonize some goods and service components of their ESS in the context of the EAC initiative supported by the UK DFID II-module. The first action is to conduct a survey of importers and exporters in 2016/17 to obtain freight and insurance data separately for trade with EAC partners to facilitate comparisons with partner countries data. Another action refers to harmonizing informal trade estimates through the adoption of common methodology for the informal cross border trade (ICBT) with the help of EAC.
II. Data Standards and Quality
Kenya participates in the Enhanced General Data Dissemination System and the EDDI2 TA project financed by DFID. A Data ROSC was conducted in October 2005.
III. Reporting to STA
The data for the General Government is reported to STA in *GFSM 2014* format and disseminated in the *GFS Yearbook*. Monthly and quarterly GFS data are regularly reported for inclusion in the *International Financial Statistics (IFS)*. Monetary data for the central bank and ODCs are regularly reported for inclusion in the *IFS*. Annual balance of payments data, following *BPM6* classifications, are regularly reported to STA.

Common Indicators Required for Surveillance					
	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication
Exchange rate	4/30/2018	5/1/2018	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	2/28/2018	3/27/2018	M	M	NA
Reserve/Base Money	1/25/2018	1/26/2018	D	M	NA
Broad Money	1/25/2018	1/26/2018	D	M	NA
Central Bank Balance Sheet	1/25/2018	1/26/2018	D	M	NA
Consolidated Balance Sheet of the Banking System	12/31/2016		A	A	A
Interest Rates[2]	4/26/18	4/27/2018	D	D	NA
Consumer Price Index	4/30/18	4/30/2018	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]— General Government[4]	NA	NA	NA	NA	NA
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	3/31/2018	4/16/2018	M	M	NA
Stocks of Central Government and Central Government-Guaranteed Debt[5]	6/30/2017	1/26/2018	A	A	NA
External Current Account Balance	12/31/2017	2/12/2018	M	M	NA
Exports and Imports of Goods and Services	12/31/2017	2/12/2018	M	M	M
GDP/GNP	12/31/2017 (A) 12/31/2017(Q)	4/26/2018 4/26/2018	Q,A	Q,A	Q,A
Gross External Debt	NA	NA	NA	NA	NA
International Investment Position[6]	NA	NA	NA	NA	NA

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic-bank, and domestic non-bank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).

JOINT WORLD BANK-FUND WORK PROGRAM, 2018

Title	Products	Provisional timing of missions (if relevant)	Expected delivery date
A. Mutual information on relevant work programs			
Key elements of World Bank work program in next 12 months	Kenya economic update (bi-annually)		October 2018
	The World Bank is providing technical assistance in support of a Comprehensive Public Expenditure Review (PER) process in Kenya with government.		December 2018
	Governance and public sector (including PFM)		Ongoing
	County Own Source Revenue Technical Assistance.		September 2018
	IDA Catastrophe Deferred Drawdown Option (CAT DDO): A Disaster Risk Management Development Policy Operation ($200 million).		June 2018
	Development Policy Lending		Ongoing
	Kenya Poverty and Gender Assessment		August 2018
	Oil and gas management (including revenue management)		Ongoing
	Technical Assistance in boosting Competitiveness of the Private Sector		Ongoing
	Infrastructure/PPP project		Ongoing
	Second review under the SBA	July 2018	September 2018
	2019 Article IV	February 2019	May 2019

B. Requests for work program inputs			
Fund requests to Bank	1. Assessment of key infrastructure projects and sectoral programs.		Continuous
	2. Inputs on the design of a social protection framework.		Continuous
	3. Inputs on sources of growth for private sector development and job creation.		Continuous
Bank requests to Fund	1. Monitoring of government contracting of non-concessional borrowing.		Continuous
	3. Sharing macro-framework updates.		Continuous
	4. Statement of fiscal risk and contingent liabilities.		Continuous
C. Agreement on joint products and missions			
Joint products in next 12 months	1. Collaborate on a joint DSA		ongoing
	2. Enhancing PFM systems at national and sub-national level		ongoing
	3. Support to development of regulatory framework, fiscal regime, and macro-fiscal management for oil and gas		ongoing

Statement by the Executive Director, Mr. Maxwell M. Mkwezalamba, and by the Senior Advisor of the Executive Director Mr. Ted Sitima-wina on Kenya
June 13, 2018

Introduction

1. The Kenyan authorities appreciate the constructive policy dialogue during the recent Article IV consultations and program negotiations that led to the extension of the Stand-By Arrangement (SBA) to September 14, 2018. The arrangement remains instrumental in anchoring the macroeconomic policy framework and backstopping the foreign exchange reserve buffers. The authorities broadly concur with the staff assessment and conclusions.

2. Kenya has maintained robust economic growth averaging 5.5 percent for nearly a decade, and poverty has significantly reduced. The medium-term growth prospects remain favorable. To realize the full growth potential and continue reducing poverty, the authorities intend to address the remaining bottlenecks through focusing on *The Big Four Plan*. The Plan builds on the gains achieved under the Economic Transformation Agenda, which has been under implementation since 2014. It tilts the focus of the government's economic development agenda in the next five years to the manufacturing sector, provision of affordable housing, universal affordable health care, and food security.

3. The authorities are conscious of the limited fiscal space and will therefore leverage on partnerships with the private sector. In this context, they reiterate their commitment to a sustainable fiscal policy path that will aim to enhance domestic revenue mobilization, rationalize expenditures, and reverse the recent upward debt trajectory. They are also working towards significantly modifying the interest rate controls introduced in September 2016.

Establishment of Performance Criteria for the SBA Arrangement

4. With respect to the extended SBA, the authorities look forward to the Executive Board's approval of new end-June 2018 quantitative performance criteria (QPCs), indicative targets, a monetary policy consultation clause (MPCC), and structural benchmarks (SBs) for end-August 2018, as proposed in the staff report. The new performance criteria have been necessitated by the extension of the SBA program, which rendered the previous ones obsolete for the second review of the program. The extension provides the authorities more time to work towards the objectives of the program, including meeting the SBs by end August 2018, and reducing vulnerabilities.

Recent Economic Developments and Outlook

5. Real GDP growth remains strong and, for nearly a decade, Kenya has registered growth rates exceeding 5 percent, supported by agricultural production, tourism, public investments in infrastructure, rapid increase in financial inclusion, and significant improvements in the business environment. However, in 2017, growth slowed down to 4.9 percent, from 5.9 percent in 2016. This was attributed to a contraction in agriculture due to a drought in late 2016 to early 2017, the extended election period, and a weak credit growth. Growth is expected to rebound to 5.7 percent in 2018 and exceed 6 percent in the medium term. This will be supported by favorable weather conditions that would boost agricultural output, positive supply effects from the completed Standard Gauge Railway linking Mombasa and Nairobi, continued strong expansion in the construction and electricity sectors, and a strong recovery in tourism.

6. Following a sharp rise in food prices due to the drought that pushed headline inflation above the target range (5 ± 2.5 percent) starting in February 2017, inflation decelerated to 3.7 percent in April 2018, from a peak of 11.7 percent in May 2017. Food inflation fell to pre-drought levels in July 2017, bringing inflation within the target range. Since December 2017, inflation has been below the mid-point of the target, and it is expected to remain within the authorities’ target range in the near to medium-term.

7. Kenya’s external positions remain stable, notwithstanding the widening of the current account deficit to 6.8 percent of GDP in 2017, from 5.2 percent in 2016. This development is largely explained by higher food and fuel imports during the drought and rising global oil prices. Over the medium term, the current account deficit is projected to narrow owing to high tea, coffee, and horticulture exports, coupled with strong remittance inflows and higher tourism earnings.

Medium Term Policies

8. To sustain the robust investment-driven inclusive growth into the medium term, our authorities will pursue an appropriate mix of fiscal and monetary policies, supported by an array of far reaching structural reforms, including enhancing public financial management (PFM) and further improving the business environment and governance.

Fiscal Policy and Public Financial Management

9. Over the medium term, our authorities are committed to sustain a gradual fiscal consolidation and ensure that public debt remains sustainable without compromising social expenditures. While the 2016/17 fiscal deficit was 2.3 percent of GDP higher than the program target due to a combination of factors, including higher-than-programmed foreign-financed investment, lower tax revenues, drought, and election related expenditures, they are determined to ensure that the 2017/18 fiscal deficit is within the 7.5 percent of GDP target and 5.7 percent in 2018/19 fiscal year. Consistent with the fiscal consolidation

objective, the authorities plan to put in place additional revenue and expenditure measures. Expenditure measures will largely focus on cutting low priority spending, including domestically financed development projects. Priority social spending, including for free primary and secondary school education, will be preserved. To help reduce inequality, allocations to facilitate expansion of access to healthcare and promote housing for low income groups will be made. On the revenue side, tax measures will include removal of the VAT exemption on petroleum imports; removal of various VAT and CIT exemptions; and expanding taxes on betting to cover both operator profits and winnings. The authorities expect that these and other planned measures would yield more than 1 percent of GDP in additional revenues. The impending income tax bill is also expected to boost revenue collection and enhance tax administration.

10. The envisaged pace of fiscal deficit reduction is expected to support private sector growth, as well as bring the country closer to the East African Monetary Union deficit ceiling of 3 percent of GDP by 2020/21. The need to finance public investments to address infrastructure gaps contributed to the recent increase in public debt. That said, our authorities are determined to ensure that debt returns on a downward trajectory. In this respect, they continue to strengthen capacity in debt management and evaluation of Public Private Partnership (PPP) proposals.

11. In addition, the authorities will implement further PFM reforms to strengthen expenditure controls and increase transparency. These will include automation of the release of funds through the exchequer account to prevent the accumulation of pending bills, and operationalization of a centralized payment system to ensure better control of public expenditure. They will also clarify fiscal rules and standardize guidelines for project appraisal and selection to improve the efficiency of public investment projects.

Monetary and Exchange Rate Policies, and Financial Sector Issues

12. The Central Bank of Kenya (CBK) remains committed to achieving and maintaining price stability. In this regard, they aim to keep headline inflation around the midpoint of the target range. On the exchange rate, they reiterate their adherence to a flexible exchange rate regime, and limiting foreign exchange interventions to addressing volatility.

13. The authorities are also committed to strengthening the monetary policy framework and underscore their intention to establish an interest rate corridor after the interest rate controls have been modified. The interest rate controls, which were primarily aimed at reducing the cost of borrowing and increasing the return on savings, have constrained the conduct of monetary policy and weakened the link between the central bank rate (CBR) and commercial bank lending and deposit rates. In this regard, the authorities concur that significantly modifying the interest rate controls is key for transitioning to an interest-rate based monetary policy framework.

14. Kenya's financial sector remains stable despite the recent reduction in bank profits and an increase in non-performing loans (NPLs) from 9.6 percent in April 2017 to 12.4 percent in April 2018. To safeguard financial sector stability, our authorities will continue to strengthen the supervisory framework, enhance specialized on-site inspections of banks' ICT systems, and ensure implementation of International Financial Reporting Standards (IFRS) 9. In addition, they will continue to implement remedial plans for banks that are not compliant with capital and liquidity ratios, and will, in this context, support the recapitalization plans of the two government-owned banks.

15. Furthermore, the authorities are making progress with Anti-Money Laundering/Combatting Financing of Terrorism (AML/CFT) reforms. In this regard, Kenya's financial supervisors are working towards developing risk-based AML/CFT supervisory tools and enhancing the operations and procedures of the financial intelligence unit, which would strengthen anti-corruption efforts.

Structural Reforms and Data

16. Irrespective of the recent impressive achievement in strengthening the business environment, our authorities continue to implement structural reforms to further improve the business environment and remove any impediments to an investment-led inclusive growth. In the period 2016–18, Kenya significantly improved its ranking in the *World Bank Doing Business Indicators*, moving up a combined 33 places to 80. Notable improvements were on starting a business, protecting minority investors, resolving insolvency, and in overall competitiveness. Our authorities are also making considerable progress in improving macroeconomic statistics, including in government finance and balance of payments, and taking steps to address staffing challenges and overall capacity constraints.

Conclusion

17. Our authorities reiterate their commitment to further strengthening macroeconomic stability and enhancing the resilience of the economy. In this connection, they will pursue gradual fiscal consolidation that should bring public debt on a downward trajectory while preserving space for growth friendly public investment, including *The Big Four*. In parallel, they are working to modify interest rate controls that should improve the effectiveness of monetary policy, boost lending to the private sector, and support inclusive economic growth. They will also continue to sustain efforts towards maintaining low and stable inflation, further strengthening financial sector supervision and regulation, and deepening structural reforms.