REPUBLIC OF KENYA

THE NATIONAL TREASURY

2017 Medium Term Debt Management Strategy for FY2017/18- F Y2019/20

November 2016

2017 Medium Term Debt Management Strategy for FY2017/18- F Y2019/20

To obtain copies of the document, please contact:

Public Relations Office
The National Treasury
Treasury Building
P. O. Box 30007-00100
NAIROBI, KENYA

Tel: +254-20-2252-299
Fax: +254-20-341-082

The document is also available on the website at: www.treasury.go.ke

TABLE OF CONTENTS

FOREWORD

Preparation of the Medium Term Debt Management Strategy (MTDS) is a requirement under the PFM Act, 2012 and is prepared utilizing a set of analytical tools and procedures in accordance with international best practice. The MTDS is prepared taking into account the terms of any borrowing, the type of borrowing and the attendant risks or shocks that may impact on the government's ability to meet its debt obligations, taking into account global and domestic economic and financial developments in order to inform the preparation of MTEF Budget for fiscal years and the medium term.

The MTDS analysis looked at the cost-risk implications of a range of debt strategies which were assessed under a set of informed assumptions on the macroeconomic environment and outlook as well as a set of risk scenarios. The implications of possible shocks including interest and exchange rates on the preferred choice of strategy weré tested.

The aim of the MTDS is to support the government's strategy in implementing the FY2017/18 budget and over the medium term by ensuring that the government's financial requirement and payment obligations are met at the lowest cost with prudent degree of risk in line with PFM Act, 2012.

Consistent with the Kenya Constitution 2010 and PFM Act, 2012 with respect to transparency and accountability, the MTDS therefore underscores the Government's commitment to developing and designing a strategy that is evidence based and feasible in ensuring that public debt levels remains sustainable and supports broad-based and inclusive growth. The outcome of the MTDS analyses is a strategy of financing the fiscal deficit.

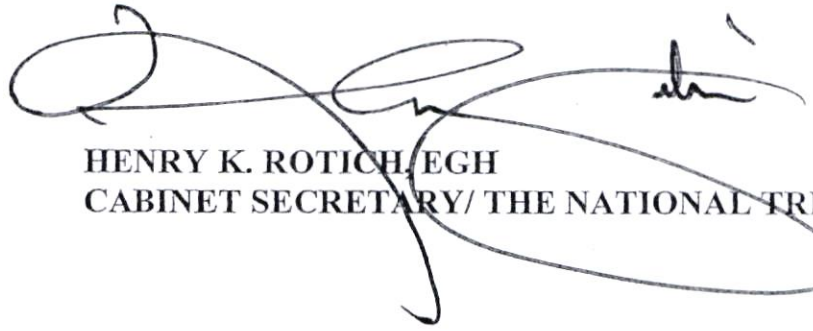
The MTDS 2017 recognizes that a diversified debt currency structure and development of the domestic debt market is important for hedging against exchange rate risks on a country's external debt. To address this, Kenya has made a deliberate effort to diversify our sources of external borrowing, this is becoming even more urgent now that Kenya has attained lower middle income country with hardened terms and less concessional borrowing. To address this we are now accessing international capital markets to diversify her sources of financing targeting the Samurai bond, Sukuk among others.

At operational level the National Treasury will link the MTDS to cash management. In this regard, the implementation of the MTDS is closely coordinated with cash management to enable management of liquidity around a targeted balance at a regular basis.

At the domestic level, we are well aware that broadening Kenyan markets to include more Kenyans and in particular the retail segment will go a long way in not only mobilizing more resources for development but even at lower interest rates. Towards this end the government is in the process of introducing a retail based product M-Akiba, an initiative aimed at providing an avenue for investing in Treasury Bonds conveniently through mobile phone

platforms. This will enable Kenyans who were excluded from the conventional capital markets to access government securities and will thereby lower the cost of borrowing. It is also consistent with our Vision 2030 objective of mobilizing domestic savings to support broad-based and inclusive growth.

Finally, let me underscore our commitment to prudent debt management in accordance with our Constitution and the PFM Act, 2012. We assure public that the National Treasury will continue to manage the National debt prudently and help ensure that we don't get into a situation of debt distress which could overburden our future generations. In the same vein, we look forward to support from all of residents of Kenya when we institute measures aimed at curtailing unnecessary and unproductive expenditures.



HENRY K. ROTICH, EGH
CABINET SECRETARY/ THE NATIONAL TREASURY

ACKNOWLEDGEMENT

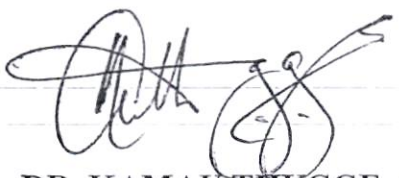
This is the ninth Medium Term Debt Management Strategy (MTDS 2017) to be tabled in Parliament and the fourth in the series under the requirement of Public Finance Management Act, 2012 (PFMA).

The MTDS 2017 continues to play an important role in the achievement of the government's goal for public debt management within provided macroeconomic framework to fund budgetary needs. The MTDS 2017 will guide debt management operations over the medium term. The preparation of MTDS is a technical process involving use of an analytical tool to analyze data inputs to produce scenarios from which an optimal borrowing strategy is determined.

Let me take this opportunity to acknowledge the MTDS 2017 Working Group composed of the National Treasury and the Central Bank of Kenya staff who were involved in the preparation of the Strategy for the valuable contribution and dedication to the process.

The preparation of the MTDS 2017 document also benefited from the team at the International Monetary Fund which provided quality assurance in the process.

In addition, we gratefully appreciate the comments received from Directorates and Departments of the National Treasury, as well as the Central Bank of Kenya in enriching the document. The MTDS 2017 can be obtained from the National Treasury Website: www.treasury.go.ke.



DR. KAMAU THUGGE, CBS
PRINCIPAL SECRETARY/THE NATIONAL TREASURY

Legal Basis for the Publication of the Debt Management Strategy

The Debt Management Strategy is published in accordance with Section 33 of the Public Finance Management Act, 2012. The law states that:

1) On or before 15th February in each year, the Cabinet Secretary shall submit to Parliament a statement setting out the debt management strategy of the national government over the medium term with respect to its actual liability in respect of loans and guarantees and its plans for dealing with those liabilities.

2) The Cabinet Secretary shall ensure that the medium term debt management strategy is aligned to the broad strategic priorities and policy goals set out in the Budget Policy Statement.

3) The Cabinet Secretary shall include in the statement the following information:-

    a) The total stock of debt as at the date of the statement;

    b) The sources of loans made to the national government and the nature of guarantees given by the national government;

    c) The principal risks associated with those loans and guarantees;

    d) The assumptions underlying the debt management strategy; and

    e) An analysis of the sustainability of the amount of debt, both actual and potential.

4) Within fourteen days after the debt strategy paper is submitted to Parliament under this section, the Cabinet Secretary shall submit the statement to the Commission on Revenue Allocation and the Intergovernmental Budget and Economic Council, publish, and publicize the statement.

ABBREVIATIONS AND ACRONYMS

ADB	African Development Bank
ADF	African Development Fund
ATtM	Average Time to Maturity
ATR	Average Time to Re-fixing
BoP	Balance of Payments
BROP	Budget Review and Outlook Paper
BPS	Budget Policy Statement
CBK	Central Bank of Kenya
CBR	Central Bank Rate
CPI	Consumer Price Index
CPIA	Country Policy and Institutional Assessment
CS-DRMS	Commonwealth Secretariat Debt Recording and Management System
DGIPE	Department of Government Investment and Public Enterprises
DPSRMD	Debt Policy, Strategy and Risk Management Department
DSA	Debt Sustainability Analysis
DX	Domestic currency denominated debt
EAC	East African Community
ECF	Extended Credit Facility
EEC	European Economic Community
EIB	European Investment Bank
RMD	Resources Mobilization Department
FX	Foreign currency denominated debt
FY	Financial Year
GDP	Gross Domestic Product
GoK	Government of Kenya
IDA	International Development Association
IRA	Insurance Regulatory Authority
IFB	Infrastructure Bond
IFC	International Finance Corporation

IFMIS	Integrated Financial Management Information System
IMF	International Monetary Fund
ISB	International Sovereign Bond
Ksh	Kenya Shilling
KenGen	Kenya Electricity Generating Company
LIC	Low Income Country
LMIC	Lower Middle Income Countries
MEFMI	Macroeconomic and Financial Management Institute of Eastern and Southern Africa
MTDS	Medium Term Debt Strategy
NPV	Net Present Value
NSE	Nairobi Securities Exchange
NT	National Treasury
PFM	Public Finance Management
PPP	Public Private Partnerships
PPG	Public &Public Guaranteed Debt
PV	Present Value
SBA	Stand-By Arrangement
SCF	Stand-By Credit Facility
SDR	Special Drawing Rights
T-Bills	Treasury Bills
T-Bonds	Treasury Bonds
US	United States
USD	United States Dollars

EXECUTIVE SUMMARY

An MTDS is a plan aimed at achieving the desired debt portfolio. Government debt management is the process of establishing and executing a strategy for managing government debt in order to raise the required amount of funding, achieve its risk and cost objectives, and meet any other debt management goals, such as developing and maintaining an efficient market for government securities. In this regard, the MTDS 2017 covering the period FY2017/18- FY2019/20 intends to implement government's plan over the medium term in order to achieve a desired composition of the government debt portfolio.

Kenya's public indebtedness in nominal terms as at end-June 2016 was at 53.1 per cent of GDP and remains sustainable. However, the scope of the MTDS analysis covers total National government external and domestic debt amounting of Ksh 3.4 trillion or US$33.5 billion as at end-June 2016, equivalent to 51.4 per cent of GDP. This takes into account, external debt amounting to 26.3 percent of GDP and domestic debt amounting to 25.1 percent of GDP but excludes CBK overdraft, commercial bank advances and Tax Reserve Certificates.

Because of our success in economic management and implementation of far reaching structures and institutional reforms, Kenya is now a lower middle income country but this comes with its attendant responsibilities. For Kenya, graduation to lower middle income country status means a move into the (mixture of commercial and concessional financing terms) ("blend")) window, with financial terms that are hard compared to the soft terms in the concessional window from multilateral agencies. Some bilateral creditors are also increasingly providing credit on commercial terms. As official sector credit is limited, and the domestic market faces limits in the medium term, credit from the external private sector is increasing. For instance, 2-year US$600 million syndicated loan was contracted in 2012, followed by 5- and 10-year US$2.75 billion Eurobond issuances in 2014, and another 2-year US$750 million syndicated loan in 2015. In June 2016, two additional commercial loans were contracted; a 7 year US$600 million loan from China Development Bank Corporation, and a 2 year US$200 million loan from Africa Export-Import (Afrexim) Bank. The latter was for on-lending to Kenya Airways.

Kenya's integration with the international capital markets exposes the country to the risks in the global financial markets. These include, weaker than expected growth in the global economy, continued low demand in advanced and emerging market economies as well as the low commodity prices that may impact negatively our exports and tourism activities. Further, the uncertainty in the global markets due to potential tightening of US monetary policy and consequent increase in the US interest rates, Britain's vote to exit the European Union and persistent uncertainty in the international oil markets may have an impact on Kenya's external balance.

Kenya's public debt is managed prudently to reduce financial vulnerabilities. The government's medium-term debt management strategy (MTDS) document is a critical instrument. It informs investors and the general public of the strategic financing plan to meet the government's financing needs at the lowest cost taking due consideration of the risks, including those arising from global and local financial market volatilities.

The debt portfolio as at June 2016 is characterized;

- Low but rising annual interest payment as a share of GDP.
- Refinancing risk.
- Stable relative exposure to exchange rate risk. The government debt portfolio has maintained equal proportions in the composition of external and domestic debt during the same period.

The 2017 Budget Policy Statement (BPS 2017) anticipates continued fiscal consolidation over the medium term. Over the medium term, commitments to fiscal consolidation, ongoing revenue reforms and completion of key infrastructure projects (such as SGR) are expected to result in a further reduction in overall fiscal balance. Real economic growth is expected to rise over the medium term. External buffers to date have remained adequate with international reserves at above 4.5 months of projected imports. Inflation is expected to stay within the target range of 5 percent ±2.5 percent over the medium term.

The government will continue maximizing borrowing from external concessional and semi-concessional sources. The domestic debt market is currently constrained in relation to the size of fiscal deficit.

To evaluate the optimal fiscal deficit funding strategy four alternative debt management strategies were examined:

- Strategy 1: This strategy represents current policy intent, and will be referred to as the baseline strategy. As part of the 2017 BPS, over the next three fiscal years, the government aims to finance more than half of the fiscal deficit by net domestic borrowing on average. It assumes US$ 3.20 billion as domestic financing while external commercial borrowing will be US$ 1.5 billion in FY2017/18, and US$1.25 billion each in FY2018/19 and US$ 0.53 billion in FY2019/20. Net domestic financing is divided 40:60 between T-bills and T-bonds.
- Strategy 2: Relative to Strategy 1, it increases external semi concessional borrowing, and instead reduces domestic borrowing.

- Strategy 3: Relative to Strategy 1, it reduces external borrowing, and instead increases issuance of domestic medium term debt to reduce the exchange rate exposures that results from external commercial borrowing.

- Strategy 4: Envisages increased issuance of external commercial borrowing for both Export Credit Agencies (ECA) and Sovereign Bond issuance with reduced domestic net financing.

Given the near term financing constraint, the strategy choices are able to address either - the risks or costs, but not both:

- Strategy 2 reduces refinancing risk, but raises the exchange rate exposure of the public debt portfolio. Under an exchange rate shock scenario of 30 percent in FY 2018/19, public debt will increase from 53.1 per cent of GDP under the baseline to 59.3 per cent by end-FY2019/20. Strategy 2 is to balance exchange rate risk and refinancing risk, although the strategy considers greater external borrowing. Given the upcoming maturities of the 5-year Eurobond issued in 2014, the syndicated loan issued in 2015 and the two year on-lent loan issued in 2016, the strategy assumes a net commercial external borrowing of US$1,500 million and US$ 1,250 million in FY2017/18 and FY2018/19 respectively. With domestic debt market absorption capacity constraint, external commercial borrowing of this magnitude will be necessary to alleviate pressures on the domestic debt market.

- Strategy 3 reduces exchange rate risk but increases domestic refinancing risk. Debt coming due in the following year as at end-FY2019/20 will be 11.1 percent of GDP. This strategy will likely lead to an increase in domestic interest payments given the fact that domestic interests are high compared to external rates and the domestic debt market has not deepened enough to absorb that capacity.

- Strategy 4 focuses on increased issuance of commercial debt in the capital market but the level of issuance in the domestic market will reduce. Given the two maturities due in 2017/18 and 2018/19 and the level of domestic debt development, Strategy 4 may be attainable but this will depend on government efforts to manage its investor relations.

Optimal Strategy

In selecting the optimal strategy, three key indicators were considered – ratio of interest payments to GDP (*Interest/GDP*), ratio of interest payments to Revenue (*Interest/Revenue) and PV of Debt to GDP (PV of Debt/GDP)).*

The *MTDS 2017* presents "S2" as the optimal strategy after taking into account both risk and cost trade-offs, the implied quantity of gross borrowing, the need to develop the domestic

debt market, the need to diversify the funding sources and ability to implement the strategy over the medium term.

The strategy comprises the following actions:

- 60 per cent external borrowing and 40 per cent domestic borrowing to finance the national government budget;

- Considering macro-economic and domestic market environment issuance of medium term domestic debt through benchmark bonds is recommended;

- Of the 60 per cent allocated to external borrowing, it will be comprised of 20 per cent on concessional terms, 30 per cent on semi-concessional terms and 10 per cent on commercial terms.

The Debt Sustainability Analysis (DSA) for Kenya's current and projected medium term debt indicates that Kenya's debt is sustainable. In the long term, the PV of public debt-to-GDP is expected to be 47.9 percent of GDP in 2019 while the PV of public debt-to-revenue remains below the threshold of 300 percent throughout the period of analysis.

A domestic borrowing plan anchored on government cash flow requirements will be developed for implementation, monitoring and evaluation. The Government will also actively monitor the key macroeconomic indicators and interest rates against those assumed in the analysis. Any significant and sustained change will trigger the need for revision of the strategy. Consistent with the principles of public finance in the Constitution of Kenya, 2010 (Section 201), the Government will seek to widen dissemination of the *MTDS 2017*. The MTDS 2017 is available in the national treasury website www.treasury.go.ke .

I. INTRODUCTION

1. A Medium Term Debt Strategy (MTDS) is a plan aimed at achieving the desired debt portfolio. Government debt management is the process of establishing and executing a strategy for managing the government's debt in order to raise the required amount of funding, achieve its risk and cost objectives, and meet any other debt management goals such as developing and maintaining an efficient market for government securities and diversification of funding sources. An MTDS operationalizes these objectives and is a plan that the government is implementing over the medium term in order to achieve the desired composition of the government's debt portfolio, which captures the government's strategy with regard to the cost-risk trade-offs.

2. This MTDS was prepared in accordance with the international practice and in particular framework developed by the IMF and the World Bank but customized to take into account the Kenyan economic and structuralized conditions. As such it was a collaborative effort between the key Departments of National Treasury and other key stakeholders. The process for developing an MTDS involves eight steps: (i) definition of objectives and scope; (ii) review of the existing debt management strategy and the cost-risk characteristics of the existing debt portfolio; (iii) identification of the potential sources of financing; (iv) review of the macroeconomic framework and medium-term projections and risks; (v) identification of structural factors; (vi) analysis of the cost and risks of alternative debt management strategies; (vii) review of preferred strategies to ensure policy consistency; and (viii) approval and dissemination of the debt management strategy.

3. This MTDS report documents the analysis conducted and the recommendations for future action. The MTDS is structured as follows: Section II presents the background; Section III reviews the performance of the MTDS for the FY2015/16. Section IV documents the debt management objectives and the scope of the MTDS analysis. Section V presents the cost and risks of the existing debt portfolio as at end-June 2016. In Section VI, the baseline macroeconomic assumptions underlying the analysis and key risk to the macroeconomic projections are discussed. Section VII discusses the potential external and domestic sources of financing. Section VIII presents the cost and risk analysis of alternative debt management strategies; Section IX presents debt sustainability; Section X is on implementing the MTDS and lastly; Section XI is the conclusions.

II. BACKGROUND TO MEDIUM TERM DEBT MANAGEMENT STRATEGY

4. Kenya's economy has remained resilient over the past decade. Real GDP growth is estimated at 5.8 percent in the FY 2015/16, supported by public investments in infrastructure projects particularly in rail and road construction and geothermal generation.

5. Kenya's public indebtedness in nominal terms as at end-June 2016 is estimated at 53.1 percent of GDP. Real exchange rate appreciation contributed to a debt reduction of 0.2 per cent of GDP, while the real interest rate –real growth rate differential also contributed to a debt reduction of 1.3 percent of GDP, assisted by the strong growth performance.

6. According to the latest DSA, Kenya's public debt is sustainable and expected to remain sustainable in the medium term[1]. The PV of public debt-to-GDP increases from 45.8 per cent in 2015 to 48.3 per cent in 2016 and 48.5 per cent in 2017 and remain at 48.5 per cent in 2018 before declining to 47.9 per cent of GDP by 2019. Overall, the results from the DSA indicate that Kenya's public debt remain sustainable over the medium term.

7. After falling to below 20 percent of GDP in 2013, domestic debt as a percent of GDP has risen to 27.6 percent as at end-June 2016. In 2016, the domestic debt experienced significant volatility following tight liquidity conditions in the banking sector in the first quarter of the fiscal year. Yields on the 91-day T-bills rose from 8.2 percent to 21.6 percent between July and October 2015, but came down following issuance of the syndicated loan. Yields stabilized at 7.3 percent as at end of the fiscal year 2016.

8. Kenya is increasingly integrated into the global capital markets. In 2012, a US$600 million 2-year syndicated loan was contracted. In 2014, Kenya issued its debut 5- and 10-year Eurobond totaling US$2.75 billion. Part of the proceeds raised through the Eurobond was used to retire the maturing syndicated loan. In 2015, the Government raised a 2-year syndicated loan for a sum of US$750 million and a 7 year commercial loan of US$600 million. Commercial external debt outstanding stood atUS$4.3 billion (24.2 per cent of total external debt) as at end-June 2016. However, non-resident participation in the domestic market has been negligible despite the open capital account.

9. Kenya' sovereign credit rating on stable outlook. The rating as at October 2016 by S&P remains at B+ with a stable outlook. Moody's rating for Kenya stands at B1 with a stable outlook since November 2012. .

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[1]Kenya is classified as "strong" performer in terms of the quality of its policies and institutions, measured by a three-year average of the World Bank's Country Policy and Institutional Assessment (CPIA) Index. The index stands at 3.84. The relevant indicative debt thresholds to measure external debt sustainability are: 50 percent for the PV of debt-to-GDP ratio, 200 percent for the PV of debt-to-exports ratio, 300 percent for the PV 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.

III. REVIEW OF THE FY 2015/16 MTDS AND IMPLEMENTATION OF FY2016/17 MTDS

10. The strategy for the financial year (FY2015/16 MTDS) emphasized greater reliance on domestic borrowing and concessional external borrowing. The target for net domestic financing and external financing mix was 55 percent and 45 percent, respectively. To reduce debt cost and refinancing risk, the FY2015/16 MTDS aimed to limit domestic short-term debt issuances (T-bills) to 11 percent of total domestic government securities borrowing, whereas longer maturities (10 – 30 years T-bonds) accounted for about 89 percent. However, the actual position as at end June 2016 indicates an increase in the proportion of T-bills to 34 percent and 66 per cent for T-bonds. On external debt, the FY2015/16 MTDS envisaged concessional financing to the tune of 62 percent of total gross external financing, the actual position as at end June 2016 indicates 40 per cent concessional borrowing. The envisaged concessional financing has translated to external debt Average Time to Maturity and Grace Period of 20.3 years and 6.2 years as at end-June 2016. This compares with 21.0 years and 6.4 years as at end-June 2015. However, the weighted average interest rate increased to 2.6 per cent from 2.5 percent, reflecting increased commercial borrowing during the year.

Table 1: Kenya: Average Terms of New Loan Commitments, 2014–2016

	Jun-14	Jun-15	Jun-16
Average Maturity (years)	18.1	21.0	20.3
Grace Period (years)	6.2	6.4	6.2
Average Interest Rate (%)	2.6	2.5	2.6

Source: National Treasury.

Table 1b: Kenya: Remaining Maturity of Outstanding Domestic Debt, as at end-FY2015/16-

Remaining Maturity in Years	In million US$	In Percent of Total
Less than 1 Year	16.28	0.1%
1-2 Years	886.78	5.1%
2-3 Years	953.79	5.4%
3-4 Years	132.70	0.8%
4-5 Years	116.42	0.7%
5-10 Years	4,205.48	24.0%
10+ Years	11,192.64	63.9%

Source: National Treasury.

Of the total external amount, 0.1 percent (or US$ 16.3 million) consists of debt maturing in less than one year and 87.9 per cent (US$ 15.4 billion) are maturing in the medium to long-term.

11. The actual financing outcome presented in the Annual Budgets, however, was at variance with the MTDS in FY2012/13, FY2013/14 and FY 2014/15. With exception of budget for FY2011/12, the proportion of external financing in the budget plan has always been higher and domestic debt financing lower than the proportions included in the respective MTDS documents. For instance, the 2015/ MTDS 2016 envisaged external and domestic financing in the proportion of 45:55 for FY2016/17 whereas the budget plan was 61:39, respectively (Table 2). The 63 per cent comprised of 22 per cent concessional, 11 per cent semi-concessional and 30 per cent commercial debt.

Table 2: Kenya: Net Financing Planned under the MTDS and the Budget (In percent)

Financing Source		2011/12	2012/13	2013/14	2014/15	2015/16
External	MTDS	30	35	40	45	45
	Budget	30	57	68	64	61
	Deviation	0	-22	-28	-19	-16
Domestic	MTDS	70	65	60	55	55
	Budget	70	43	32	36	39
	Deviation	0	22	28	19	16

Source: MTDS, Budget Policy Statement, National Treasury.

12. The increase in commercial borrowing to 30 per cent from the 6 per cent envisaged in the 2015 MTDS was necessitated by the need to reduce pressure on high domestic interest rates in the domestic debt market and diversification of financing sources by contracting two syndicated loans. A 2 year syndicated loan was contracted in November 2015 while a second 7 year loan was contracted in June 2016. The 2 year syndicated loan had the effect of reducing the interest rates from 21.0 per cent in October 2015 to 9.69 per cent in December 2015.

13. The financing outturns relative to the budgetary financing targets have deviated in the recent past (Table 3). The annual outturns for external net financing fell short of the budgeted amounts by an average of Ksh 66 billion or 12 percent of total net financing during the period FY2009/10 – FY2015/16. Consequently, actual domestic net financing increased by an annual average of Ksh 4 billion or 12 percent of total net financing. The period, however, experienced total annual net financing outturns that are below budget plans by Ksh 62 billion on average. The first quarter of the FY2016/17 financial outturn was below target by Ksh 90 billion or 49 per cent of total net financing. The source of the deviation was lower external financing partially due to under reporting in Projects AIA. However, this figure may not be representative of the full year outturn and will be revised.

Table 3: Financing of the Budget: Budgeted and Outturns, Kenya

Financing Source	Units	Average (FY2009/10-FY2015/16)			FY2016/17(1st Quarter)		
		Budget	Actual	Deviation from budget	Budget	Actual	Deviation from budget
External	KSH (Billion)	189	123	-66	85	39	46
	Percent	*54*	*42*	-12	*47*	*42*	-5
Domestic	KSH (Billion)	163	167	4	97	53	44
	Percent	*46*	*58*	12	*53*	*58*	5
Total	**KSH (Billion)**	**352**	**290**	**-62**	**182**	**92**	**90**

Source: Budget Policy Statement, National Treasury.

IV. DEBT MANAGEMENT OBJECTIVES AND SCOPE

14. The MTDS is published on the National Treasury website.

15. The debt management objectives are enshrined in the Public Finance Management (PFM) Act, 2012. Section 62(3) of the Act specifies that the debt management objectives are to (a) minimize the cost of public debt management and borrowing over the long-term taking account of risk; (b) promote the development of the market institutions for Government debt securities; and (c) ensure the sharing of the benefits and costs of public debt between the current and future generations.

16. In addition, at operational level the MTDS is linked to cash management to support liquidity management around targeted level.

17. The time horizon of the analysis is the medium term. Projections span three years from FY2017/18 through FY2019/20, consistent with the government's 2017 BPS. The starting point for the analysis is the existing debt portfolio as at end- June 2016 and the projected debt for the medium term.

18. The scope of the MTDS analysis is National government debt and called up guaranteed debt. The MTDS analysis thus covers total National government external and domestic debt amounting of Ksh 3.4 trillion or US$33.5 billion as at end-June 2016, equivalent to 51.4 per cent of GDP. External debt amounted to 26.3 percent of GDP (US$17.0 billion) and domestic debt to 25.1 percent of GDP (US$16.5 billion).[2]

19. External public debt stock comprises predominantly of loans from multilateral, bilateral and commercial creditors. Multilateral debt accounted for 46.0 percent of total external public debt. The largest multilateral creditors were IDA (61.4 percent), followed by AfDB (22.5 percent), IMF (10.7 percent), and EIB and IFAD (3.8 percent). Bilateral debt accounted for 28.6 percent of external public debt stock. The largest bilateral creditors were China (63.7 percent) followed by France, and Japan, each accounting for 12.1 and 9.4 percent, respectively. The US$1.5 billion in commercial loans contracted in FY 2015/16 increased the share of commercial debt to 25.1 percent.

20. The performing government guaranteed debt portfolio amounting to 0.9 per cent of GDP (US$0.56 billion) is excluded from the MTDS analysis. The loan guarantees have been issued on an IDA-financed Kenya railways concessionairing (US$40.0million) as well as to investment projects financed by the governments of Germany (US$81 million) and Japan (US$ 445million). The non performing guarantees include loans to Kenya Broadcasting Corporation and Tana and Athi River Development Authority Table 5.

[2] This amount excludes US$397 million in CBK overdraft, commercial bank advances and Tax Reserve Certificates.

21. Domestic public debt comprises predominantly of marketable securities. 32.2 percent (US$5.3billion) of the domestic debt was in T-bills with maturities of 91, 182, and 364 days while66.2 percent (US$10.9billion) was in medium and longer term T-bonds, including infrastructure bonds (IFB).[3] The government's Pre-1997 debt accounted for US$ 0.4 billion.

Table 4: Kenya: Coverage of Public Debt in the MTDS, End-June 2016

Instrument	Amount		In percent of GDP
	In millions of Kenyan Shilling	In millions of U.S. dollars	
I. Domestic Debt (included in MTDS)			
Treasury Bills	537,283	5,314.4	8.2
Banking Institutions	330,185	3,265.9	5.0
Others	207,097	2,048.4	3.1
Treasury Bonds	1,103,053	10,910.5	16.7
Banking Institutions	541,090	5,352.0	8.2
Others	561,963	5,558.5	8.5
Pre-1997 Government Debt	25,559	252.8	0.4
Sub Total	1,665,895	16,477.7	25.3
II. External debt (included in MTDS)			
African Development Fund	179,226.6	1,772.8	2.7
International Development Association	488,330.0	4,830.2	7.4
Other Multilaterals	127,240.8	1,258.6	1.9
Bilateral	491,863.9	4,865.1	7.5
Non-Performing Guarantees	3,381.0	33.4	0.1
Commercial Banks (Floating rate)	154,346	1,526.7	2.3
Commercial Banks (Fixed rate)			
Eurobond	278,031.0	2,750.1	4.2
Sub Total	1,722,419.6	17,036.8	26.1
III. Excluded from MTDS			
Suppliers Credit	8,469.4	83.8	0.1
CBK Overdraft	44,204.0	437.2	0.7
Guarantees	57,149.9	565.3	0.9
Sub Total	109,823.3	1,086.3	1.7
TOTAL DEBT Included in MTDS (I+II)	3,388,314.6	33,514.5	51.4
TOTAL DEBT (I+II+III)	3,498,137.9	34,600.8	53.1

Source: National Treasury and CBK.

[3]Government securities consisted of T-bills, T-bonds and Infrastructure Bonds.

Table 5: Kenya: Outstanding Government Guaranteed Debt (End-June 2016)
(In millions of Kenya Shillings and U.S. Dollars)

Beneficiary Entity	Ksh million	USD million
Kenya Broadcasting Corporation	2,224	22
KenGen	8,169	81
Tana and Athi River Development Authority	1,157	11
East African Portland Cement	1,438	14
Kenya Ports Authority	43,499	430
Kenya Railways	4,044	40
TOTAL	60,531	599

Source: National Treasury.

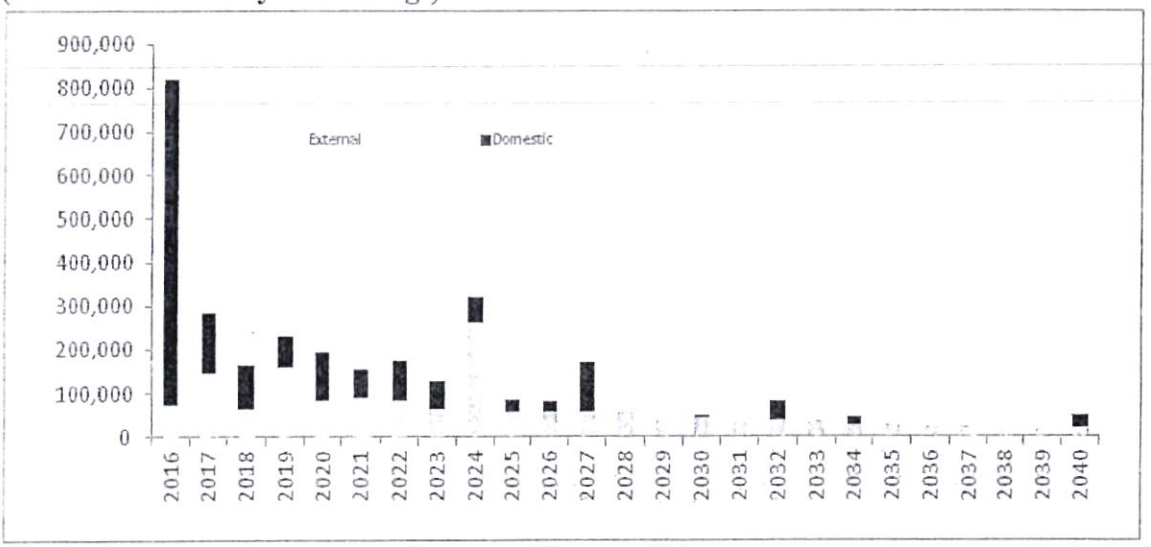
V. COST AND RISK OF THE EXISTING NATIONAL GOVERNMENT DEBT PORTFOLIO, AS AT END FY2015/16

22. Kenya's cost of public debt is low in relation to revenue (16.1 per cent). Annual interest payment was 3.7 percent of GDP, with interest payment on external debt accounting for 0.7 percent and interest payment on domestic debt 3.0 percent of GDP. The low interest payment is due to the large share (approximately 75 percent) of external concessional financing in the existing public debt portfolio. At end-FY 2015/16, the weighted average interest rate on the total debt portfolio was 6.9 percent. The weighted average interest rates for external and domestic debt portfolio were 2.6 percent, and 11.2 percent respectively.

23. There is exposure to refinancing risk. As at end- FY 2015/16, the main refinancing risk is associated with high domestic debt repayments falling due in FY2016/17. 43.0 percent of domestic debt will mature in FY2016/17, this is largely composed of treasury bills. The average time to maturity (ATtM) for domestic debt portfolio is 4.3 years. The ATtM of external debt portfolio is 11.2 years (Table 7). The long ATtM of the external debt portfolio is explained by a large stock of concessional component of the external debt, which has relatively long maturities. The ATtM for the total debt portfolio is 7.8 years (Table 7).

24. However, the refinancing needs falling due in FY2017/18 is US$ 1.4 billion, in FY 2018/2019 is US$ 1.6 billion, in FY2023/2024 is US$1.4 billion and in FY2024/25 is US$ 2.6 billion, mainly associated with a repayment of the Syndicated loan, commercial loan and the international bonds. (Figure 1).

Figure 1: Kenya: Debt Redemption Profile, as at end-FY2015/16
(In millions of Kenyan Shillings)



Source: National Treasury and Central Bank of Kenya

Table 6: Kenya: Remaining Maturity of Outstanding Domestic Debt, as at end-FY2015/16-

Remaining Maturity in Years	In Percent of Total	In million US$
< 1 Y	43	7,409
2 - 3 Y	14	2,399
4 - 5 Y	11	1,856
6 - 10 Y	18	3,119
11 - 15 Y	9	1,509
> 15 Y	5	919
Total	**100**	**17,211**

Source: National Treasury

25. Although 95.2 percent of the public debt portfolio has a fixed interest rate, the interest rates of approximately one quarter of outstanding debt will re-fix in FY2016/17. The weighted average time to re-fixing (ATR) for external debt portfolio is 11 years. 12.0 percent of outstanding external debt will be re-fixed in FY2015/16. The main external debt exposure to interest rate re-fixing, is due to variable rate loans coupled with a small share of external debt maturing in the next twelve months. In the case of domestic debt, 100 percent of domestic debt has a fixed interest rate. Nevertheless 43 percent of the domestic debt portfolio will be re-fixed within a year because of predominance of short-term debt. ATR for the domestic debt is 4.3 years.

26. Approximately half of the total government debt portfolio is exposed to exchange rate risk. The main exposure to foreign currencies was to the U.S. dollar (60.4 percent of the total external debt portfolio), followed by the Euro (22.1 percent), and the GBP and JPY accounting for 4.8 percent and 8.7 per cent respectively. Possible rate hikes by the US Fed in the fourth quarter of 2016 and uncertainties in the financial markets following the Brexit pose a potential exchange rate risk impact on the budget and the rise in external debt service payment in domestic currency, as well as on the total debt levels. (Figure 2)

27. Overall, the existing debt portfolio as at end-FY2015/16 exhibit low cost but embodies interest rate, exchange rate and refinancing risks (Table 7). The stock of debt has low cost due to the predominance of concessional external loans in the existing portfolio. However, the terms of new disbursements are hardening, therefore, the cost is expected to increase over the medium term. Refinancing risk appear to be the risk priority for Kenya, as 43 percent of domestic debt is falling due in one year and part of commercial debt will be due

in FY2017/18[4] . Exchange rate risk is significant, but it is assisted by the low cost of the concessional debt in the public debt portfolio, which offsets the depreciation risk. Interest rate risk will be addressed if refinancing risk is addressed. Future debt management strategy should therefore strive to reduce refinancing risk, while being mindful of exchange rate exposures, particularly on external commercial debt.

28. Instrument risks: The 2015 syndicated loan of USD 750 million carries an acceleration clause in case the government settles for an international debt capital market issuance during or after the fiscal year ending June 2017. This is because, the National Treasury will be liable to repay the 2015 syndicated loan an amount equal to 100 per cent.

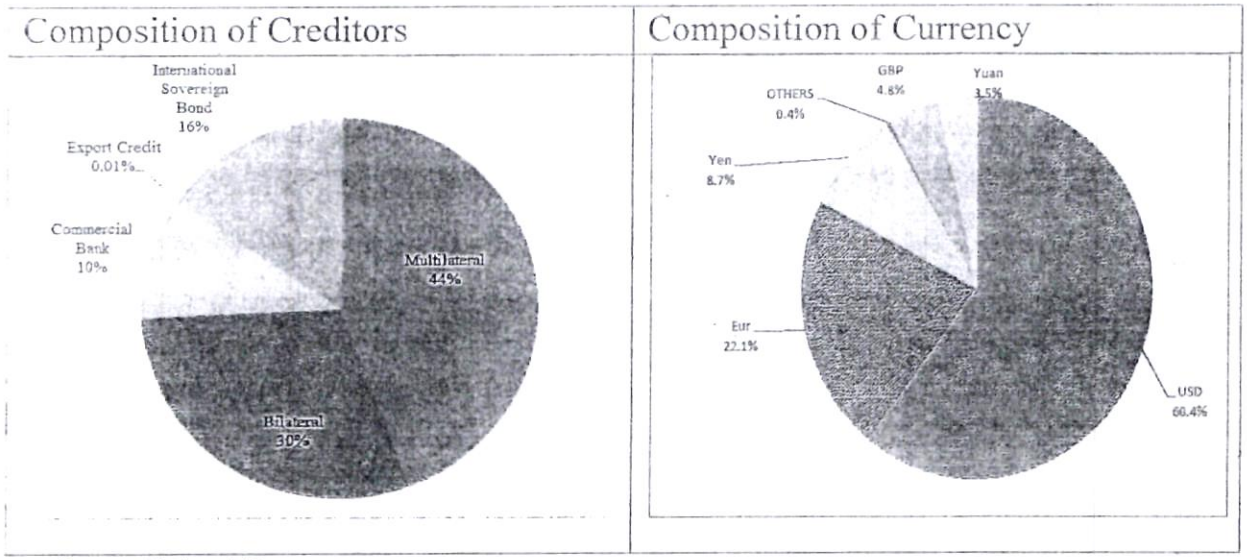
Table 7: Kenya: Cost and Risk Indicators of Existing Debt, as at end-FY2015/16

Risk Indicators		External debt	Domestic debt	Total debt
Amount (in millions of KSH)		1,787,453.8	1,740,128.9	3,527,582.7
Amount (in millions of USD)		17,036.8	16,477.70	34,600.8
Nominal debt as % GDP		26.1	25.3	51.4
PV as % of GDP		20.6	26.4	47.0
Cost of debt	Interest payment as % GDP	0.7	3.0	3.7
	Interest payment as % Total Revenue	3.1	13.0	16.1
	Weighted Av. IR (%)	2.6	11.2	6.9
Refinancing risk	ATM (years)	11.2	4.3	7.8
	Debt maturing in 1yr (% of total)	4.0	43.0	23.3
	Debt maturing in 1yr (% of total revenue)	4.8	49.9	54.7
	Debt maturing in 1yr (% of GDP)	1.1	11.4	12.5
Interest rate risk	ATR (years)	10.9	4.3	7.6
	Debt refixing in 1yr (% of total)	12.0	43.0	27.3
	Fixed rate debt (% of total)	90.5	100.0	95.2
FX risk	FX debt (% of total debt)			50.7
	ST FX debt (% of reserves)			9.5

Source: National Treasury

[4]In October 2015, Kenya contracted a two-year US$750 million syndicated loan at LIBOR plus 520 basis points that will mature in October 2017.

Figure 2: Kenya: External Public Debt, as at end-FY2015/16



Source: National Treasury

29. The currencies mix is a reflection of the source of funding. Kenya's external debt is highly diversified in terms of currency and creditor. A diversified currency structure is important for hedging against exchange rate risks on a country's external debt. Therefore, going forward effort will be made to further diversify and sustain Kenya's debt currency mix. To manage the currency exposure the National Treasury will seek to match its external liabilities with currency composition of Kenya's forex inflows, international reserves, and cost of borrowing in each currency and on relations among the cost of borrowings in different currencies.

VI. BASELINE MACROECONOMIC ASSUMPTIONS AND KEY RISKS

A. Baseline Macroeconomic Assumptions[5]

30. The medium-term macroeconomic framework used in this document is derived from the macroeconomic framework in the 2017 Budget Policy Statement (BPS) whose targets are anchored on the priorities of Jubilee Administration and the Second Medium Term Plan of the Vision 2030. The key objectives on the GOK's medium term agenda include enhancement of business environment for job creation; improvement of productivity and competitiveness in domestic and international markets; reduction in unemployment and strengthening devolution.

31. The baseline assumptions as tabulated in the 2017 BPS are summarized below (See Table 8)

Table 8: Kenya: Baseline Macroeconomic Assumptions

	Unit	2014/15	2015/16	2016/17	2017/18	2018/19	2019/2020
GDP(current prices)	Kshs billion	5,811	6,586	7,435.2	8,284.3	9,258.8	10,021
Real GDP	Per cent	5.5	5.8	6.0	6.2	6.5	6.6
GDP Deflator	Per cent	8.6	7.6	6.1	5.5	5.4	5.6
Consumer Price Index (av.)	Per cent	6.6	6.4	5.6	5.0	5.0	5.0
Revenue	Per cent of GDP	19.1	18.8	20.2	20.4	20.7	21.7
Expenditure	Per cent of GDP	28.2	27.1	27.6	27.5	26.4	26.6
Overall Fiscal Balance	Per cent of GDP	-8.4	-7.5	-6.9	-6.4	-5.1	-4.1
Primary fiscal balance	Per cent of GDP	-5.4	-4.2	-3.8	-3.0	-1.9	-0.8
Revenue	KSh billion	1,107.8	1,237.9	1,501.3	1,694.1	1,919.3	2,174.6
Expenditure	KSh billion	1,640.0	1,781.9	2,048.8	2,275.9	2,448.5	2,665.2
Overall Fiscal Balance	KSh billion	-532.8	-544.1	-547.5	-581.8	-529.2	-490.6
Primary fiscal balance	KSh billion	-315.3	-276.8	-284.8	-246.3	-173.8	-84.4

Source: National Treasury, 2017 BPS

32. Over the medium term, real GDP growth is projected at 6.6 percent in FY 2019/20 while the primary deficit is projected at 3.0 percent of GDP in FY2017/18 and at 1.9 percent of GDP by FY2018/19. Inflation is expected to remain within the current allowable margin of 2.5 per cent on either side of the target band of 5.0 per cent in the medium term.

[5] The macroeconomic assumptions are based on the Government's medium-term macroeconomic framework embodied in the 2017 BPS published for public consultation.

B. Risks to the Baseline Macroeconomic Assumptions in the 2017 MTDS

33. As articulated in the BPS 2017, the macroeconomic framework is exposed to a number of downside risks. Major risks to the macroeconomic framework include:

- Weaker than expected growth in the global economy, continued low demand in advanced and emerging market economies as well as the low commodity prices that may impact negatively our exports and tourism activities and leading to higher debt service/export ratio.

- The uncertainty in the global markets due to potential tightening of US monetary policy and consequent increase in the US interest rates, increasing the refinancing risks of external debt.

- The economy is exposed to risks including any occurrence of adverse weather conditions that may affect government revenue and lead to high debt service/revenue as a measure of sustainability.

- Contingent liability risks. Direct and indirect guarantees to state-owned enterprises (SOEs) and the likely issuance of guarantees to counties pose fiscal risks to the government. Realization of contingent liabilities would increase national government debt stocks and servicing costs as indicators of sustainability.

- PPPs- Support for Public Private Partnerships (PPPs) project through issuance of Letters of Support constitutes an implied fiscal risk to the government. This form of government support to PPPs has in turn created the need to more explicitly manage fiscal risks in the form of Fiscal Commitments and Contingent Liabilities (FCCL) for the GOK. The government will, however, continue to monitor the above risks and will undertake appropriate measures to safeguard debt sustainability.

34. The macroeconomic outlook under the MTEF anticipates prudent debt management. This will be achieved through issuance of medium to long term domestic securities to lengthen the average maturity, which will reduce the pressures on the domestic debt market.

35. The graduation of Kenya to a lower middle income country in 2015 has resulted in a shift from concessional funding to blend financing from both World Bank and African Development Bank. In addition, the cost of borrowing at the international capital markets is expected to rise should the USA Federal interest rates increase. As a result of the changing international market conditions, Kenya will put in place more emphasis on the domestic debt market development.

VII. POTENTIAL SOURCES OF FINANCING

A. External Sources

36. Official sector (Multilateral and Bilateral) creditors continue to dominate the GOK's external financing. The World Bank, through International Development Association (IDA), has been the major external official source, financing development projects and programs (Table 9). Disbursements from IDA increased by 38.5 per cent to US$647 million in FY 2015/16 from US$ 467 million in FY 2012/13, accounting for 20 per cent of total official disbursements . In the FY 2015/16, other multilateral and bilateral Paris Club creditors have also contributed to the GOK's external financing, accounting for about 7.3 percent and 35.0 percent, respectively, of total official creditor disbursements. The non-traditional 'bilateral non-Paris Club' official creditors have gained significant position in financing development projects in Kenya as has been the case in most developing countries. Financing from bilateral non-Paris Club averaged 37.3 percent of total official creditors during the period. (Figure 3).

Table 9: Disbursements by Official Creditors (Millions of US$)

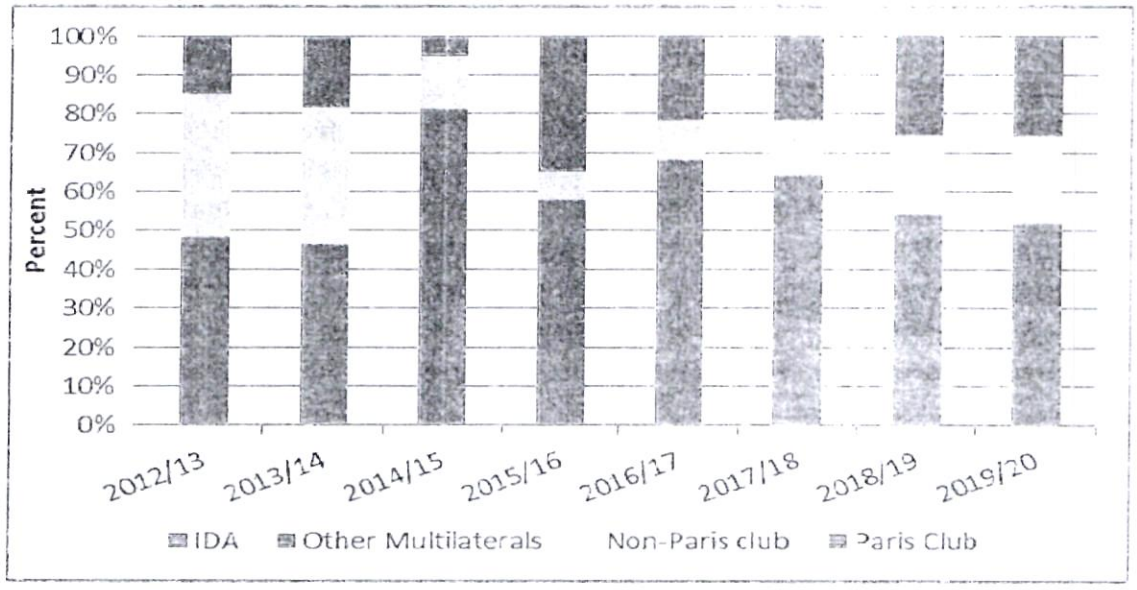
	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	Actuals				*Projections**			
IDA	467	482	1,025	647	1,199	911	784	391
Non-Paris Club	181	98	1,626	1181	1,239	1,236	1,009	266
Other Multilaterals	498	445	444	230	373	464	663	283
Paris Club	198	230	166	1,106	774	730	842	324
Total (USD)	**1,345**	**1,255**	**3,260**	**3,164**	**3,586**	**3,341**	**3,258**	**1,264**

*Projections only include credit that is contracted but is not yet disbursed. It does not include new pipeline credit.

Source: The National Treasury.

37. Based on commitments, the bilateral non-Paris Club creditors will continue to contribute significantly to the financing of projects over the medium term. During the next three years (FY2017/18 – FY2019/20) disbursements from bilateral non-Paris Club creditors will account for about 32 per cent of annual disbursements. This is partly to complete the ongoing infrastructure projects. Another major reason is the fact that Kenya has been reclassified as a lower-middle income country which is expected to reduce financing from concessional multilateral sources. Nonetheless, IDA and Paris Club creditors will continue to contribute to an average of 27 percent and 24 percent, respectively, of total official financing during the next three financial years, albeit at less favorable terms compared to the past.

Figure 3: Kenya: Composition of Official Financing



Source: National Treasury

38. GOK contracted USD$1.5 billion in external commercial loans in the FY 2015/16. In October 2015, the Government contracted a 2 year syndicated loan of US$ 750 million priced at a 520bps above 6-months LIBOR. In addition, in June 2016, a 7 year commercial loan of US$600 million was contracted from China Development Bank Corporation priced at 495 bps above 6-month LIBOR and a 2 year commercial loan of US$ 200 million from African Export Import (Afrexim) Bank at a floating rate of 3 months LIBOR plus a margin of 575bps which was on lent to Kenya Airways.

39. GOK intends to maintain its presence in the international capital markets to achieve its objective of diversifying its sources of financing and to develop the Government`s international yield curve. The government plans to refinance the 2 year syndicated loan maturing in FY2017/18 and the 5-year Eurobond maturing in FY2018/19, in the international capital markets. Alternative sources of financing, through the Islamic financing instruments, the Samurai market, Panda bonds and diaspora bonds are contemplated over the medium term.

B. Domestic Sources

40. Kenya's domestic debt market is relatively shallow and constrains GOK access to domestic savings. Deepening the domestic debt market continues to be a priority, and to this end a Joint Technical Working group, drawn from the National Treasury, Central Bank of Kenya and Capital Markets Authority has been constituted to spearhead reforms.

41. Heightened volatility in emerging market debt has increased the uncertainty of access to and costs of external borrowing at market rates. Increased use of longer-term domestic

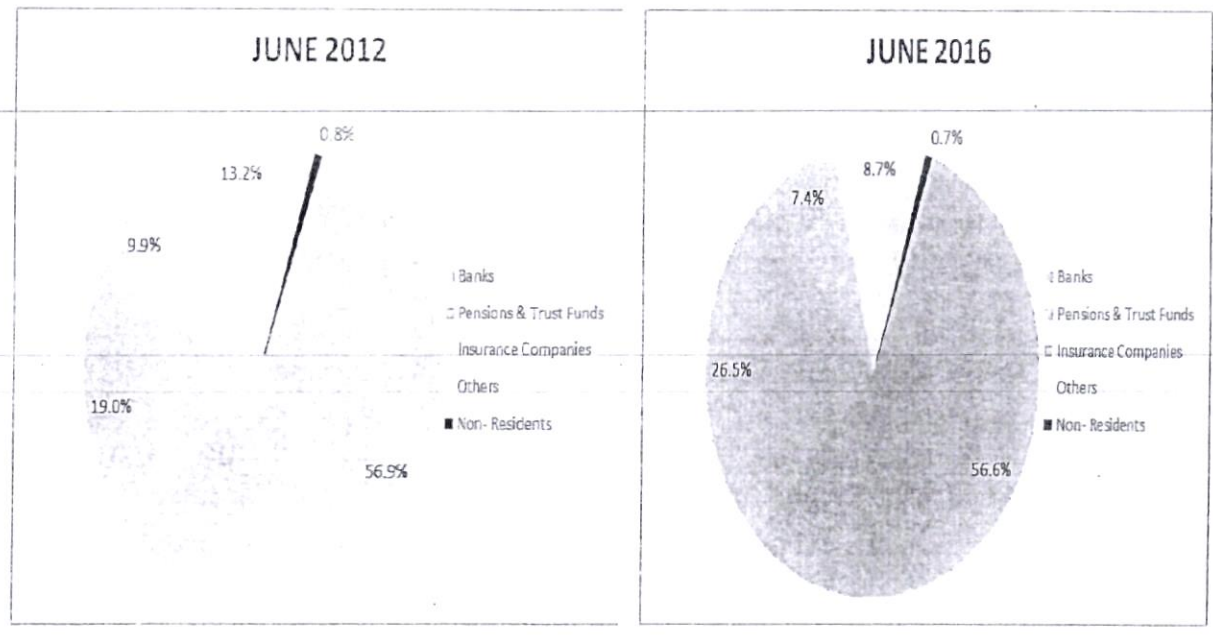
debt instruments would help mitigate exposure of the government debt portfolio to foreign currency risk and contribute to reducing domestic rollover risk. A liquid government debt market would also provide reliable pricing references for other risk assets in the Kenyan economy and accommodate more efficient monetary policy transmission.

Recent Developments in Domestic Debt

42. Commercial banks continue to dominate the domestic investor base for government securities. As at end-June 2016, commercial banks held 57 percent of total outstanding T-bonds and T-bills. Other main holders are pension and trust funds, and insurance companies at 27 percent and 7 percent respectively. Non-resident and other holdings which include among others some financial institutions and state owned enterprises contributed 1 percent and 9 percent, respectively.

43. However, over the past 5 years, there has been progress in investor diversification. There has been growth in the pension sector due to increased pension contributions.

Figure 4: Kenya: Holders of Domestic Government Debt Securities



Source: CBK.

44. Pension and other trust funds currently hold 26 percent of the outstanding stock of government debt securities. This compares with 19 percent in 2012. Industry estimates suggest that the total size of pension assets is now approximately Ksh 1 trillion, 40-50 percent of which is invested in government securities. Government securities held by the pension sector are estimated to have been growing at an average annual rate of 25 percent.

45. Insurance company net holdings of government bonds and bills have grown broadly in line with the domestic debt stock over the past 5 years in nominal terms. Growth has been supported by annual increases in insurance premiums revenues, averaging 15 percent in life insurance and 18-20 percent in non-life.

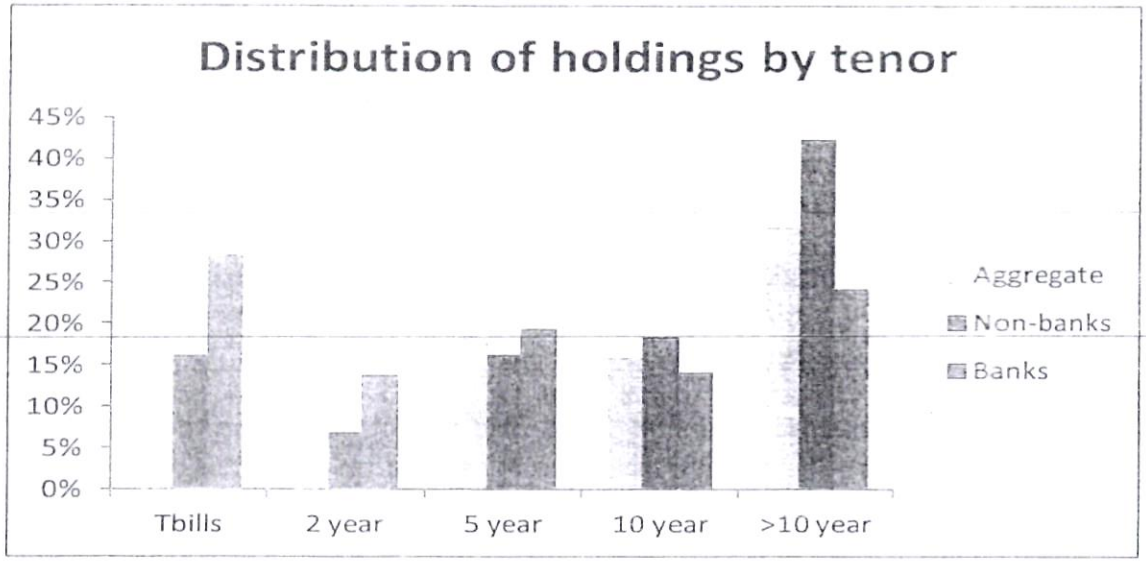
46. Foreign investor holding is relatively small. Foreign investor holdings of T-bills and T-bonds are estimated to account for less than 1 percent of the total outstanding. Foreign investors hold bonds in nominee accounts at the commercial banks, so precise information about their holdings incomplete.

Domestic Financing Prospects

47. The Kenyan banking sector is expected to sustain new demand for government securities. Banking sector customer deposits increased by 8.73 per cent from Ksh.2.29 trillion in December 2014 to Ksh.2.49 trillion in December 2015.This growth is attributed to the increased deposits mobilization by banks as they expanded their outreach and leveraged on mobile phone platforms to mobilize lower cost deposits. The recent capping of interest rates is expected to increase the appetite for government securities by commercial banks in a bid to secure risk free income streams. Interest rates spikes in the fourth quarter of 2015 resulted in the shrinking of private sector credit as banks became more cautious on lending. The private sector credit gap (actual credit advanced to private sector minus the targeted credit allocation required to support economic growth) widened rapidly from December 2015.

48. Commercial Banks continue to prefer shorter dated securities compared to longer dated government securities to best match their cash flow requirements on customer deposits. However, long term securities are held to leverage on their returns. Data from CBK indicate that the bank holdings are broadly distributed between T-bills, less than 5 year Treasury bonds and over 5 years. (Figure 5).

Figure 5: Kenya: Distribution of holdings by Tenor of Domestic Government Debt Securities (In percent of total domestic government securities outstanding)



Source: CBK

49. Pension funds are expected to continue to show robust growth in the medium term, with introduction of new products each year. Pension industry is relatively stable and has witnessed tremendous growth in the recent past. Pension assets have mainly invested in government securities especially longer dated T-bonds and quoted equities. Various innovations like introduction of new products such as post- retirement medical schemes and new asset classes like real estate investments trusts (REITs), private equity and venture capital are likely to see the industry grow in future and hence make the sector a potential source of domestic finance.

50. Demand for government securities from insurance sector continues to grow. Increased capital requirements introduced by Insurance Regulatory Authority (IRA) could lead to consolidation and restructuring in the medium term hence improving capacity, stability and higher investment returns. Non-life sector premiums remain buoyant and accounts for 65 per cent of total premiums. Future premium growth is expected to be at least as fast as the growth in nominal GDP, supported by new products such as micro-insurance targeting low income earners and agricultural insurance as well as, new technology and adoption of new distribution channels like bank assurance.

51. Non-life insurance demand for securities is expected to be skewed to T-bills and medium term bonds. General insurance have conditional liquidity requirements and thus prefer holding shorter term and more liquid securities. Life insurance demand is growing slowly due to the nature of their products.

52. Non-residents, though an important source, is not expected to provide significant source of demand for government securities due to their low base over the medium term. Reduced liquidity and lack of transparency in pricing in the secondary market raises the costs of transaction and this discourages foreign investors from participating in the domestic debt market.

53. The secondary market in Kenya continues to grow. The annual turnover of Treasury bonds worth Ksh 344.1 billion was traded in the FY20151/16.The most active bonds during the period under review were infrastructure Bonds.

54. The government is committed to its objective of developing the financial market through introduction of new products aimed at ensuring financial inclusion and also promoting the saving culture for its people. In this regard the National Treasury plans to introduce retail based product M-Akiba an initiative aimed at providing an avenue for investing in Treasury Bonds conveniently through mobile phone platforms. The product aims at promoting the saving culture as the government widens its investor base in government securities. This is in line with the second medium term objectives of stimulating long term savings and reduces vulnerability.

55. Growth prospects of the domestic market. The government has been undertaking reforms in the financial sector spearheaded by the National Treasury. Recently, the Central bank of Kenya in collaboration with the National Treasury initiated the process of ensuring there is in place, an issuance calendar to be posted on the National Treasury website, an electronic trading platform of government securities and a vibrant over the counter Government bond market. The government is also in the process of segmenting the securities market into retail and wholesale in order to develop a strong base for primary dealership.

56. In summary, the net new demand for government bonds and bills that could reasonably be drawn upon to meet net domestic debt financing targets is summarized according to investor type below (Table 10). Residual financing requirements are expected to be financed through additional T-bills:

Table 10: Kenya: Sources of Net New Potential Demand (Ksh million)

	2016/17	2017/18	2018/19	2019/20
Treasury Bills	56,000	62,000	52,000	39,000
Treasury Bonds	238,000	262,000	223,000	167,000
Banks	105,000	116,000	98,000	73,000
Pensions	91,000	100,000	86,000	64,000
Insurance Cos.	28,000	31,000	26,000	20,000
Other	14,000	15,000	13,000	10,000

Source: National Treasury

VIII. COST-RISK ANALYSIS OF ALTERNATIVE DEBT MANAGEMENT STRATEGIES

A. Baseline-Pricing Assumptions and Description of Shock Scenarios

57. The pricing assumptions for interest rates and the exchange rate under the baseline pricing assumption are presented below.

- Concessional external loans are priced at a fixed rate of 0.75 percent, with a 30-year or 40-year tenor and a 10-year grace period. The terms of concessional borrowings from IDA will harden due to Kenya's graduation from a low income to lower middle income country[6].

- Semi-concessional loans are assumed to be contracted from official creditors. These loans have a fixed interest rate of 2.5 percent, a maturity of 25 years including a 5-year grace period; this includes loans from IBRD and ADB hybrid basket which Kenya is expected to draw from after graduation from a low income to lower middle income country.

- Commercial borrowings utilizing the international syndicated loan market are priced at 6-month LIBOR[7] plus 520 basis points (bps).

- Accessing the international capital markets is priced-off the assumed effective yield curve, which is based on the underlying forward US Treasury curves plus an assumed credit spread as discussed below.

58. Future baseline interest rates are projected based on the observed U.S. Treasury interest rates in FY2016/17.

- The future interest rates are calculated by projecting the implied forward rates from the observed rates. For instance, given the observed 1- and 2-year interest rates, the implied forward 1-year rate one year from today can be calculated, assuming no arbitrage conditions. This methodology is applied to determine the future 1-year reference rates.

- The future interest rates of market-based fixed-rate debt instruments in the international capital markets are based on the currently prevailing interest rates, which are derived by first adding a credit spread of 700 bps to the U.S. Treasury spot

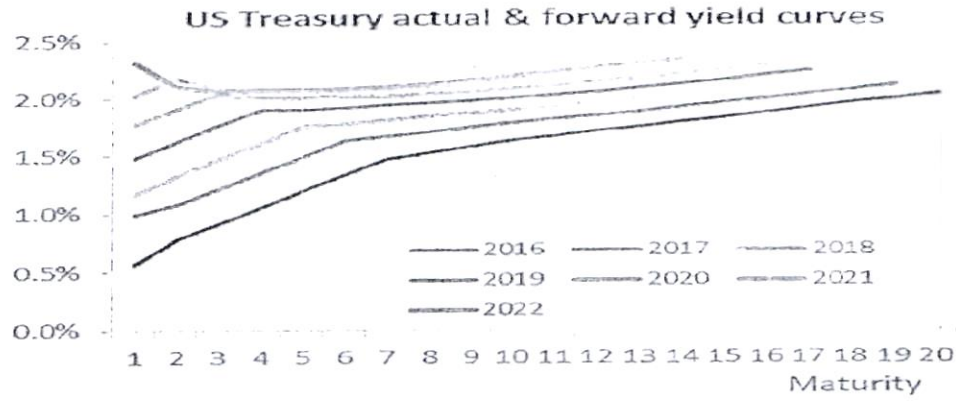
[6] The new financial terms from IDA applicable from 2018 will be 2 percent interest rate, 25 year final maturity and 5 year grace period

[7] London Interbank Offered Rate.

yield curve, and the forward yield curve is derived using the same methodology described above.[8]

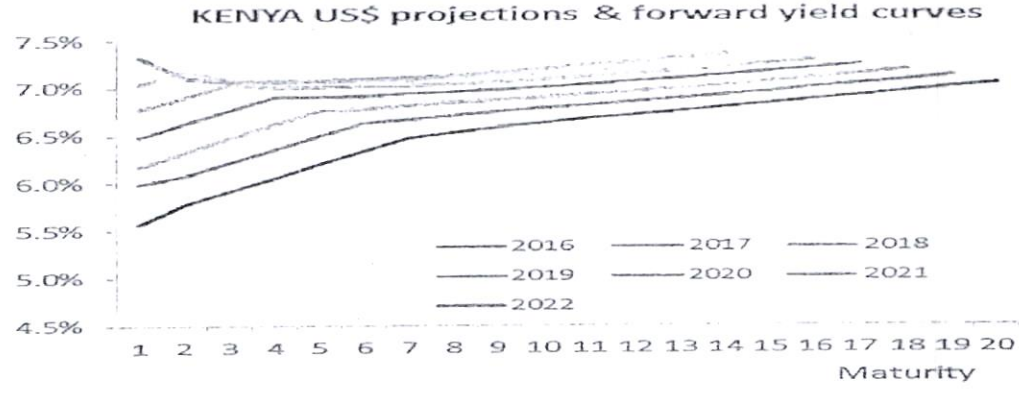
- The forward yield curve for the Ksh denominated borrowing is calculated further by adding the difference in the inflation rates between Kenya and the United States of 7.0 percent and 2 percent in 2016, respectively, thus deriving an additional 5 percent inflation rate differential spread. The Ksh yield curve as of end-December 2015 is flat to downward sloping reflecting the expectation that inflation will come down over the medium-term.

Chart 1: US Treasury Actual & Forward Yield Curves



Source: US Treasury

Chart 2: Kenya US$ Projections & Forward Yield Curves



Source: US Treasury

[8] Based on secondary market spreads of the 2019 and 2024 Eurobond as at February 1, 2016.

59. The baseline exchange rate assumptions are as follows: Under the baseline scenario, Ksh is assumed to depreciate 5 percent against the U.S. dollar in, 2017, 2018 and 2019, which is consistent with prevailing government's macroeconomic framework and reflecting the inflation differential.

60. The interest rates may increase unexpectedly relative to the baseline projections. For example, the U.S. interest rates could increase faster than expected, Kenya's credit risk premium could increase, or Kenya's inflation expectation may not be anchored. The robustness of the strategies must therefore be examined against possible interest rate shocks.

61. The following interest rate and exchange rate shock scenarios for FY2017/18–FY2019/20 are considered against the baseline interest rate shock scenarios. Three risk scenarios are analyzed, including a combined exchange-rate and interest-rate risk scenario, a stand-alone risk scenario for interest rates, and a stand-alone risk scenario for the exchange rate, as follows:

- The first risk scenario assume that U.S. Treasury rates increases faster than expected by 2018, it increases by a moderate shock of 3 percent and remains constant thereafter (Chart 3). Domestic interest rates also receive a moderate shock of: (i) 10 percent for T-bills; (ii) 6 percent for 2-year; (iii) 3 percent for 5-year; and (iv) 2.5per cent for 10-year and longer (Chart 4). This interest rate risk scenario is combined with the 15 percent exchange rate depreciation.

Chart 3: Kenya Domestic Projections & Forward Yield Curves

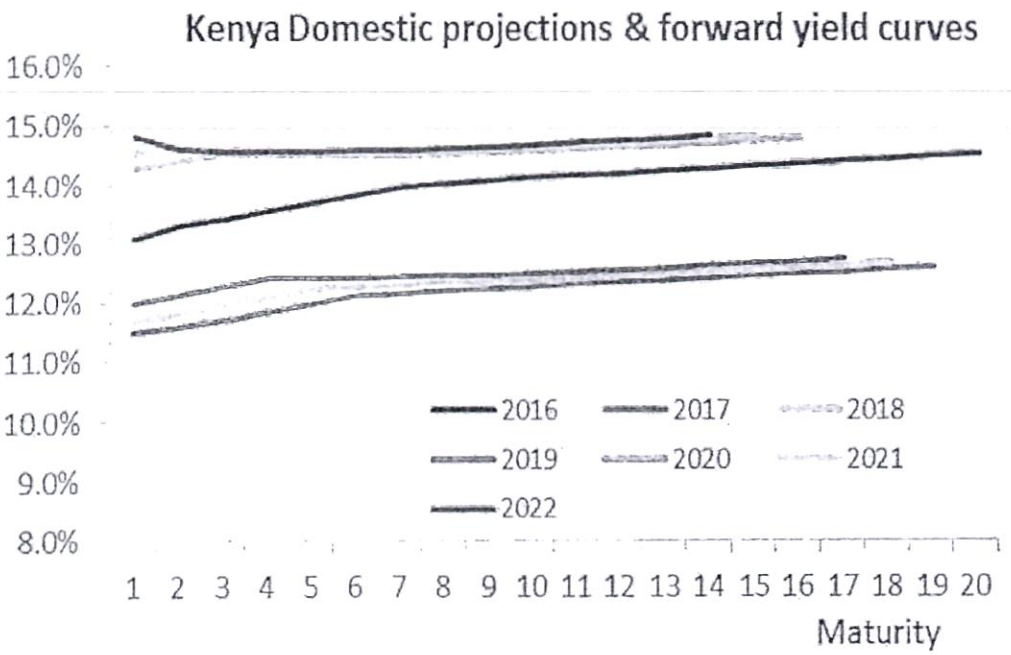
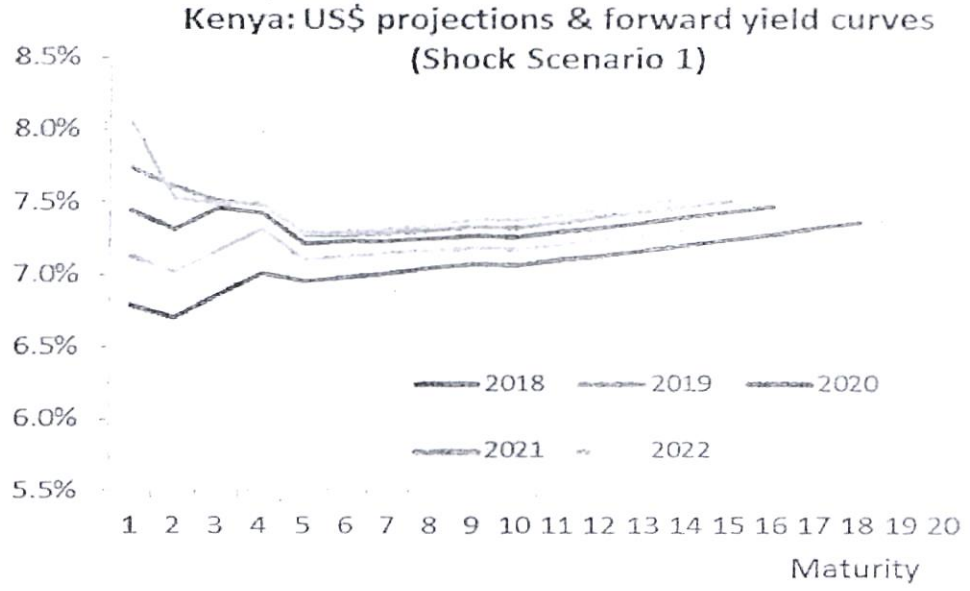
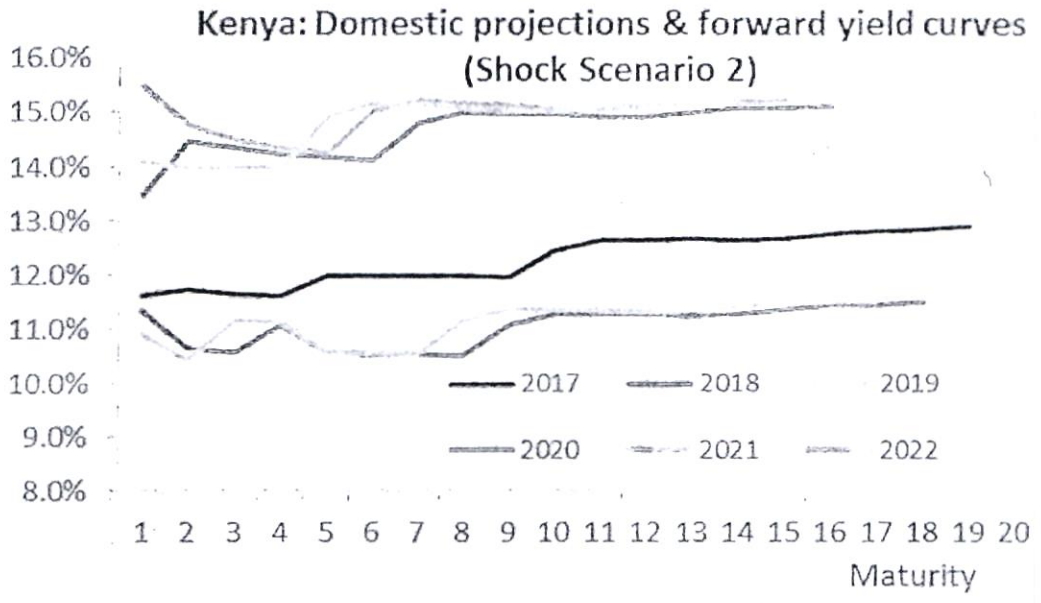


Chart 4: Kenya US$ Projections & Forward Yield Curves (Shock Scenario 1)



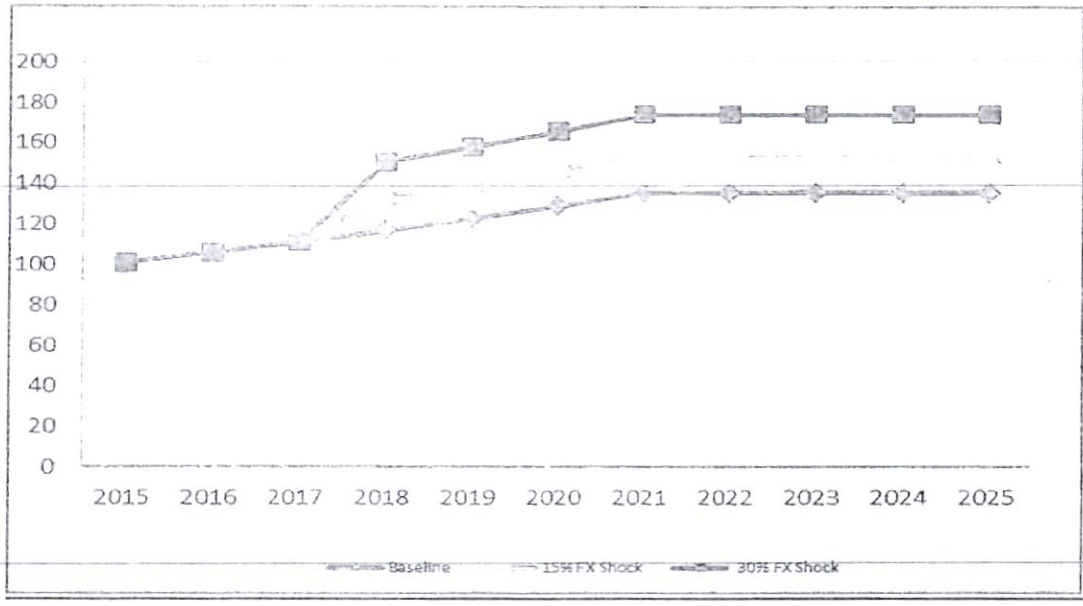
- The second risk scenario assumes U.S. Treasury rates increases faster than expected by 2017, it increases by an extreme shock of 4percent over the baseline projections and remains constant thereafter (Chart 5). Domestic interest rate also increases in an extreme shock of: (i) 15 percent for T-bills; (ii) 10 percent for 2-year; and (iii) 5 percent for 5-year and longer bonds.

Chart 5: Kenya Domestic Spot & Forward Yield Curves (Shock Scenario 2)



- A stand-alone exchange rate risk shock scenario is applied where by the Ksh declines by an aggressive depreciation shock of 15 and 30 per cent against the US$ in 2018 compared to the baseline exchange rate projections. (Chart 6)

Chart 6: Kenyan Shilling Exchange Rate Projected Depreciation & Shock Scenarios



62. The domestic interest rate shocks are more severe in the short end compared to the long end. Historically, sharp interest rate shocks in Kenya are most severely felt in the short end of the yield curve, i.e., 1-year and less, while longer rates e.g. 5-year plus remain relatively stable. Thus the two scenarios will witness a sharp increase in short-term rates and a moderate increase in medium to long-term bonds causing a severe inversion of the yield curve or a downward sloping yield curve.

B. Description of Alternative Debt Management Strategies

63. Four strategies were considered for the MTDS 2017. These strategies reflect alternative ways to meet the borrowing requirement during FY2017/18–FY2019/20. The strategies combine different mix of stylized instruments that reflect the potential sources of financing outlined in Section VII. The strategies are built first on the split between net external and domestic financing (Table 11), and then on the share of T-Bills used for net domestic financing (Table 12).

Table 11: Net Borrowing (In percent of GDP)

	Strategies	2016	2017	2018	2019
External net borrowing	S1	3.4	3.4	4.1	2.6
	S2	3.4	5.5	5.3	3.4
	S3	3.4	3.1	3.8	2.0
	S4	3.4	4.0	4.5	3.6
Domestic net borrowing	S1	3.5	3.0	0.9	1.5
	S2	3.5	0.9	-0.3	0.7
	S3	3.5	3.3	1.3	2.1
	S4	3.5	2.4	0.5	0.5
Fiscal Deficit	S1	6.9	6.4	5.1	4.1
	S2	6.9	6.4	5.1	4.1
	S3	6.9	6.4	5.1	4.1
	S4	6.9	6.4	5.1	4.1

- **Strategy 1 (S1): Status quo.** This strategy represents current policy intent, and will be referred to as the baseline strategy. Under this strategy, as part of the 2017 BPS, over the next three fiscal years, more than half of the fiscal deficit will be met by net domestic borrowing on average. Considering shorter maturities of the domestic debt, this is equivalent to a split of 55:45 between external and domestic borrowing in gross terms. This composition is to be achieved by external commercial borrowing of issuing US$ 1.5 billion in FY2017/18, US$1.25 billion in FY2018/19 and US$ 0.53 billion FY2019/20, in addition to the contracting of credit from concessional sources. On the domestic side, the objective is to reduce the share of T-Bills in total net domestic financing. However, under this strategy, T-bill issuance will continue to be high in FY2017/18 as a result of the issuance outcome in FY2016/17, at a T-bill to T-bond net financing mix of 59:41. In a three year period, the share of T-Bills in net domestic financing is to be reduced to a level around 55 percent from the current level of 59 percent.

- Strategy 2 (S2): More semi-concessional loans each year. This strategy increases the size of external borrowing by increasing the amount of loans from the semi concessional sources in each of the three years, as compared to S1. The increase in semi concessional external borrowing will help in reducing the issuance of T-Bills and T-Bonds volumes as in S1.

- Strategy 3 (S3): Increased Issuance of Domestic medium term debt. As opposed to S2, this strategy reduces the volume of external semi concessional and commercial borrowing every year. The resulting financing gap is to be met mainly by T-Bonds, keeping their share in net domestic borrowing to around 70 percent and to reduce exchange rate exposure.

- Strategy 4 (S4): Increased Issuance of commercial borrowing. This strategy assumes accelerated borrowing from capital market or other commercial sources, while maintaining presence in the domestic market through issuance of T bills and T-Bonds, maintaining their share in net domestic financing at 59:41percent in FY2017/18 of the strategy.

64. The gross issuance volumes of the instruments are derived by adding the actual and projected redemptions to the net financing. The share of instruments in gross financing for each year for each strategy is depicted in Table 13. While T-Bills dominate the gross financing profile (Figure 6 and 7), the concessional and non-concessional loans are still the main sources of net financing. (Figure 6 and 7).

Table 12: Composition of Net Domestic Borrowing (In percent of total net borrowing)

	Strategies	2016	2017	2018	2019
Share of T-Bills	S1	59%	32%	49%	79%
	S2	59%	29%	9%	13%
	S3	59%	30%	30%	32%
	S4	59%	59%	18%	46%
Share of T-Bonds	S1	41%	68%	51%	21%
	S2	41%	71%	91%	87%
	S3	41%	70%	70%	68%
	S4	41%	41%	82%	54%

Figure 6: Gross Issuance by Instrument, by Strategy, by Year (In billions of Kenyan Shilling)

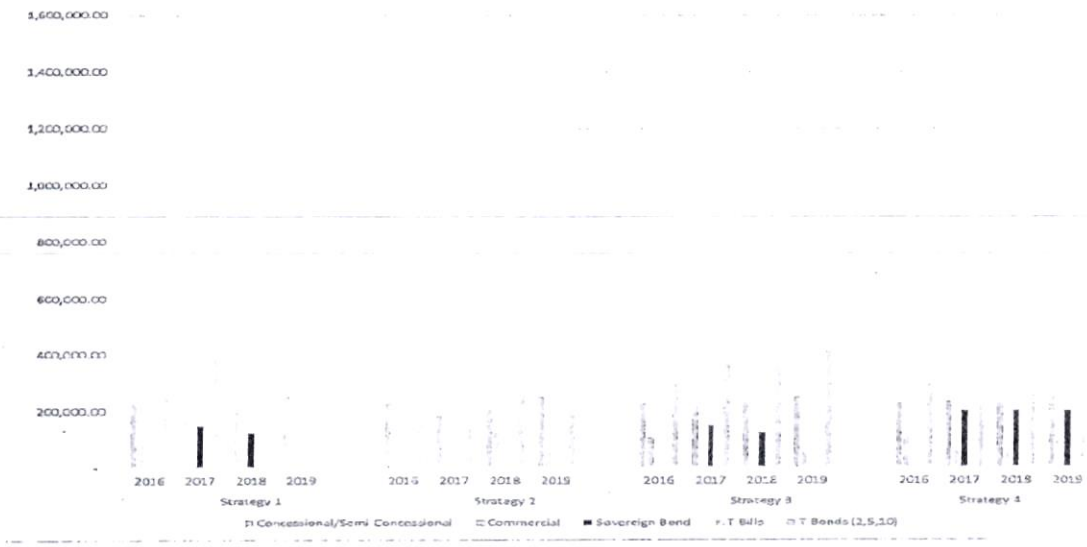
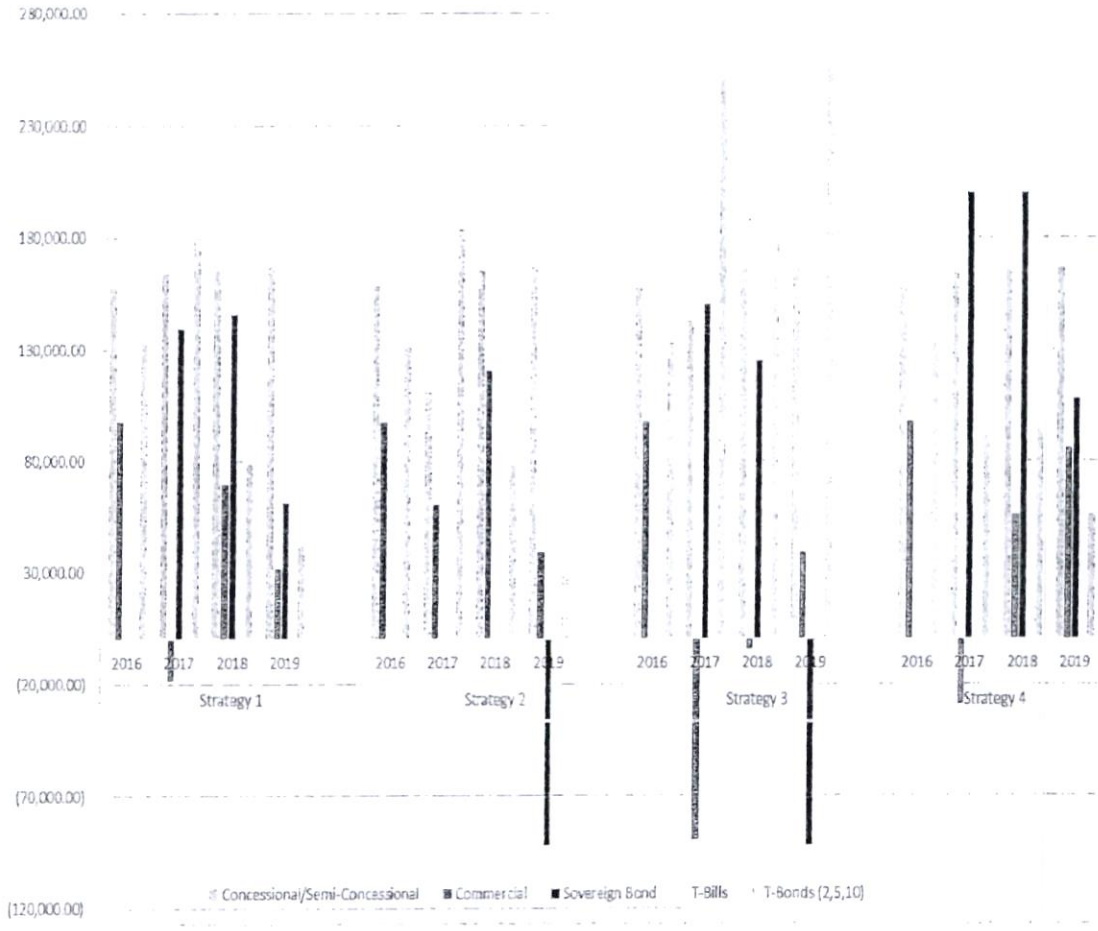


Figure 7: Net Issuance by Instrument, by Strategy, by Year (In billions of Kenyan Shilling)



C. Cost-Risk Analysis of Alternative Debt Management Strategies

65. The performance of the selected four strategies was assessed under both the baseline and shock scenarios. Several cost and risk indicators were computed to determine how the strategies respond to a set of shocks. Upon the input of existing debt and applying the alternative financing strategies, using the baseline projections for relevant macro-fiscal and market variables, the MTDS Analytical Tool generates future cash flow and provides information on future debt composition and size, i.e. at the end of the chosen time horizon which in this analysis covers the period FY2017/18-FY2019/20.

Baseline results

66. The financing policies to be pursued during FY2017/18-FY2019/20 will have an important effect on the portfolio composition. The near-to-medium term redemption profile is dominated by domestic repayments and external commercial debt maturing during

FY2017/18 and FY2018/19. This underscores the importance of a medium-term approach to debt management. The results of pursuing alternative debt management strategies in terms of composition of the debt at end-FY 2019/20 is presented in Table 13. The table shows the ultimate impact of the borrowing policies.

Table 13: Composition of Debt by Instrument under Alternative Strategies, as at end-FY2019/20 (in percent of outstanding portfolio)

	FY2015/16 Existing Debt	As at end FY2019/20			
		S1	S2	S3	S4
Instrument					
Concessional	23	22	22	22	22
Semi-Concessional	11	13	22	16	13
Commercial	9	9	10	7	10
Sovereign Bond	8	12	9	9	14
T-Bills	17	18	13	16	16
T-Bonds (2,5,10)	32	26	24	29	25
External	51	56	63	54	59
Domestic	49	44	37	46	41
Total	**100**	**100**	**100**	**100**	**100**

Source: National Treasury

67. The baseline strategy (S1) foresees an increase in the share of external debt. Although in terms of gross financing, the weight is greater on domestic borrowing, the picture is reversed in net financing. The long maturity profile of external debt, due to outstanding concessional and semi-concessional loans, means that the gross external borrowing will be much greater than maturing debt. Therefore, net external financing will be higher than net domestic financing. This will eventually lead to an increase in the portion of external debt.

68. Demand for longer term T-Bonds will increase gradually. The sizes of the external commercial borrowing will therefore determine the share of T-bills and T-bonds in the debt portfolio. In S2, where semi concessional borrowing is increased, T-Bonds will meet the financing gap; T-Bills are envisaged to be used only to manage the cash-flows within the budget year, without the need for raising funds for the overall financing. The reliance on T-Bills can be still is reduced by issuance of medium term bonds, as in S3 to reduce the refinance risks.

69. As the portfolio composition changes, the cost and risk indicators will also change. Table 14 depicts how these indicators result under each of the strategies, compared to current status. Under each strategy, the debt to GDP ratio increases as a result of the assumptions for fiscal policy and economic growth. This is an outcome of the macro-economic policies, which is not within the scope of decision making for the debt strategy. The baseline interest

costs of alternative strategies are also comparable, reflecting Kenya's credit spread in the domestic and external markets, and the expected path of depreciation for the local currency.

Table 14: Cost and Risk Indicators under Alternative Strategies (End-FY2019/20) (Baseline Scenario)

Risk Indicators		FY2015/16	As at end FY2019/20			
		Current	S1	S2	S3	S4
Nominal debt as % of GDP		53.1	59.1	59.3	59.1	59.2
Present value debt as % of GDP		47.0	51.9	51.9	51.6	51.8
Interest payment as % of GDP		3.7	3.7	3.5	3.6	3.7
Implied interest rate (%)		6.9	6.9	6.5	6.8	6.9
Refinancing risk	Debt maturing in 1yr (% of total)	23.3	20.4	15.6	18.8	18.3
	Debt maturing in 1yr (% of GDP)	12.5	12.1	9.3	11.1	10.8
	ATM External Portfolio (years)	11.2	10.8	11.1	11.2	10.5
	ATM Domestic Portfolio (years)	4.3	3.2	3.6	3.5	3.5
	ATM Total Portfolio (years)	7.8	7.8	8.6	8.0	7.9
Interest rate risk	ATR (years)	7.6	7.5	7.7	7.6	7.7
	Debt refixing in 1yr (% of total)	27.3	24.0	25.2	23.4	21.8
	Fixed rate debt (% of total)	95.2	95.8	89.8	94.8	95.8
FX risk	FX debt as % of total	50.7	58.1	64.4	56.1	61.4

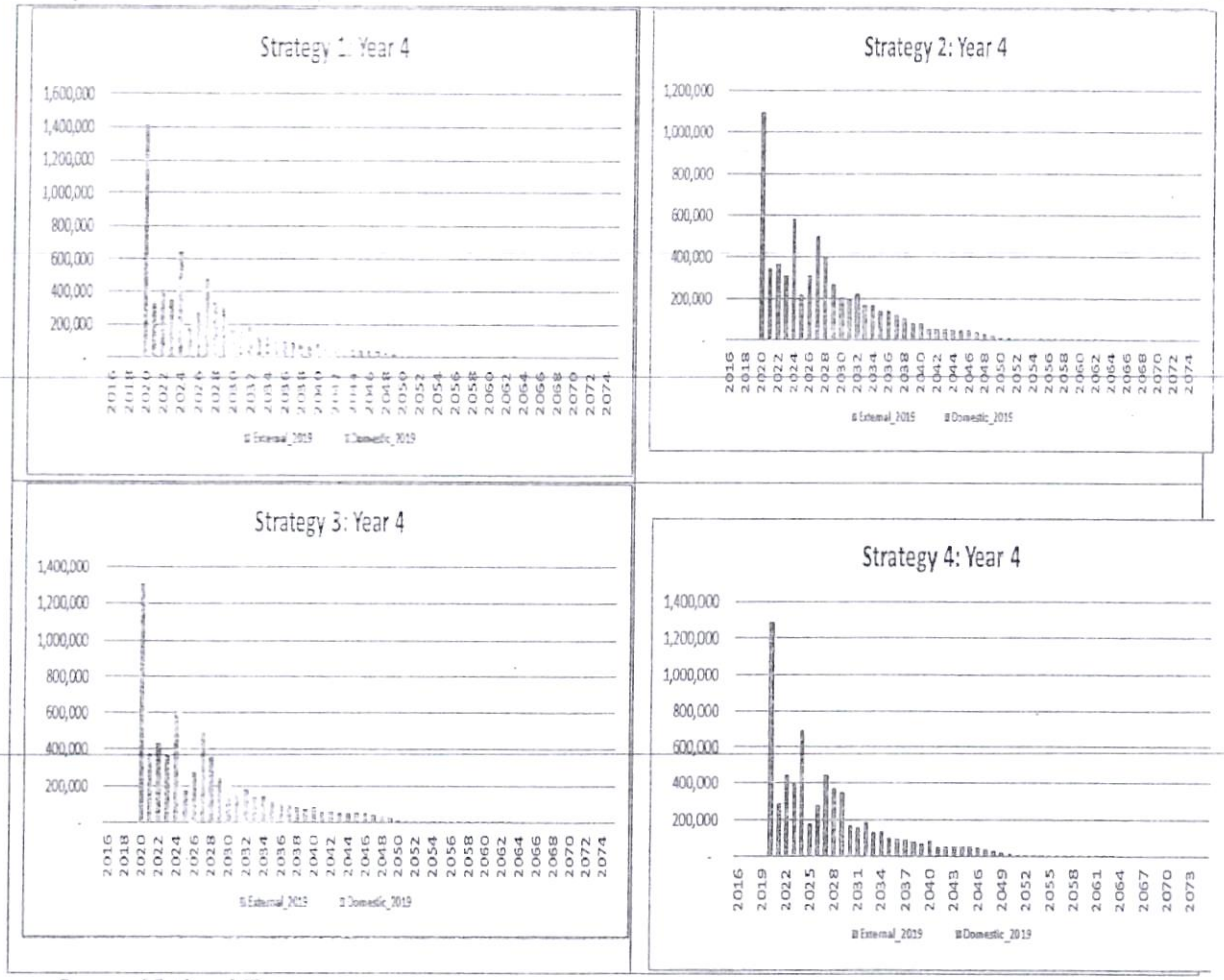
Source: National Treasury

70. Should the domestic interest rates increase, the cost of financing will be immediately reflected on the T-Bills and T-bonds. In such a case, Strategy 2 can be more resilient, as there will be less debt to be re-fixed in one year compared to other strategies though not comparable to the current portfolio. It does, on the other hand, increase the growth rate of the share of external debt to total debt. This would lead to a high exchange rate risk.

71. Refinancing risk will still be dominated by the short maturities of domestic debt. Strategy 2, encompassing increased semi concessional loans, has one of the longest average-time-to-maturity (ATtM), and the lowest ratio of debt maturing within the next year.

72. The maturity profile provides more detailed information about the evolution of the exposure to refinancing risk. As depicted in Figure 8, as the share of T-Bills continue to dominate the financing mix, near term redemption levels will be elevated as in Strategies 1 and 3. This would be alleviated by increasing the share of external debt Strategy 2 and issuance of medium to long term T-Bonds which will smoothen the redemption profile.

Figure 8: Redemption Profiles for Alternative Strategies (End-FY2019/20) (Baseline Scenario)



Source: National Treasury

Impact of market shocks

73. The performances of the four alternative debt management strategies were also evaluated under the shock scenarios. Among a number of cost and risk indicators considered as part of the scenario analysis, three key indicators, debt/GDP and interest payments/Revenues and interest payments/GDP were computed to determine the cost of various strategies under the baseline pricing scenario and shock scenarios. Risk for a given financing strategy is the difference between its cost outcome under a risk scenario (i.e., one with a shock to the baseline) and under the baseline scenario. The worst-case outcome across the three stress scenarios described above is used to quantify the risk associated with each of the strategies.

74. The debt/GDP ratio illustrates changes in the size of the outstanding debt under the baseline and market shock scenarios. The variations are mainly due to exchange rate fluctuations and the cumulative impact of higher interest payments, primary deficit, and

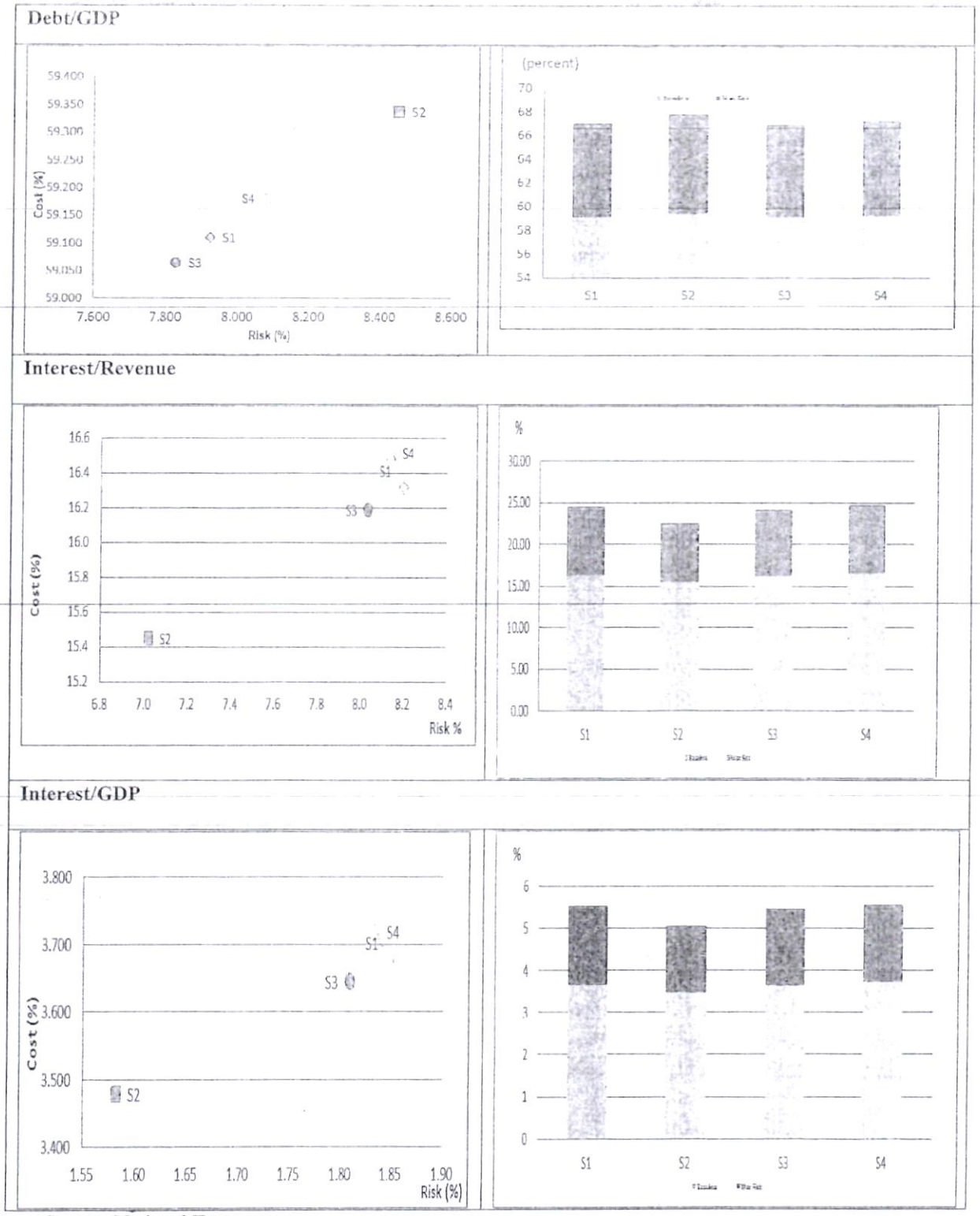
refinancing of maturing debt and refinancing of the fiscal deficit at higher interest rates. External debt can be issued at lower interest rates, and thus the real effect of an increase in the exchange rates is captured more effectively by analysing the changes in the level of outstanding debt, rather than interest payments. On the other hand, this measure does not account for the debt service costs as depicted in the government budget or in terms of Treasury cash-flows.

75. Interest payments/revenue and interest payments/GDP measures each strategy in terms of direct interest costs. These measures capture the outcome of rising interest rate levels, as reflected in the actual cash-flows. The burden of interest service on the budget is reflected by the ratio of interest divided by revenue or GDP. However, this measure does not reveal the full cost associated with exchange rate variations.

76. The outcome of the analysis identifies the trade-offs between costs and risk, even though the strategies can be more and less efficient .This means that a better result cannot be achieved in either cost or risk without losing on either. The results with respect to different indicators can also pose a different picture about the ranking of the strategies. As different indicators capture different features, the three measures discussed above as well as the other risk indicators in Table 15 were used together to enable a more complete evaluation of costs and risks. The results are depicted in Figure 9.

77. The ranking of the strategies is almost reversed with respect to the two indicators. While S3 seems to dominate other strategies with regard to the debt/GDP indicator, it performs the worst when taking into account the interest/revenue and interest/GDP ratio. Reduced external borrowing decreases the level of exchange rate risk, but the resulting increase in the issuance of T-Bonds and T-bills exposes the government to interest rate risk. The opposite argument holds for S2, while S4 is more costly due to the commercial nature of the loans. It should also be emphasized that strategies S4, S3 and S1 are close in terms of the risks, therefore other considerations, including the redemption profile, market outlook implementation practicability etc., also need to be taken into account in making a decision.

Figure 9: Cost-Risk Representation of Alternative Borrowing Strategies (End-FY2019/20)



Source: National Treasury

78. Given the limitations in the domestic debt market, Kenya will have to diversify its funding sources to mitigate refinancing risk. In this regard, the Government should maximize the utilization of semi concessional and concessional financing. The utilization of available multilateral and bilateral loans help reduce refinancing and interest-rate risk, without adding to the cost.

79. Reducing the share of external debt would help to mitigate the exchange rate risk. While increasing the size of borrowing through semi concessional loans (S2) leads to a lower interest cost due to the lower coupon rates, this would increase the exposure of the debt portfolio to exchange rate fluctuations. In the event of a shock, the debt/GDP ratio will increase, which may intensify the risk perception in the markets with regard to debt sustainability.

80. A well-managed external borrowing program will help in reducing the pressures in the domestic debt market. However, the Government will need to have a view on the targeted level of debt portfolio composition in terms of the share of external debt taking into account the external factors which may impact the level of debt/GDP ratio. Maintaining a certain volume of presence in international markets, as part of a well-designed borrowing program, will enhance the predictability and credibility of the sovereign, leading to improvement in the borrowing terms. The preparation of such a program should be accompanied by improved market investor relations as well as s enhanced communication with information disclosure policies with regard to the debt strategy, fiscal and macro outlook etc.

81. Gradual reduction of reliance on T-Bills will not only improve the redemption profile, but also mitigate interest rate risk. The near term refinancing profile is determined by the composition of domestic debt, and changing it would help contain the risks. Strategies 1 and 4 have different speeds of achieving a financing mix that would increase the share of net financing raised by T-Bonds. Ideally, T-Bills should be used for cash management purposes, while long term financing needs are met by T-Bonds. While increasing the share of T-Bonds rather rapidly, as in S4, would lead to better debt management environment, the final decision on the path of achieving this end will depend on the demand side constraints discussed in Section III b. Maintaining a certain volume of presence in the foreign bond market will also help achieve this objective.

82. In conclusion, taking into account both risk and cost trade-offs, the implied quantity of gross borrowing, the need to develop the domestic debt market , the need to diversify the funding sources and ability to implement the strategy, the *MTDS 2017* proposes Strategy 2 (S2) as the optimal strategy. The results of the cost and risk analysis (Tables 15, 16 and 17; Figures 10, 11 and 12) reveal that the *MTDS 2017* is still the most favorable going forward in terms of interest payments to GDP and revenue .This strategy is realistic in terms of managing the large repayments falling due for both domestic and external debt in 2017/18. The strategy also provides an opportunity to extend the debt maturities for the overall debt which will improve the average time to maturity of the overall debt.

83. Strategy 2 involves increased borrowing of semi concessional loans. This strategy decreases the size of domestic bond issuance in each of the three years, as compared to S1. Concessional external borrowing provisions remain the same as in the baseline - The external debt comprising 63 per cent of gross borrowing while 47 per cent comprise of the domestic borrowing. On the external front concessional is proposed at 22 per cent, semi-concessional 22 per cent and commercial 19 per cent. In this strategy, T-bonds will be the main source of net domestic financing, while T-bills will primarily be an instrument to manage government cash position. Considering the macroeconomic and domestic market environment issuance of medium term domestic debt through benchmark bonds is recommended.

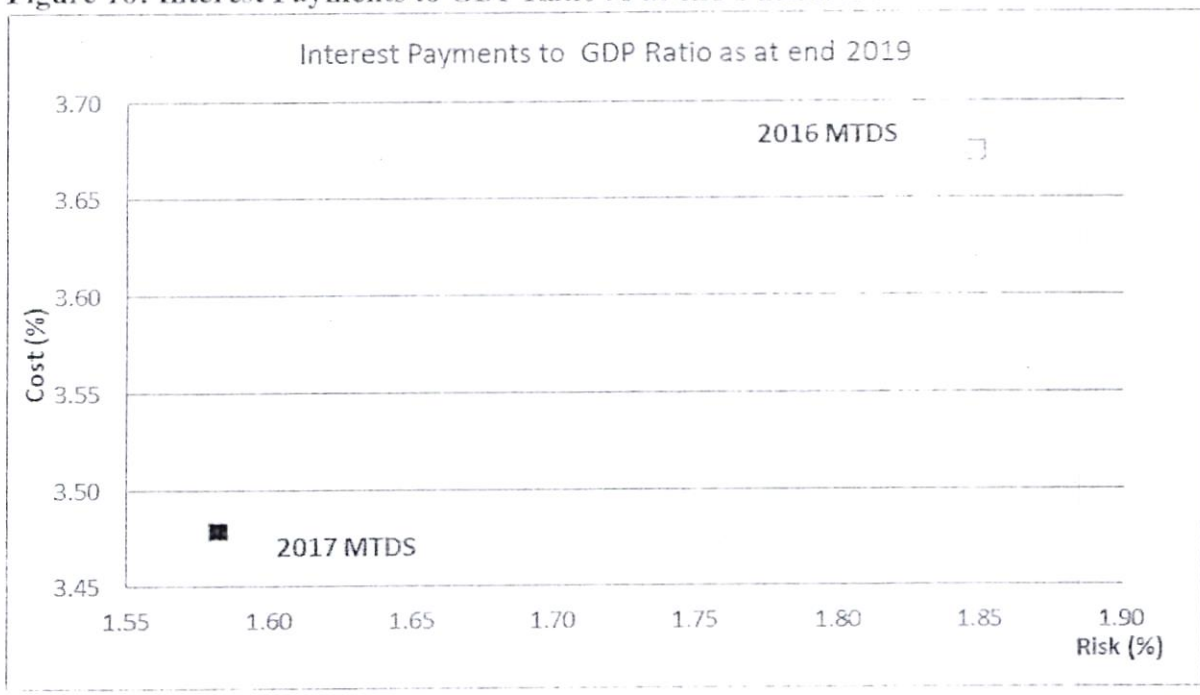
84. The comparison between 2016/17 and 2017/18 MTDS: The analysis below gives the comparison on the recommended strategy in 2016/17 (2016) MTDS represented by S1: status quo strategy and the 2017/18 (2017) MTDS recommended strategy which is represented by S2: More semi concessional borrowing.

Table 15: Cost and Risk Analysis: MTDS 2016 vis-à-vis MTDS 2017: Interest to GDP as at 2019

Scenarios	MTDS 2016	MTDS 2017
	%	%
Baseline	3.67	3.48
Exchange rate shock (30%)	3.95	3.77
Interest rate shock 1 (Moderate Shock)	4.86	4.50
Interest rate shock 2 (Extreme Shock)	5.52	5.06
Combined shock (15% depreciation and interest rate shock 1)	5.02	4.67
Max Risk	1.85	1.58

Source: National Treasury

Figure 10: Interest Payments to GDP Ratio as at end FY2019/20



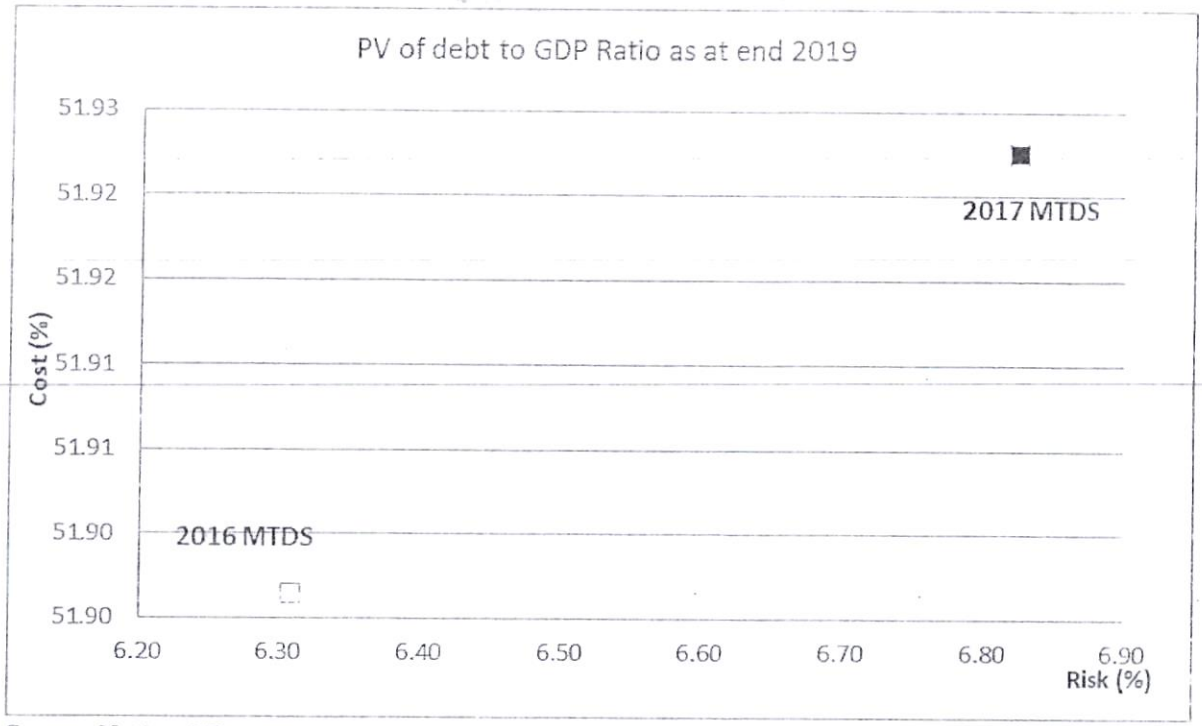
Source: National Treasury

Table 16: Cost and Risk Analysis: MTDS 2016 vis-à-vis MTDS 2017: PV of Debt to GDP as at 2019

Scenarios	MTDS 2016	MTDS 2017
	%	%
Baseline	51.90	51.92
Exchange rate shock (30%)	58.20	58.75
Interest rate shock 1 (Moderate Shock)	51.97	52.10
Interest rate shock 2 (Extreme Shock)	51.99	52.15
Combined shock (15% depreciation and interest rate shock 1)	55.13	55.52
Max Risk	6.31	6.82

Source: National Treasury

Figure 11: PV of Debt to GDP Ratio as at end FY2019/20



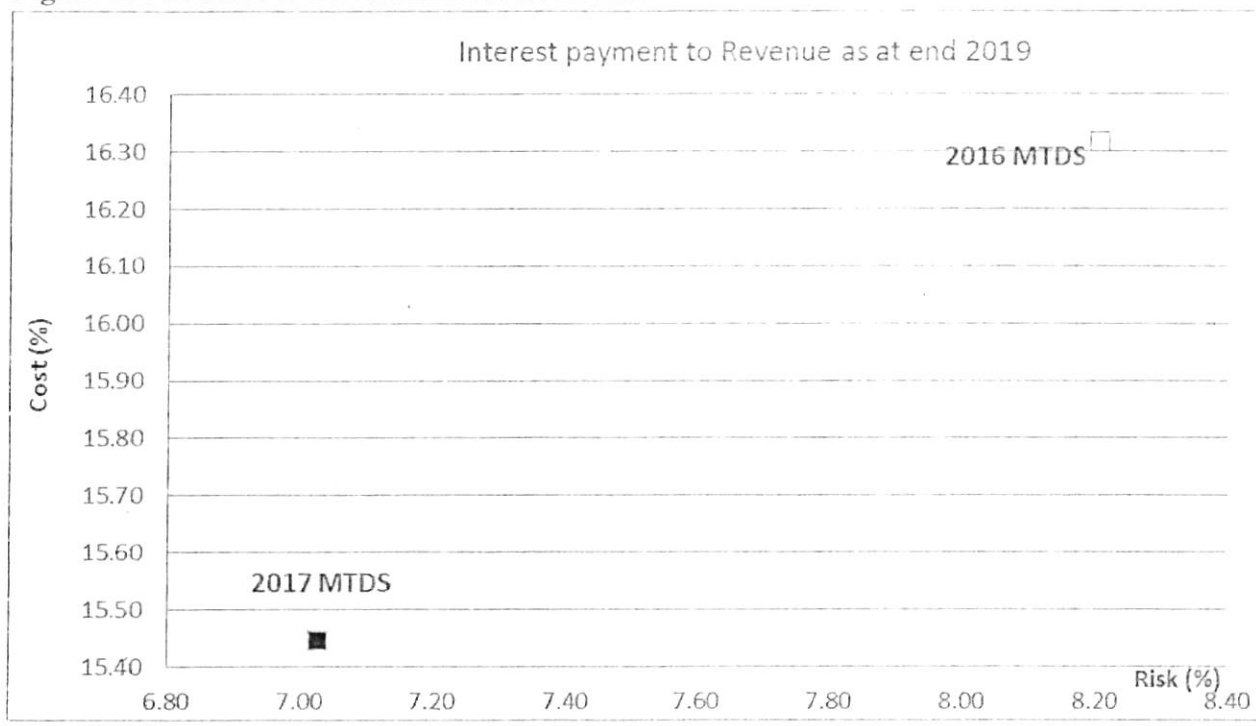
Source: National Treasury

Table 17: Cost and Risk Analysis: MTDS 2016 vis-à-vis MTDS 2017: Interest to Revenue Ratio as at 2019

Scenarios	MTDS 2016	MTDS 2017
	%	%
Baseline	16.32	15.45
Exchange rate shock (30%)	17.53	16.76
Interest rate shock 1 (Moderate Shock)	21.57	19.98
Interest rate shock 2 (Extreme Shock)	24.52	22.47
Combined shock (15% depreciation and interest rate shock 1)	22.27	20.74
Max Risk	8.20	7.03

Source: National Treasury

Figure 12: Interest to Revenue Ratio as at 2019



Source: National Treasury

IX. DEBT SUSTAINABILITY

85. The Government recognizes the importance of managing debt prudently to avoid unwarranted debt burden to the future generation and reduce the risk of macroeconomic instability. Significant effort has been made to improve the institutional arrangement for debt management as well as capacity to assess risks.

86. The latest (March 2016) Debt Sustainability Analysis (DSA) update for Kenya indicates that Kenya's debt is sustainable. The DSA compares debt burden indicators to indicative thresholds over a 20-year projection period. A debt-burden indicator that exceeds its indicative threshold suggests a risk of experiencing some form of debt distress. There are four ratings for the risk of external debt distress:

- *Low risk* - when all the debt burden indicators are well below the thresholds;
- *Moderate risk* - when debt burden indicators are below the thresholds in the baseline scenario, but stress tests indicate that thresholds could be breached if there are external shocks or abrupt changes in macroeconomic policies;
- *High risk* - when the baseline scenario and stress tests indicate a protracted breach of debt or debt-service thresholds, but the country does not currently face any repayment difficulties; or
- *In debt distress* - when the country is already having repayment difficulties.

87. Countries are classified into one of three policy performance categories (strong, medium, and poor) using the World Bank's *Country Policy and Institutional Assessment* (CPIA) index, which uses different indicative thresholds for debt burdens depending on the quality of a country's policies and institutions. Kenya is rated a strong policy country and as such is subject to the following thresholds:-

Table 18: Kenya: External Debt sustainability thresholds

Classification	NPV of External Debt in per cent of:			External Debt Service in percent of:	
	GDP	Exports	Revenue	Exports	Revenue
Strong Policy Performer	50	200	300	25	22

Source: IMF Country Report No. 16/85, March 2016

a. External debt sustainability

88. Given the above thresholds, under the baseline scenario, Kenya's debt ratios listed in Table 19 indicates that external debt is within sustainable levels for a country rated as a strong performer. The debt sustainability indicators show that Kenya faces a low risk of external debt distress. This is attributed to the high level of concessionality of current external debt and the positive outlook in other macroeconomic indicators.

Table 19: External debt sustainability

Indicator	2015	2016	2017	2019	2025
PV of PPG External debt–to-GDP ratio (50)	21.7	24.8	24.8	24.4	23.8
PV of PPG External debt-to-exports ratio (200)	118.5	140.9	138.8	134.3	130.3
PV of PPG External debt-to-revenue ratio (300)	109.5	122.2	118.6	114.5	109.3
PPG External Debt service-to-exports ratio (25)	6.4	8.0	14.8	13.9	9.7
PPG External Debt service-to-revenue ratio	5.9	6.9	12.7	11.9	8.1

Source: IMF Country Report No. 16/85, March 2016

b. Public debt sustainability

89. Kenya's public debt sustainability threshold on PV of Debt/GDP as a strong performer and a low middle income country is 74 percent. However, Kenya endeavors to be within the East African Community convergence criteria for PV of Debt to GDP[9].

90. Under the baseline scenario shown in Table 21, the PV of public debt-to-GDP increases from 45.8 per cent in 2015 to 48.3 per cent in 2016 and 48.5 per cent in 2017 before declining to 47.9 per cent of GDP by 2019. In the long term, the PV of public debt-to-GDP is expected to decline further to about 40.9 percent by 2025. The PV of public debt-to-revenue ratio is expected to gradually decline from 231.8 percent in 2015 to 224.5 percent in 2019.Going forward, the debt service-to-revenue ratio is expected to decline from 29.7 percent in 2015 to 29.4 percent in 2016 before increasing to 31.6 per cent in 2019. Overall, the results from the DSA indicate that Kenya's public debt remain sustainable over the medium term as long as fiscal consolidation remains on course.

[9]The EAC public debt convergence criterion for PV of Debt/GDP is 50 percent.

Table 20: Public debt sustainability

Indicator (Threshold)	2015	2016	2017	2019	2025
PV of public sector debt to GDP ratio (74)	45.8	48.3	48.5	47.9	40.9
PV of public sector debt-to-revenue ratio(300)	231.8	237.8	232.0	224.5	187.6
Debt service-to-revenue and grants ratio (30)	29.7	29.4	34.1	31.6	21.7

Source: IMF Country Report No. 16/85, March 2016

91. In Table 21, a worst-case scenario, a "borrowing shock" scenario is presented which assumes Government borrowing increases by 10 percent of GDP in FY2016/17. The results indicate that in the medium term, the debt burden indicators do not breach any of the debt sustainability thresholds.

Table 21: Sensitivity Analysis for Key Indicators of Public Debt

Indicator	Threshold	2016 ratios	*Impact of 10% of GDP increase in borrowing in 2016 on debt indicators in 2017*
PV of Debt as % of GDP	74	48.3	58
PV of Debt as % of Revenue	300	231.8	272
Debt Service as % of Revenue	30	30.4	34

Source: IMF Country Report No. 16/85, March 2016 and National Treasury

92. It is also noteworthy that the 10 percent shock is way above the planned borrowing. In FY2017/18, the Government plans to borrow, on a net basis amount equivalent to 6.9 per cent of GDP to finance the budget. The net borrowing is expected to decline to 4.1 percent of GDP in FY2019/20.

93. The sustainability of Kenya's debt depends on macroeconomic performance and a prudent borrowing policy. Recourse to significant uptake of domestic debt financing could further increase the domestic interest rates, and put pressure on the debt sustainability position. In addition, non-concessional external financing carries an inherent foreign exchange risk, worsens the PV of debt and therefore increases the risk of debt distress. The

borrowing envisaged under the *MTDS 2017* will be undertaken with caution taking these factors into account.

X. IMPLEMENTING THE MTDS 2017

94. The Government will prepare a borrowing plan to accompany the *MTDS 2017* (Strategy 2) and meet the financing requirement for the financial year 2017/18. The borrowing composition assumed in the MTDS analysis together with the Government cash flow plan provides the basis for the projected annual borrowing plan. The Government will communicate the domestic borrowing plan to the market participants through the *Consultative Forum for Domestic Debt Market (CDDDM).*

95. The *MTDS 2017* provides a clear set of assumptions and some information on key risk parameters that are associated with the Strategy (S2) (Table 9). These provide the basis on which the implementation of the strategy will be monitored and reported. If there is a significant and sustained deviation in the outturn relative to that assumed in the MTDS analysis, the strategy will be reviewed and revised.

96. Debt management strategy development needs a robust legal framework. The Government has enacted legislation governing both external and internal borrowing under the Public Finance Management Act, 2012 with provisions that are in line with the requirements of the Constitution of Kenya, 2010 and best international practice. In addition, the institutional arrangement for public debt management will continue to be strengthened taking into account the provisions for the establishment of a Public Debt Management Office (PDMO) and the new system of devolved government.

97. Comprehensive, accurate and timely information on public debt is critical in managing investors' sovereign risk assessment and the cost of debt. Public debt information will be published more regularly to enhance transparency on debt management in accordance with best international practice.

Continued collaboration with partners, such as the US Treasury, the IMF, the World Bank, IFC, MEFMI and the Commonwealth Secretariat will be encouraged in developing the Government and corporate bond markets and capacity building in debt management. Recent experience in issuance of a Euro bond will enhance capacity in future issuances. The debt recording system has been upgraded but is yet to be integrated with IFMIS, additional skilled staff posted to PDMO while training in debt management techniques is on-going.

XI. CONCLUSION

98. The *MTDS 2017* is a robust framework for prudent debt management. It provides a systematic approach to decision making on the appropriate composition of external and domestic borrowing to finance the budget in the financial year 2017/18, taking into account both cost and risk. The cost-risk trade-off of the *2017MTDS* has been evaluated within the medium term context.

99. The debt strategy complements the DSA, a forward-looking framework concerned with long-term sustainability of debt. Whereas Kenya's current debt level is sustainable, it is imperative that the Government continues to implement prudent debt management practices and policies supported by sustained macro-economic stability.

100. The *MTDS 2017* has considered the current macro-economic environment both at the local and international scene and the related vulnerabilities. The recommended strategy is one that seeks the issuance of medium to long term domestic debt, and contracting of external concessional debt.

101. This is the ninth time that the Government is formally presenting the Medium Term Debt Management Strategy and the fourth time it is being presented in accordance with the PFM Act, 2012. As required under the Act the Strategy is in line with the Budget Policy Statement and Estimates presented to Parliament. Going forward, the Government will implement measures aimed at enhancing the transparency and accountability in public debt management.