

International Monetary Fund

[Kenya](#) and the IMF

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February 2, 2015

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

January 16, 2015

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

Letter of Intent

Nairobi, Kenya

January 16, 2015

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

Dear Ms. Lagarde:

1. Kenya is consolidating major institutional reforms following the launch of a devolved system of government—comprising both National and County Governments—as mandated by the 2010 Constitution. By increasing representation and public participation of all Kenyans in decision making, the ongoing process of devolving responsibilities to the 47 newly created counties is strengthening social cohesion, fostering shared growth and thereby promoting political stability. In addition, our economic program, supported by a three-year Extended Credit Facility during 2011-13, has contributed to strengthen macroeconomic stability. Growth has been strong, and Kenya has achieved low-middle income status; inflation has remained contained; our public debt position is sustainable; and fiscal and external buffers have been strengthened. Moreover, Kenya is becoming increasingly integrated into the global market. Our successful debut sovereign bond issue—the largest so far in Sub-Saharan Africa—reflects international investors’ recognition of Kenya as a frontier market, and their growing confidence in our reform efforts and economic outlook.

2. In line with our Vision 2030 Development Agenda and the Budget Policy Statement (BPS), we are committed to preserving a stable macro-economic and financial environment while continuing to implement our program of ambitious structural transformation. Our main objective is to promote more rapid and inclusive private sector-led growth, and to achieve stronger results in poverty reduction, while adhering to sustainable medium-term debt targets. We are improving our monetary policy framework and the prudential oversight of our financial sector. At the same time, we are strengthening our public finance management systems with a view to reducing fiscal risks and increasing transparency in government operations.

3. In this context, the government intends to use available fiscal space to scale up investments in human capital (including on health and education) and physical infrastructure, while at the same time providing sufficient resources to ensure the success of devolution. To increase food security, we plan to improve productivity in agriculture by expanding irrigation and reducing reliance on rain-fed agricultural production. Infrastructure investments will also address growth bottlenecks and contribute to a more competitive business environment that supports job creation. In particular, we plan to accelerate infrastructure investments in key areas, including the Standard Gauge Railway, a major project fostering regional integration; the upgrading of the port of Mombasa; the construction of new roads; and the expansion of renewable power generation capacity. And we are

investing in modernizing the security sector to protect our citizens and mitigate security-related risks. These measures should help ease the cost of doing business and contribute to a better business environment.

4. However, while these reforms and investments are under way, our economy remains vulnerable to exogenous shocks. Kenya's growing financial integration in global markets, while creating new financing opportunities, has increased vulnerabilities to shifts in investors' risk perceptions. The incidence of security threats and international terrorism affecting our country, and the increasing frequency of weather-related shocks, represent additional challenges.

5. While we are taking determined steps to address these vulnerabilities, to support the sustained implementation of our wide-ranging reforms and mitigate the impact of possible exogenous shocks, we request a blended program supported by Stand-By Arrangement (SBA) and Stand-By Credit Facility (SCF) with total access of SDR488.52 million (180 percent of quota) over the next 12 months, of which SDR352.82 million under the SBA and SDR135.70 million under the SCF. We do not have balance of payments needs under our baseline projections. Nonetheless, potential needs could materialize if major external, security or weather-related shocks were to hit our economy. Therefore we intend to treat both arrangements as precautionary, and we do not intend to draw under these arrangements unless exogenous shocks generate an actual balance of payments financing need. We expect to complete the first review of the program by July 2015 and the second review by January 2016.

6. In addition to providing a buffer against exogenous shocks, the envisaged program supported by SBA-SCF arrangements will provide a policy anchor for our comprehensive reform program. We believe that the policies set out in the attached Memorandum of Economic and Financial Policies (MEFP) will enable us to achieve our program objectives. However, we will take any further measures that may become necessary for this purpose.

7. We will consult with the IMF on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the IMF's policies on such consultations. We will provide such information as the IMF may request in connection with progress in implementing our economic and financial policies. We authorize the publication of the staff report for the request of the program supported by SBA-SCF arrangements, this letter of intent, and the attached MEFP and technical memorandum of understanding.

Sincerely yours,

/s/

Henry Rotich
Cabinet Secretary
The National Treasury

/s/

Njuguna Ndung'u
Governor
Central Bank of Kenya

Attachments:

Memorandum of Economic and Financial Policies
Technical Memorandum of Understanding

Attachment I: Memorandum of Economic and Financial Policies

I. BACKGROUND

1. Kenya is consolidating major institutional reforms. Following the adoption of a new Constitution in 2010, accountability at all levels of government is being enhanced. A key component of this reform effort is the devolution of previously centralized functions and public resources to the 47 newly-created counties. This process plays a major role in promoting political stability, ensuring adequate representation and public participation of all Kenyans in decision making, and improving the delivery of public services at the local level, under a strong governance framework. In particular, the roles of the National Treasury and Parliament have been redefined for a better oversight of public finances, with strict provisions on budget preparation, regular reporting to Parliament, stakeholder consultations, sharing of information with the public, and prudent public debt management.

2. Our economic program supported by the Extended Credit Facility during 2011-13 was instrumental in achieving macroeconomic stability and advancing economic reforms. Growth has been strong, as reflected by the revised national accounts that show Kenya has achieved low-middle income status as measured by per-capita income. Inflation has remained contained reflecting prudent fiscal and monetary policies supported by the modernization of the monetary policy and operations framework. Public debt remains sustainable, supported by the overhaul of the expenditure management framework and VAT reform. Moreover, fiscal and external buffers have been strengthened, supported by Kenya's increasing integration in global markets and its recognition as a frontier market.

3. However, a number of challenges need to be addressed as part of the economic transformation to underpin shared prosperity. Our economy remains vulnerable to external and domestic shocks. In particular, Kenya's growing integration to global markets, while creating new financing opportunities, also makes our economy more vulnerable to changes in global risk sentiment. Our economy is also vulnerable to droughts and other weather-related shocks, the frequency of which has increased in the recent past, given the prevalence of rain-fed agriculture and high dependence on hydro-power generation. In addition, fiscal related challenges surrounding devolution (including increasing pressures on the government's wage bill), if not addressed early enough, would be a drag on our development effort in the medium term.

4. We are taking determined steps to address these vulnerabilities and bolster our resilience to shocks. In particular, we are committed to maintain macroeconomic stability, including by gradually consolidating fiscal policy, which would allow us to further strengthen our fiscal buffers and our resilience to shocks. We will also continue to bolster prudential oversight of the financial sector, and to improve public finance management, with a view to reducing fiscal risks especially arising from the fast-track implementation of the devolution process and from contingent liabilities. However, implementing these reforms will take time. The Fund-supported program supported by SBA-SCF arrangements provides a buffer to mitigate the impact of potential exogenous shocks.

II. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

5. Real GDP growth has been robust, inflation is within the Government's target range, and the exchange rate has remained broadly stable. The economy expanded by 5.8 percent in real terms during the second quarter of 2014, driven mainly by rising private and public investments. However, poor rains have constrained agriculture growth, and the security concerns have dampened tourist activity. Following an increase in the first half of the year reflecting food and energy price increases, inflation has remained since August within our target range (5 ± 2.5 percent), and stood at 6.4 percent in October. Gross international reserves amounted to US\$7.6 billion in October ($4\frac{1}{4}$ months of prospective imports), also helped by the US\$2 billion debut sovereign bond in June 2014.

6. Our baseline projections are for continued strong growth and contained inflation, but subject to downside risks. Growth is expected to slow modestly to $5\frac{1}{4}$ percent in 2014 from $5\frac{3}{4}$ percent in 2013, reflecting the headwinds from poor rains and the impact of security threats on tourism, but to increase to around 7 percent over the medium term. This reflects rising public investments that are removing bottlenecks for private sector activity, and continued strong Foreign Direct Investments (FDI) taking advantage of our market-friendly business environment. Growth risks are tilted on the downside in the near term, reflecting weaker global growth, potential turbulence in global markets from the expected normalization of monetary policy in advanced economies, and security concerns. Inflation is expected to be on a downward trend in the coming months, as the food and energy price shocks wear off, although continued strong credit growth could put pressure on prices. We project headline inflation to converge gradually towards the mid-point of our target range.

III. PROGRAM OBJECTIVES

7. Our main policy objectives are to strengthen macroeconomic stability, deepen structural and governance reforms, improve security and support devolution. Progress in these areas would help strengthen the business environment, encouraging in turn innovation, investment, growth and expansion of economic and employment opportunities in Kenya. The Fund-supported program would provide a policy anchor to implement our ambitious reform program, and includes the following key policy priorities:

- **Fiscal policy.** Adhering to medium-term debt targets, while preserving room to implement an ambitious public investment program aimed at reducing social and infrastructure gaps, minimizing vulnerabilities to weather-related shocks, and supporting devolution.
- **Public financial management.** Taking decisive steps to (i) increase the efficiency, effectiveness, transparency and accountability in the use of public resources, and (ii) contain fiscal risks arising especially from the fast-track devolution rollout and contingent liabilities.
- **Monetary policy.** Achieving a low inflation rate of around 5 percent, and further improving the monetary policy framework to facilitate the transition towards a fully-fledged inflation targeting framework.

- **Financial stability.** Enhancing prudential oversight to address potential vulnerabilities arising mainly from rapid credit growth and expansion of cross-border operations by Kenyan banks.
- **Business environment.** Creating a more favorable business environment, including by strengthening security, deepening structural and governance reforms with a view to ease cost of doing business, and thus boost investments and employment creation.
- **Data provision.** Improving data quality to support economic policy making and facilitate transition to frontier/emerging market status.

IV. PROGRAM POLICIES

A. Fiscal Policy

8. Main policy objectives. Our fiscal anchor is to maintain gross public debt below 45 percent of GDP in present value terms, which is below the EAMU convergence criterion of 50 percent and well below the LIC DSA debt threshold of 74 percent. Consistent with this objective, our Medium-Term Fiscal Framework envisages a gradual fiscal adjustment, to be achieved through a combination of (i) lower current spending; and (ii) a further mobilization of revenues, which we will achieve by broadening the tax base and improving revenue administration. Such a strategy will create room for greater social and infrastructure spending, thus supporting inclusive growth. Additional important priorities for the government include improving public finance management, and containing and managing fiscal risks associated with fast-track implementation of devolution and contingent liabilities.

9. Fiscal stance. Our fiscal target under the program for 2014/15 is an overall fiscal deficit for the national government (excluding SGR-related spending) of 6.1 percent of GDP. The 2014/15 budget keeps recurrent spending broadly unchanged relative to the previous year, and provides room for increasing development spending by about 2¾ percent of GDP, mainly on account of a front-loading of capital spending related to the Standard Gauge Railway (SGR). Consistent with our commitments to meet the EAMU convergence criteria on fiscal deficit and debt targets, we intend to adopt additional revenue raising measures (outlined below) that would allow us to reduce gradually the overall fiscal deficit to about 4 percent of GDP by 2018/19, while at the same time preserving adequate space for priority social and infrastructure spending in line with our Vision 2030 Development Agenda.

10. Revenue mobilization. We have recently taken several steps to broaden the tax base and improve revenue administration. These include the introduction of: (i) a new capital gains tax, effective January 1, 2015, expected to yield annually around 0.2 percent of GDP in additional revenues; and (ii) a VAT withholding tax (at 6 percent, out of the 16 percent standard VAT rate) that would raise 0.2 percent of GDP over the medium term. Going forward, we will submit to Parliament by end-June 2015 a proposal to revise excise rates for selected products, and an automatic semi-annual inflation indexation of specific excise taxes, to prevent the erosion of excise revenue in real terms. This is aimed at generating additional revenue of 0.1 percent of GDP per year. Moreover, we are committed to abolish by August 2016 the VAT exemption on oil products. This measure is

expected to increase VAT revenue by about 0.3 percent of GDP per year. We will also introduce several measures aimed at improving tax compliance. These include: (i) removing the waiver of interest on overdue tax obligations; (ii) adopting a new Tax Procedure Code, which would significantly simplify tax payment procedures for several taxes (VAT, income, and excise taxes); (iii) establishing a national single window for trade facilitation, which together with the recently introduced electronic payment system for taxes (i-tax), would improve efficiency of tax collection and reduce scope for leakages. This package of measures will allow us to make significant progress towards the EAMU indicative tax revenue target of 25 percent of GDP.

11. Expenditure measures. To reorient our spending towards critical social and infrastructure areas, we will strengthen efforts to adhere to the 30:70 percent of development to recurrent spending consistent with the PFM Act. This will be pursued in particular by containing the wage bill. To this end, we have put in place a hiring freeze for the national government during the current fiscal year (except for priority sectors such as education, health, and security), and are in the process of finalizing a staff rationalization and remuneration policy. Specifically, based on recent biometric staff audits, by end-March 2015, we will complete a report on personnel audits including a time-bound action plan for the national and county governments aimed at rationalizing personnel to avoid overlapping positions (**structural benchmark**). With these inputs, we intend to define a remuneration and hiring policy aimed at reducing the national government's wage bill by about ¼ percent of GDP per year over the medium term. In addition, by end-June 2015, we will fully integrate payroll payments to core civil service through the Government Human Resource Information System (GHRIS) in the Integrated Financial Management Information System (IFMIS) (**structural benchmark**), strengthening the integrity of the government's payroll.

12. Devolution process. We are committed to ensure the success of the devolution process, by strengthening accountability and fiscal discipline in the use of devolved resources, to achieve our Constitutional objective of better service delivery and enhanced equitable economic development at the county level. To that end, we will adopt by end-March 2015 a framework establishing limits and guidelines for borrowing by county governments consistent with the PFM Act, and incorporate future county borrowing in the general government's medium-term debt strategy (**structural benchmark**), which will help contain fiscal risks and ensure public debt sustainability. Going forward, we are committed to (i) adequately staff the Intergovernmental Fiscal Relations Department to make it fully operational; and (ii) complete by end-September 2015 an audit of outstanding county assets and liabilities, including those inherited at the onset of devolution (**structural benchmark**). Further, to avoid duplication and/or distortions in the introduction of local taxes and fees that could hurt the business environment, the Treasury intends to organize a consultation process to discuss ways to help ensure that revenue raising initiatives (including fees and charges) at the county level are conforming to the Constitution and PFM Act. In addition, the national government will support counties build capacity in improving revenue collection, including by automation of county revenue collection and leveraging of the Kenya Revenue Authority (KRA) infrastructure.

13. Public finance management. To strengthen cash and debt management, we have completed the implementation of Phase I interim solution for the core Treasury Single Account (TSA) system. This will allow us to aggregate daily in the TSA all revenue; payments by ministries, departments, and agencies; the Exchequer's activities; the CBK advances; and proceeds from

borrowing activities, to compute the overall cash/overdraft position of the national government on a daily basis. Further, by end-June 2015, we will complete the full Phase I core TSA, which will result in the full integration of the TSA with IFMIS (**structural benchmark**). Progress in TSA implementation will be reviewed during the first program review. In addition, we will:

- ensure that, by end-March 2015, IFMIS is fully operational for all ministries and county governments;
- submit to Parliament by end-March 2015 new Bills on Public Procurement and on Disposal of Assets, bringing on board new public procurement and asset disposal methods, and enhanced sanctions, penalties and new procedures to limit fiscal risks;
- produce, by September 2015, GFS-compliant consolidated financial statements for the national government and extra-budgetary units and entities (**structural benchmark**), with a view to, by end-December 2015: (i) publish these data in the Quarterly Budget and Economic Review (QBER); and (ii) extend the coverage of financial statements to all county governments;
- to contain and manage fiscal risks from contingent liabilities beyond those associated with devolution, we will (a) report on all commitments and obligations under all existing PPPs and guarantees, starting with the 2015 Medium-Term Budget Policy Statement (**structural benchmark**); and (b) adopt by end-June 2015 a new risk and exposure assessment framework under the Public Private Partnership (PPP) program.
- complete by end-March 2015, an action plan aimed at strengthening the staffing of the Public Debt Management Office at the National Treasury (**structural benchmark**), with a view to implement it by June 2015.

14. Parastatal reform. We are overhauling the legal and regulatory framework governing our parastatal sector, aimed at strengthening governance, improving accountability, reducing budgetary transfers to parastatals for current spending, and providing a framework for the establishment of county-owned enterprises. The envisaged reforms in this area include: (i) separating the commercial activities from the regulatory and policymaking functions to improve service delivery; (ii) establishing a modern governance framework to increase efficiency and accountability (including transparent rules for the appointment of boards and management team, as well as Codes of conduct, professional ethics, and performance management); (iii) continue to reduce the number of parastatal institutions to eliminate duplication and overlaps (we are already in the process of reducing the number of parastatals from about 300 to under 200); and (iv) establishing a Government Investment Corporation, which would act as a holding company exercising ownership and oversight responsibilities for all extra-budgetary units and entities under the National Treasury, ensuring that the annual budgets of parastatals are fully integrated with the national government's budget. We will continue to discuss progress in implementing these reforms during program reviews.

15. Framework for extractive industries. The Extractive Industry Tax Regime Bill has been enacted into law and the new Mining Bill is currently before parliament. In addition, we are formulating a new Petroleum Bill aimed at modernizing the production-sharing scheme for oil

extraction, and establishing a new such scheme for gas extraction. The potential boost in fiscal revenues over the medium term from the ongoing exploration of oil, gas and other natural resources will be fully and transparently recorded in the budget, and their use fully accounted in the context of the budget reporting system. Once the above legal framework is in place, we intend to submit to Parliament a draft law that would establish a National Sovereign Wealth Fund (NSWF), conforming with international best practices regarding transparency, governance, accountability, and full integration with the budget. The key objectives of the NSWF would include: (i) supporting macroeconomic stability and protecting public investment from volatility in natural resource revenues; and (ii) saving for future generations. We are committed to preserve a sound asset and liability management framework, and therefore transfers of public resources to the NSWF will occur only when the budget is in a surplus position.

B. Monetary Policy

16. Policy objectives: The CBK will continue to aim at maintaining headline inflation at the mid-point of target range (5 ± 2.5 percent), in the context of a floating exchange rate regime. Except for a temporary surge in July and August 2014, inflation has trended downwards in recent months. We are confident that our monetary policy framework will continue to lower inflation and anchor inflation expectations around the mid-point of the target band. The inflation objectives under the program will be monitored through a monetary policy consultation clause (MPCC), although we will continue to monitor developments in CBK's net domestic assets (**indicative target**). Consistent with the EAC convergence criterion on international reserves ($4\frac{1}{2}$ months of imports), and with a view to strengthen buffers against external shocks, we aim at a build-up of net international reserves during 2015 (**performance criteria for end-March and end-September 2015**).

17. Monetary policy framework. We will submit to Parliament by end-March the draft Central Bank Bill, which enshrines in legislation the CBK's current policy of prioritizing price stability and strengthens further CBK's operational independence (**structural benchmark**). Further measures to support the eventual adoption of a fully-fledged inflation targeting framework include:

- **Entrenching the forecasting and policy analysis framework** into the organizational structure of the CBK. Specifically, to improve CBK's institutional capacity in inflation forecasting, we are going to establish by March 2015 an inflation modeling and forecasting unit at the CBK. This unit will provide scenario analysis and other inputs to inform monetary policy decisions.
- **Increasing flexibility in the use of monetary instruments**, to enhance CBK's capacity to steer market rates and improve the interest rate transmission channel. In that regard, the CBK and the National Treasury are exploring options to increase the stock of government securities, for the CBK to have a wider scope for repo operations.
- **Improving liquidity forecasting**, including strengthening the coordination between the National Treasury and the CBK. In this context, we are committed to: (i) ensure that the CBK's overdraft facility will cover only temporary liquidity shortfalls in line with the PFM Act provisions; (ii) increase the frequency of submission by the National Treasury to the CBK of government cash flow plans to quarterly (rather than annually); and (iii) strengthen the

analytical capacity in liquidity forecasting and cash flow management at both the National Treasury and the CBK.

- **Monitoring effectiveness of the KBRR.** The recent introduction of the Kenya Bank Reference Rate (KBRR) has allowed bank customers to better compare lending rates offered by different financial institutions. We are committed to continue monitoring the effectiveness and take remedial actions as needed.

C. Financial Sector

18. Policy objectives: We intend to continue safeguarding financial stability by further strengthening the prudential oversight framework; and managing risks associated with rapid credit growth, rising cross-border operations, and expansion of banks activities into holding group structures. As part of this process, we intend to enhance our stress testing capacity. Finally, we are committed to strengthen consolidated supervision and our crisis preparedness and management framework, including in cooperation with host supervisors in the region.

19. Prudential oversight. With a view to strengthen our banking sector prudential framework and maintain financial stability, we will:

- By end-March 2015, review and strictly implement the Prudential Guideline on Risk Classification of Assets and Provisioning, in order to address the observed trend decline in the non-performing loans provisioning coverage ratio. We are committed to assess the progress made in this regard in the course of program reviews.
- Starting in March 2015, require banks to provide CBK on a monthly basis: (i) detailed information on restructured loans with a view to avoid lending ever-greening practices for bank credit; and (ii) data on loan-loss recovery rates.
- Prepare by March 2015 an action plan to strengthen the CBK's stress testing framework and methodology which will be used for both micro- and macro-prudential supervision purposes, and augment staff's technical capacity. The roadmap for implementation and progress made will be discussed with IMF staff during program reviews.
- Initiate measures to mitigate banks' exposure to mortgages. To that end, in consultation with the IMF, by end-April 2015, we will carry out a survey of banks' risk exposure to mortgages, and will take remedial action to address vulnerabilities.
- Develop by March 2015 the assessment framework of the supervisory and regulatory regimes of host supervisors in order to improve cross-border banking oversight. We will subsequently conduct a pilot assessment of the most significant host jurisdictions.

D. Ease of Doing Business and Data Quality

20. Policy objectives: We are taking steps to further improve the business environment, including by deepening structural and governance reforms, with a view to ease cost of doing business and thus boost investments and employment creation. In addition, a successful transition to emerging market status will require, among other things, improving the quality, coverage and timeliness of Kenya's macroeconomic statistics.

21. Governance and business environment. We consider creation of a conducive business environment a key prerequisite for strong economic growth and poverty reduction. Our efforts in this area are focused on the following reforms:

- **Advancing business regulatory reforms to reduce the cost of doing business.** Two new important draft bills—the Company Bill and Insolvency Bill—are currently under consideration by Parliament, and are expected to be enacted by September 2015. In addition, during 2015 we plan to: (i) consolidate all government approvals for starting a business at one access point; (ii) commence the company registration online; (iii) develop a policy on preferential debtors and creditors to facilitate the implementation of the new expected insolvency framework; (iv) complete the digitization of construction records in all counties; (v) finalize the declaration module under the Single Window to provide a one-stop shop for faster import clearance of cargo; and (vi) submit to Parliament a new bill aimed at easing property registration.
- **Strengthening security.** We are taking a number of steps aimed at strengthening security of our borders and throughout the country, including by: (i) increasing investments in security infrastructure such as housing, offices, and security installations and equipments; (ii) developing standards and guidelines for installation of integrated closed-circuit television (CCTV) systems in all urban buildings; (iii) strengthening institutional and legal framework for border security; (iv) undertaking a comprehensive training program on modern personnel management and policing; and (v) investing in a modern and functional command and control.

22. Data quality and timeliness. We are taking concrete steps to improve the quality and timeliness of key data towards subscribing to the Fund’s Special Data Dissemination Standard. In particular, we recognize the need to make rapid progress in (i) national accounts (production indices and unemployment statistics); (ii) external sector statistics (gaps include service exports, long-term inflows, the international investment position, and private sector debt); and (iii) social indicators (latest household survey is from 2005/06). To make progress in addressing external sector data gaps, and mitigate risks arising from the current lack of information on private sector debt, we have allocated the necessary resources to KNBS to carry out promptly a Foreign Investment Survey (FIS) covering 2012 and 2013. We are committed to publish the FIS surveys for 2012-13 by end-September 2015 (**structural benchmark**), and intend to conduct regular annual surveys for subsequent years, with a view to improving the assessment of the financial account of the balance of payments. Finally, we will conduct a new household survey in 2015/16, and start publishing annual unemployment statistics in 2016.

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

(In billions of Kenyan shillings; unless otherwise indicated)

	2014		2015		
	Projection	Performance Criteria (PC)/Indicative targets (IT)			
	End-Dec.	End-Mar (PC)	End-Jun (IT)	End-Sep (PC)	End-Dec (IT)
Quantitative performance criteria ¹					
Fiscal targets					
Primary budget balance of the national government (-=deficit, floor) ^{2,3}	-104.1	-171.9	-209.9	-52.9	-98.8
Monetary targets ^{4,5}					
Stock of central bank net international reserves (floor, in millions of US\$) ^{6,7}	5,909	5,956	6,115	6,173	6,132
Public debt targets					
Contracting and guaranteeing of all medium and long term nonconcessional external debt by the national government (ceiling, millions of US\$) ^{8,9}	1,100	1,100	1,600	1,600	2,100
National government external payment arrears (ceiling, millions of US\$) ¹⁰	0	0	0	0	0
Monetary policy consultation clause					
Upper band	...	7.5	7.5	7.5	7.5
Center inflation target ¹¹	...	5.0	5.0	5.0	5.0
Lower band	...	2.5	2.5	2.5	2.5
Indicative targets					
Stock of net domestic assets of the central bank (ceiling)	-230	-206	-186	-177	-192
Priority social expenditures of the national government (floor) ³	24	40	52	14	25
Stock of all guarantees issued by the national government (ceiling) ³	45	50	50	50	50
<i>Memorandum items:</i>					
Maximum upward adjustment of the primary deficit ceiling owing to excess in concessional loans relative to program projections ³	...	59.5	79.3	16.8	42.0
Programmed concessional loans ³	...	85.6	119.0	23.7	69.5
Budgeted concessional loans ³	...	145.1	198.3	40.5	111.4
Programmed external commercial debt (millions of US\$) ³	...	750	750	750	1,250
Program grants ³	...	3.8	6.1	0.5	2.5

¹ Performance criteria for end-March 2015 and end-September 2015, and indicative target for end-June 2015 and end-December 2015.

² The primary budget balance of the national government is defined as overall balance including grants, plus interest payments, excluding SGR-related expenditure. Targets will be adjusted upwards by the excess in concessional loans relative to the programmed amounts, up to the budgeted amounts, and downwards by the shortfall in concessional loans relative to the programmed amounts.

³ Targets for end-March 2015 and end-June 2015 are cumulative flows from July 1, 2014 (beginning of the 2014/15 fiscal year). Targets for end-September 2015 and end-December

2015 are cumulative flows from July 1, 2015.

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

⁵ The NIR floor will be adjusted upward by half of the excess, and downward fully by the shortfall in external budgetary support (program grants) and external commercial debt relative to the programmed amounts. The NDA ceiling will be adjusted downward by half of the excess and upward fully for the shortfall of external budgetary support (program grants) and external commercial debt relative to the programmed amounts.

⁶ Excludes encumbered reserves.

⁷ Using exchange rates as at end-October 2014 (see TMU ¶9).

⁸ Cumulative flow of contracted debt, from July 1, 2014.

⁹ The targets on the ceiling of non-concessional external debt combine nonconcessional project loans, syndicated loan and sovereign bond.

¹⁰ Continuous.

¹¹ Compliance will be evaluated based on the 12-month inflation average of the latest three months.

Table 2. Kenya: Proposed Structural Benchmarks

Measure	Target Date	Macro Criticality
Complete the full Phase I core TSA to fully integrate the TSA with IFMIS (¶13).	End-June 2015	Improve liquidity management
Complete an action plan aimed at strengthening the staffing of the Public Debt Management Office at the National Treasury (¶13).	End-March 2015	Improve public debt management and reduce fiscal risks
Report in the Budget Policy Statement: (i) all existing PPPs, with their key features, including all commitments and obligations in PPP projects; and (ii) all government guarantees including those to counties (¶13).	End-March 2015	Limit fiscal risks
Complete report on personnel audits for the national and county governments including a time-bound action plan aimed at rationalizing personnel to avoid overlapping of positions (¶11).	End-March 2015	Contain current spending to create space for infrastructure and social spending
Fully integrate payroll payments to core civil service through the GHRIS in IFMIS (¶11).	End-June 2015	Contain current spending to create space for infrastructure and social spending
Adopt a framework for county borrowing with guidelines consistent with PFM Law, and incorporate future county borrowing in the government's medium-term debt strategy (¶12).	End-March 2015	Limit fiscal risks
Complete the audit of assets and liabilities of all counties including those inherited at the onset of devolution (¶12).	End-September 2015	Limit fiscal risks
Produce GFS-compliant consolidated fiscal accounts for the national government and extra-budgetary units and entities (¶13).	End-September 2015	Limit fiscal risks
Submit to Parliament a new Central Bank Bill that sets price stability as primary CBK objective (¶17).	End-March 2015	Strengthen CBK's independence and clarify policy objectives
Publish Foreign Investment Survey covering years 2012-13 (¶22).	End-September 2015	Improve BOP data quality, assessment of private debt vulnerabilities, and information for macro policy making

Attachment II. Technical Memorandum of Understanding

1. This memorandum sets out the understandings between the Kenyan authorities and the IMF regarding the definitions of quantitative performance criteria and indicative targets, their adjusters and data reporting requirements for the 12-month Stand-By Arrangement and Standby Credit Facility.
2. For the purposes of the program, the National Government of Kenya corresponds to the budgetary central government encompassing the activities of the national executive, legislative and judicial powers covered by the National Budget. Specifically, it includes the parliament, presidential office, national judiciary, Ministries, Departments, Agencies, and Constitutional Commissions and Independent Offices.

I. QUANTITATIVE PERFORMANCE CRITERIA AND BENCHMARKS

3. Quantitative performance criteria are proposed for March 31, 2015, and September 30, 2015 with respect to:
 - the primary balance of the national government including grants, and excluding spending related to the Standard Gauge Railway project, cash basis (**floor**);
 - the net official international reserves (NIR) of the Central Bank of Kenya (CBK) (**floor**);
 - nonconcessional medium- and long-term external debt contracted or guaranteed by the national government (**ceiling**); and
 - national government medium- and long-term external public debt arrears (**continuous ceiling**);
 - monetary policy consultation clause (**band**).
4. The program sets indicative targets for June 30, 2015 with respect to:
 - the net domestic assets (NDA) of the CBK (**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 the Standard Gauge Railway project, 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, excluding securitization of VAT refund arrears; (b) the negative of net external financing of the national government, excluding the executed amount of disbursements related to the Standard Gauge Railway project; and (c) domestic and external interest payments of the national government. For the March 31, 2015 and June 30, 2015 test dates, the national government primary balance will be measured cumulatively from July 1, 2014, and for the September 30, 2015 test date cumulatively from July 1, 2015.

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;
 - change in the stock of domestic arrears as reported by the National Treasury; and
 - proceeds from privatization.
- **Net external financing** is defined as the sum of:
 - disbursements of **external nonconcessional project loans**, including securitization and excluding executed amounts of disbursements related to the Standard Gauge Railway project;
 - disbursements of **budget support loans**;
 - the negative of principal repayments on all **external loans**;
 - net proceeds from issuance of external debt;
 - any exceptional financing (including rescheduled principal and interest);
 - net changes in the stock of short-term external debt; and
 - any change in external arrears including interest payments.
- **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 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 upwards by the excess in concessional loans relative to the programmed amounts, up to the budgeted amounts in line with Kenyan law.

TMU Table 1. Kenya: African Mission in Somalia (AMISOM) Grant Schedule				
(Billions of Kenyan Shillings)				
	2015			
	Mar.	Jun.	Sep.	Dec.
Program Amount ¹	3.8	6.1	0.5	2.5

Source: Authorities' data.

¹ For FY2014/15 cumulative from July 1, 2014, and for FY2015/16 cumulative from July 1, 2015.

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), including the August 28, 2009 General allocation and the September 9, 2009 Special allocation;
 - CBK holdings of convertible currencies in cash or in nonresident financial institutions (deposits, securities, or other financial instruments).
- **Gross official international reserves** exclude:
 - the reserve position in the IMF;
 - pledged, swapped, or any encumbered reserve assets, including but not limited to reserve assets used as collateral or guarantees for third-party external liabilities;
 - deposits with Crown agents; and
 - precious metals other than gold, assets in nonconvertible currencies and illiquid foreign assets.
- **Gross official reserve liabilities** are defined as:
 - the total outstanding liabilities of the CBK to the IMF except those arising from the August 28, 2009 SDR general allocation and the September 9, 2009 SDR special allocation;
 - convertible currency liabilities of the CBK to nonresidents with an original maturity of up to and including one year;
 - commitments to sell foreign exchange arising from derivatives (such as futures, forwards, swaps, and options).

- The following **adjustors** will apply to the target for NIR:
 - If budgetary 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.
 - 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

(US\$ millions)

	2015			
	Mar.	Jun.	Sep.	Dec.
Program grants ¹	40	52	14	25
External commercial debt ²	750	750	750	1,250

Source: Kenyan authorities.

¹ For FY2014/15 cumulative from July 1, 2014, and for FY2015/16 cumulative from July 1, 2015.² Cumulative from July 1, 2014.

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 October 31, 2014)

Currency	Kenyan Shillings per currency unit	US Dollars per currency unit
US Dollar	89.35	1.0000
STG Pound	142.74	1.5975
Japanese Yen	0.81	0.0091
Canadian Dollar	79.76	0.8926
Euro	112.34	1.2573
Swiss Franc	93.29	1.0444
Swedish Kronor	12.14	0.1359
Danish Kronor	15.09	0.1689
SDR	132.09	1.4783

Source: Central Bank of Kenya.

IV. PERFORMANCE CRITERION ON NONCONCESSIONAL EXTERNAL DEBT CONTRACTED OR GUARANTEED BY THE NATIONAL GOVERNMENT

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

- Debt is understood to mean a direct, that is, not contingent, liability, created under a contractual agreement through the provision of value in the form of assets (including currency) or services, which requires the obligor to make one or more payments in the form of assets (including currency) or services at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows:
 - loans, that is, advances of money to the obligor by the lender made on the basis of 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);
 - suppliers’ credits, that is, contracts where the supplier permits the obligor to defer payments until sometime after the date on which the goods are delivered or services are provided; and
 - leases, that is, arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lesser retains title to the property. For the purpose of this guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property.
- Under the definition of debt set out above, arrears, penalties, and judicially awarded damages arising from failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (for example, payment on delivery) will not give rise to debt.

11. Debt is considered concessional if, on the date on which the contract was signed, the ratio of the present value of the loan to the nominal value of the loan is less than 65 percent (that is, the grant element of the loan is at least equal to 35 percent of its nominal value). The present value of the loan will be calculated by discounting future payments of interest and principal using a discount rate set at 5 percent.

12. The definition of **external debt**, for the purposes of the program, is any debt as defined in paragraph 10 above, which is denominated in foreign currency, i.e., currency other than Kenyan shillings (Ksh). Similarly, external borrowing is borrowing denominated in foreign currency.

13. The performance criterion on nonconcessional external debt is measured as a cumulative flow from July 1, 2014 and this includes nonconcessional external debt contracted or guaranteed by the national government. The authorities should report to Fund staff nonconcessional medium- and long-term external borrowing undertaken without national government guarantee by the public enterprises and other parastatals, in order to monitor the potential fiscal risk to the government. Medium- and long-term debt refers to debt with maturity of one year or longer.

14. The ceiling on nonconcessional external borrowing (see Table 1 in the MEFP) encompasses commercial loans, including the proceeds of syndicated loans, sovereign bonds, and other non-concessional financing instruments including non-concessional project financing.

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

15. National government external payment arrears to official and private 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.

16. The performance criterion on the national government external payment arrears is defined as a flow from July 1, 2014 and applies on a continuous basis.

VI. MONETARY POLICY CONSULTATION CLAUSE

17. The quarterly consultation bands around the projected 12-month rate of inflation in consumer prices (as measured by the headline consumer price index (CPI) published by the Kenya National Bureau of Statistics), are specified in the TMU Table 4 below. If the observed average for the latest three months of the 12-months rate of CPI inflation falls outside the lower or upper bands specified in the TMU Table 4 below for end-March 2015 and end-September 2015 test dates, the authorities will complete a consultation with the Executive 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) on proposed remedial actions if deemed necessary. When the consultation is triggered, access to Fund resources would be interrupted until the consultation takes place and the relevant program review is completed.

TMU Table 4. Inflation Consultation Band								
	2014				2015			
	Mar. Actual	Jun. Actual	Sep. Actual	Dec. Actual	Mar. Target	Jun. Indicat.	Sep. Target	Dec. Indicat.
Upper band					7.5	7.5	7.5	7.5
Actual/Center point	6.3	7.4	6.6	6.0	5.0	5.0	5.0	5.0
Lower band					2.5	2.5	2.5	2.5

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

18. 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, including those arising from the August 28, 2009 SDR General allocation and the September 9, 2009 SDR Special allocation; minus the value in shillings of encumbered reserves converted at the accounting exchange rate 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.
 - 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.

19. 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 PRIORITY SOCIAL SPENDING

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

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

IX. INDICATIVE TARGET ON GUARANTEES ISSUED BY THE NATIONAL GOVERNMENT

21. The guarantees issued by the national government include all guarantees extended by the national government to counties, public enterprises and all parastatal entities. Indicative targets for end-March 2015 and end-June 2015 are cumulative flows from July 1, 2014, and the indicative target for end-September 2015 and end-December 2015 are cumulative from July 1, 2015.

X. STRUCTURAL BENCHMARK ON PREPARATION OF GFS-COMPLIANT CONSOLIDATED FISCAL ACCOUNTS

22. The institutions to be covered under the end-September 2015 structural benchmark on the production of GFS-Compliant consolidated fiscal accounts includes (i) the budgetary central government; and (ii) all extrabudgetary units and entities.

XI. DATA REPORTING

23. 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 15 days after the end of the month.	CBK
Net nonbank financing of the national government	Monthly	Within 15 days after the end of the month.	CBK
National government arrears accumulation to domestic private parties and public enterprises outstanding for 90 days or longer.	Monthly	Within 15 days after the end of the month.	National Treasury (NT)
Proceeds from privatization	Monthly	Within 15 days after the end of the month.	NT
Interest paid on domestic debt	Monthly	Within 15 days after the end of the month.	CBK
Interest paid on external debt	Quarterly	Within 4 weeks after the end of the quarter.	CBK
Disbursements of external nonconcessional project loans, including securitization	Quarterly	Within 45 days after the end of the quarter.	NT
Disbursements of budget support loans	Quarterly	Within 45 days after the end of the quarter.	NT
Principal repayments on all external loans	Quarterly	Within 15 days after the end of the month.	CBK
Net proceeds from issuance of external debt	Monthly	Within 15 days after the end of the month.	CBK
Any exceptional financing (including rescheduled principal and interest)	Monthly	Within 15 days after the end of the month.	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	Monthly	Within 45 days after the end of the quarter.	NT
2. Gross official international reserves			
CBK's holding of monetary gold (excluding amounts pledged as collateral)	Monthly	Within 15 days after the end of the month.	CBK
Holdings of SDRs	Monthly	Within 15 days after the end of the month.	CBK
CBK holdings of convertible currencies in cash or in nonresident financial institutions (deposits, securities, or other financial instruments)	Monthly	Within 15 days after the end of the month.	CBK

TMU Table 5. Summary of Data to Be Reported (continued)

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