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THE NATIONAL TREASURY

Medium Term Debt Management Strategy, 2016

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**Medium-Term Debt Management Strategy,
2016**

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FOREWORD

The Medium Term Debt Management Strategy (MTDS) is a useful public debt management tool that recognizes the cost and risk trade-offs in setting sustainable borrowing limits and ensuring that debt is serviced under a wide range of shocks without risk of default.

MTDS 2016 intends to implement government's plan over the medium term in order to achieve a composition of the government debt portfolio that captures the government's preferences to operationalize debt management objectives namely, ensuring the government's financing needs and payment obligations are met at the lowest possible cost consistent with a prudent degree of risk in line with the Public Financial Management Act, 2012.

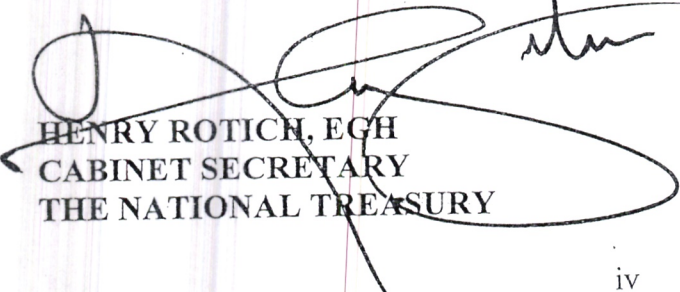
In an environment requiring increased accountability and transparency, this document, represents the government's unwavering commitment to developing and executing feasible strategies designed to maintain public debt at a sustainable level.

The analysis looked at the cost-risk implications of a range of debt strategies. These strategies were assessed under a set of agreed assumptions on the macroeconomic environment and a set of risk scenarios. The robustness of the analysis was also checked by analysing the implications of shocks to interest and exchange rates on the preferred choice of strategy.

The Medium-Term Debt Management Strategy 2016 was prepared taking into account the broad strategic priorities and policy goals set out in the Budget Policy Statement 2016.

Kenya's debut international sovereign bond issuance in June 2014 was oversubscribed at favourable lower cost than our peers. The successful issue was an indication of a vote of confidence in Kenya's economy. Following the successful issuance of the sovereign bond, the government plans to launch the M-Akiba Infrastructure Bond early 2016. The M-Akiba Infrastructure Bond is a new initiative to provide an avenue for investing in Treasury Bonds conveniently through mobile phones. This is a well-timed initiative that will enable Kenyans to take part not only in financing on-going infrastructure projects but also build savings for their future.

It is our hope that this document contributes to the analysis on government debt administration and that it helps to strengthen Kenya's international status as an example of sound debt management.



**HENRY ROTICH, EGH
CABINET SECRETARY
THE NATIONAL TREASURY**

ACKNOWLEDGEMENT

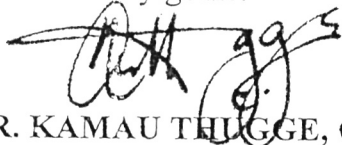
This is the eighth Medium Term Debt Management Strategy (2016 MTDS) to be tabled in Parliament and the third in the series under the requirement of Public Finance Management Act, 2012 (PFMA). The MTDS sets out the debt management strategy of the National Government over the medium term as provided for in the PFMA 2012. The preparation of MTDS is a technical process involving use of an analytical tool to analyse data inputs to produce scenarios from which an optimal borrowing strategy is determined.

Let me take this opportunity to acknowledge the MTDS Working Group of the National Treasury and the Central Bank of Kenya which was involved in the preparation of the 2016 MTDS for the valuable contribution and dedication to the process. The MTDS 2016 was undertaken under the guidance of Felister Kivisi, Ag. Director, Debt Policy, Strategy and Risk Management. The Technical core team with Charles Kairu as the team leader comprised of Benard Gibet, Robert Osudi, Stella Osoro, Elizabeth Chepkemboi Mary Munyingi, Lucy Muraya, William Ng'ang'a, and Geoffrey Kimani all from the Debt Policy, Strategy and Risk Management Department; Geraldine Kyalo and Maurice Omete of the Directorate of Budget, and Economic Affairs; and Patrick Mbehi of the Portfolio Management Directorate; Caroline Wanjiku, Charles Weda and Daniel Ndolo of the Central Bank of Kenya. The team provided valuable information and data which helped in completing this report.

The drafting of the MTDS 2016 document also benefited to a great extent from the International Monetary Fund/World Bank/MEFMI Technical Assistance Mission which also carried out training during the MTDS preparation as part of capacity building initiative in MTDS. Further, the Mission Team provided guidance that helped to ensure that the contents and quality of this document meet international standards.

In addition, the document incorporates valuable comments received from Directorates and departments of the National Treasury, as well as the Central Bank of Kenya. All these are gratefully appreciated.

In order to ensure wide circulation, 2016 MTDS is available in the 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
ATM	Average Time to Maturity
ATR	Average Time to Re-fixing
BoP	Balance of Payments
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
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
PV	Present Value
SACCO	Savings and Credit Cooperative
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 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. In this regard, the 2016 MTDS 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 as at end-June 2015 was at 48.8 percent of GDP and remains sustainable. Despite high real economic growth, the higher pace of debt accumulation has contributed to a rapid increase in public debt, particularly over the past two years. The main driver for public debt accumulation in the past two fiscal years is the primary deficit, which contributed to a 8.8 percent of GDP increase in the public debt level.

The external financing environment facing Kenya is rapidly changing. The secular trend is a hardening of financial terms as well as reduced access to official sector credit. The terms of the concessional window of multilateral creditors is hardening. In the specific case of Kenya, graduation to lower middle income country status will close its access to the concessional window, and it will move into the "blend" window, drastically hardening the financial terms of credit 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. A 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. Part of the proceeds of the 2014 Eurobond was used to retire the syndicated loan maturing the same year.

Kenya's increasing integration with the international capital markets will expose the country to volatilities in the global financial markets. Past global financial crisis did not affect Kenya through the financial channel, but through the trade channel. This will likely have changed and the contagion risk through the financial channel must be closely monitored. Recent events with the lift-off of United States interest rates, slowdown in China, collapse in oil and other commodity prices, and the resultant dramatic reversal of capital flows from emerging markets have negatively affected yields of Eurobonds across the emerging and frontier markets. Although investors are clearly distinguishing credit risk, as evidenced by tighter spreads for Kenya's Eurobonds relative to its peers, investors will be scrutinizing Kenya's public finances more closely.

Kenya's public debt, now half the size of the economy must be managed prudently to reduce financial vulnerabilities. Events in the global financial markets should be closely

monitored and their implications for Kenya's public finance regularly analyzed and well understood, and that investors are informed how Kenya is mitigating those risks. 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 government debt portfolio as at June 2015 is characterized by low but rising cost and increasing risk, particularly refinancing risk. Compared to the period FY2009/10, when the first MTDS was developed, the government debt portfolio is characterized by:

- A still low but rising annual interest payment as a share of GDP. Annual interest payments stood at 3.5 percent of GDP at end-June 2015, compared to 2.5 percent of GDP at end-June 2010.
- Rising refinancing risk. Total debt coming due within one year stood at 9.2 percent of GDP at end-June 2015, compared to 6.9 percent of GDP at end-June 2010.
- 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 overall government debt level has remained stable, at 47.1 percent of GDP at end-June 2010 and 48.2 percent of GDP at end-June 2015, although the debt level has risen sharply in the past two years after reaching a low of 42 percent of GDP at end-June 2013.

Future financing strategies should therefore be mindful of refinancing risk and exchange rate risk. Interest rate risk is also high but this is driven by the high refinancing risk that will trigger a reset of interest rates. Addressing the refinancing risk will reduce interest rate risk.

The Budget Policy Statement (BPS) covering the remainder of FY2015/16 through FY2018/19 envisages fiscal consolidation over the medium term. The primary deficit is projected at 5.1 percent of GDP for FY2015/16, compared to 5.5 percent in the previous fiscal year. Over the medium term, commitments to contain current spending and mobilize additional revenue are expected to mitigate excess demand pressures and are expected to result in a deficit reduction, to 3.9 percent in FY2016/17, 3.0 percent in FY2017/18, and 1.8 percent in FY2018/19. Real economic growth has been revised down to 5.8 percent from 6.5 percent for FY2015/16. However, over the medium term, growth is expected to rebound to 6.1 percent, 6.3 percent, and 6.5 percent over the subsequent three years. External buffers to date have remained adequate with international reserves at about 4.5 months of projected imports in 2016. Inflation is expected to stay within the target range of 5 percent \pm 2.5 percent.

The government intends to continue maximizing borrowing from external concessional and semi-concessional sources. The domestic debt market for Treasury-bonds (T-bonds) is currently constrained by the size of the domestic institutional investor base. Given the

limits on absorptive capacity of the domestic market, the residual financing needs will have to be divided between external commercial debt and domestic Treasury-bills (T-bills). This presents a conflict between the two main risks arising from the existing debt portfolio for managing exchange rate risk on the one hand, and managing refinancing risk, on the other. 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 2016 BPS, over the next three fiscal years, the government aims to finance around two-thirds of the fiscal deficit by net external borrowing on average. It assumes external commercial borrowing at US\$ 1.0 billion in FY2016/17, and US\$1.25 billion each in FY2017/18 and FY2018/19. Net domestic financing is divided 40:60 between T-bills and T-bonds.
- **Strategy 2:** Relative to Strategy 1, it increases external commercial borrowing by US\$500 million, and instead reduces T-bill issuance.
- **Strategy 3:** Relative to Strategy 1, it reduces external commercial borrowing by US\$500 million, and instead increases T-bill issuance.
- **Strategy 4:** Same external domestic net financing mix as in Strategy 1, but net domestic financing is divided 20:80 between T-bills and T-bonds.

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

- **Strategy 2 reduces refinancing risk and is in addition likely to help bring down domestic interest rates closer to the inflation target range, but raises the exchange rate exposure of the public debt portfolio.** Under an exchange rate shock scenario of 30 percent in FY 2017/18, external debt will increase from 58.2 percent of GDP under the baseline to 66.7 percent by end-FY2018/19.
- **Strategy 3 reduces exchange rate risk but significantly increases domestic refinancing risk.** Debt coming due in the following year as at end-FY2018/19 will be in excess of Ksh1 trillion, representing 11.2 percent of GDP. The volume of T-bill issuance will be 3.5 percent higher than the estimated absorptive capacity of the market. This will likely lead to a significant increase in domestic interest rates.
- **Strategies 1 and 4 appear to balance exchange rate risk and refinancing risk, although the strategies are already tilted towards greater external borrowing.** But given the assumed commercial external borrowing, the net commercial borrowing in FY2017/18 and FY2018/19 is US\$500 million each year, as the syndicated loan issued in 2015 and the 5-year Eurobond issued in 2014 mature. Given the constrained domestic debt market, external commercial borrowing of this magnitude will be necessary to alleviate pressures on the domestic debt market.

- Strategies 1 and 4 differ in the extent to which efforts are made to lengthen domestic maturities, with Strategy 1 tilted towards greater T-bills and Strategy 4 towards more T-bonds. The maturity extension helps to reduce T-bills to levels similar to Strategy 2 where Eurobond issuance is increased by US\$500 million each year. The extent to which Strategy 4 may be attainable will depend on simultaneous government efforts to deepen the domestic debt market.

Recommendations

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 ratio of PV of Debt to GDP (*PV of Debt/GDP*). As anticipated, “S4” outperforms all other strategies.

The 2016 MTDS presents “S4” as the optimal strategy after taking into account both cost and risk considerations, the need to develop the domestic debt markets and the feasibility of implementing the strategy over the medium term. The strategy comprises of the following actions:

- 60% external borrowing and 40% domestic borrowing to finance the central government budget;
- Considering macro-economic and domestic market environment issuance of medium term domestic debt through benchmark bonds is recommended;
- External borrowing will comprise of 24% on concessional terms, 24% on semi-concessional terms and 12% commercial.

The latest Debt Sustainability Analysis (DSA) for Kenya indicates that Kenya’s debt is sustainable. In the long term, the PV of public debt-to-GDP is expected to be 46.0 percent of GDP in 2018 while the PV of public debt-to-revenue remains below the threshold of 300 percent throughout the period of analysis.

Consistent with the principles of public finance in the Constitution of Kenya, 2010 (Section 201), the Government will seek to widen outreach of the 2016 MTDS. 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.

I. INTRODUCTION

1. **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 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 the government may have set, such as developing and maintaining an efficient market for government securities. An MTDS operationalizes the objectives and is a plan that the government intends to implement over the medium term in order to achieve the desired composition of the government's debt portfolio, which captures the government's preferences with regard to the cost-risk trade-offs.
2. **The National Treasury followed the MTDS framework developed by the IMF and the World Bank, in developing this debt management strategy.**¹ 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 has greatly benefited from the joint IMF-World Bank-MEFMI MTDS Technical Assistance (TA) mission that took place in January/February 2016.** The TA mission focused on capacity building resulting to a collaborative exercise between the Mission, NT and CBK to produce the 2016 MTDS.
4. **This MTDS 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 FY2014/15. 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 2015. 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; Section XI is the conclusions.

¹ IMF and World Bank (2009). "Developing a Medium-Term Debt Management Strategy—Guidance Note for Country Authorities" <http://www.imf.org/external/np/pp/eng/2009/030309a.pdf>.

II. BACKGROUND

5. **Kenya's economy grew at a robust pace over the past decade.** Real growth averaged 5.5 percent during the period 2004-15, supported by public investments in infrastructure projects particularly in road construction and geothermal energy generation. However, growth for 2015 has been revised downward from 7.0 percent to 5.8 percent.

6. **Kenya's public indebtedness as at end-June 2015 is estimated at 49.6 percent of GDP, the highest level seen since 2004.** Despite high real economic growth, the still higher pace of debt accumulation has contributed to a rapid increase in public debt, particularly over the past two years. The main driver for public debt accumulation in the past two years is the primary deficit, which contributed to a 8.8 percent of GDP increase in the public debt level. Real exchange rate appreciation contributed to a debt reduction of 0.7 percent of GDP, while the real interest rate –real growth rate differential also contributed to a debt reduction of 2.2 percent of GDP, assisted by the strong growth performance.

7. **According to the latest DSA, Kenya's upward public debt trajectory is expected to continue through 2018².**

8. **Domestic debt as share of GDP is rising.** After falling to below 20 percent of GDP in 2013, domestic debt as a percent of GDP has risen to 24.2 percent as at end-June 2015. In 2015, the domestic debt market experienced significant strains as inflationary pressures built up and the CBK raised the monetary policy rate twice. Successive auctions saw under-subscriptions resulting in high volatility on yields. Yields on the 91-day T-bills rose from 8.2 percent to 22.1 percent between July and October 2015.

9. **Government successfully contracted a syndicated loan in October 2015.** This has reduced pressure on domestic interest rates with the 91 Days T-bill yield declining from 19.5 per cent to 13.8 per cent. Talks of the syndicated loan created expectations that pressures on the domestic debt market would be relieved. In November, following months of undersubscribed auctions, 91-day T-bill yields fell from 19.5 percent in the previous week, to 13.8 percent in a heavily oversubscribed auction of over 10 times cover. However, subsequent auctions reverted to undersubscribed outcomes, as rates declined to about 10 percent but are once more on a rising trend. Yields on longer term bonds also saw some volatility but not as marked as those of the T-bills.

² 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.

10. **The supply of concessional external financing is declining.** In 2004, concessional financing comprised 95 per cent of new external debt disbursements. By 2014, concessional financing had dwindled to 45.3 percent of total external debt. As a result, the average term of new loan commitments have hardened significantly (see Table 1). Kenya reached a lower middle income country (LMIC) status due to strong economic performance over the past years, and therefore its access to highly concessional loans will be reduced. Coupled with Kenya's increased reliance on access to international capital markets, and the hardening of the lending terms of loans provided by traditional concessional creditors (regardless of the change in income status), Kenya's financing cost will see an increasing trend over the medium term.^{3, 4}

Table 1: Kenya: Average Terms of New Loan Commitments, 2013–2015

	Jun-13	Jun-14	Jun-15
Average Maturity (years)	33.7	18.1	21.0
Grace Period (years)	8.0	6.2	6.4
Average Interest Rate (%)	1.2	2.6	2.5
Grant Element (%)	68.6	63.9	63.2

Source: National Treasury.

Note: Discounted at 5 percent.

11. **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. Commercial external debt outstanding is US\$3.5 billion (23 per cent of total external debt) as at end-December 2015. Non-resident participation in the domestic market has been negligible despite the open capital account.

12. **Kenya's sovereign credit ratings are on negative watch.** Until early 2015 ratings review, Kenya was rated B+ with a stable outlook by both Fitch and Standard and Poor's. However, the rating agencies revised the outlook to negative in July/October 2015 due to worsening public finances, mounting debt stock and increasing external vulnerability. Moody's rating for Kenya stands at B1 with a stable outlook since November 2012.

³ In June 2015, the World Bank reclassified Kenya as a lower middle income country. Since Kenya's per capita GNI is above the IDA operational cutoff for LICs, its access to highly concessional resources will be reduced.

⁴ For instance, the standard term of an IDA loan is now 5 year grace period and 38 year final maturity with an interest rate of 2 percent. This no longer qualifies as concessional, defined as grant element of over 35 percent. This compares with concessional terms of 10 year grace period and 40 year final maturity with an interest rate of 0.75 percent.

13. **Strengthening capacity at the National Treasury's Debt Management Department is a priority in the context of the IMF's Stand-By Agreement (SBA) with Kenya.**⁵ High staff turnover has eroded capacity, while poor inter-institutional coordination has resulted in the unintended occurrence of technical external debt arrears in the recent past. Notwithstanding the capacity constraints, Kenya has been the only low income country that has continuously produced an MTDS on a rolling annual basis and tabled to Parliament together with the budget.

⁵ . In order to support government efforts, the IMF Executive Board approved a SDR 352.82 million Stand-By Arrangement and a SDR 135.7 million arrangement under the Stand-By Credit Facility (SBA/SCF) for Kenya for a combined SDR 488.52 million on February 2, 2015. The one-year arrangements are intended to mitigate the impact of exogenous shocks while the reforms are being pursued, thereby supporting continued economic growth.

III. REVIEW OF THE FY2014/15 MTDS AND ITS IMPLEMENTATION

14. The strategy for the ongoing financial year (FY2015/16 MTDS) emphasized greater concessional external borrowing with reduced reliance on domestic financing. The target for external and domestic net financing mix was 45 percent and 55 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 gross domestic borrowing, whereas longer maturities (10 – 30 years T-bonds) accounted for about 51 percent. This has translated into a decline in the proportion of T-bills to 22.5 percent of total domestic debt as at end-June 2015 from 23.3 percent end-June 2014. Proportionately, the share of T-bonds in total domestic debt increased to 72.9 percent from 71.2 percent during the period. On external debt, the FY2015/16 MTDS envisaged concessional financing to the tune of 62 percent of total gross external financing. The envisaged concessional financing has translated to lengthening of external debt Average Time to Maturity and Grace Period to 21 years and 6.4 years as at end-June 2015. This compares with 18.1 years and 6.2 years as at end-June 2014. However, the weighted average interest rate increased to 2.5 percent from 1.7 percent, reflecting increased commercial borrowing during the year.

15. The actual financing mix presented in the Annual Budgets, however, did not reflect the MTDS. With exception of budget for FY2011/12 and closely for FY2014/15, the proportion of external financing in the budget plan has always been higher and domestic financing lower than the proportions included in the respective MTDS documents. For instance, the FY2014/15 MTDS envisaged external and domestic financing in the proportion of 40:60 for FY2014/15 whereas the budget plan was 68:32, respectively (Table 2).

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

Financing source		2010/11	2011/12	2012/13	2013/14	2014/15
External	MTDS	25	30	35	40	45
	Budget	44	30	57	68	46
	Deviation	-19	0	-22	-28	-1
Domestic	MTDS	75	70	65	60	55
	Budget	56	70	43	32	54
	Deviation	19	0	22	28	1

Source: MTDS and Annual Public Debt Reports, National Treasury.

16. The financing outturns relative to the budgetary financing targets have deviated significantly in the recent past (Table 3). The annual outturns for external net financing fell short of the budgeted amounts by an average of Ksh47 billion or 15 percent of total net financing during the period FY2009/10 – FY2013/14. Consequently, actual domestic net financing increased by an annual average of Ksh 26 billion or 15 percent of total net financing.

The period, however, experienced total annual net financing outturns that are below budget plans by Ksh 21 billion on average.

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

Financing Source	Units	Average (FY2009/10 - FY2013/14)			FY2014/15		
		Budget	Actual	Deviation	Budget	Actual	Deviation
External	KSH (Billion)	111	64	47	301.9	240	61
	Percent	46	32	15	48	47	1
Domestic	KSH (Billion)	109.8	136	-26	323.7	266	58
	Percent	54	68	-15	52	53	-1
Total	KSH (Billion)	221	199	21	626	506	119

Source: Annual Public Debt Reports, National Treasury.

IV. DEBT MANAGEMENT OBJECTIVES, AND SCOPE OF THE MTDS ANALYSIS

17. The debt management objectives are enshrined in the Public Financial 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.

18. The PFM Act mandates the development of the medium-term debt management strategy. Section 33 states: (1) "On or before the 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 and potential 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 (BPS). The MTDS is published on the National Treasury web site.

19. The time horizon of the analysis is the medium term. Projections span three years from FY2016/17 through FY2018/19, consistent with the government's 2016 BPS. The starting point for the analysis is the debt portfolio as at end-June 2015, which is the end of FY2014/15.

20. The scope of the MTDS analysis is central government debt and called guaranteed debt. The MTDS analysis thus covers total central government external and domestic debt in the amount of Ksh 2.8 trillion or US\$28.2 billion as at end-June 2015, equivalent to 48.8 percent of GDP. External debt amounted to 24.6 percent of GDP (US\$14.2 billion) and domestic debt to 24.2 percent of GDP (US\$14.0 billion).^{6, 7} External guarantees amounting to 0.8 percent of GDP (US\$0.45 billion) were excluded from the MTDS, as these are contingent liabilities that are currently performing (Table 4).

21. External public debt stock comprises predominantly of loans from multilateral and bilateral creditors. Multilateral debt accounted for 51 percent of total external public debt. The largest multilateral creditors were IDA (60 percent), followed by AfDF (22 percent), IMF (12 percent), and EIB and IFAD (4 percent). Bilateral debt accounted for 29 percent of external public debt stock. The largest bilateral creditors were China (60.5 percent) followed

⁶ This amount excludes US\$397 million in CBK overdraft, commercial bank advances and Tax Reserve Certificates.

⁷ For analysis of cost and risks of the PPG, only the outstanding balance of guarantees serviced 'assumed' by the Central Government were included.

by France, and Japan, each accounting for 12 and 11 percent, respectively. The US\$2.75 billion in international sovereign bond increased the share of commercial debt to 20 percent.

22. **The performing government guaranteed debt portfolio is excluded from the MTDS analysis.** The loan guarantees have been issued on an IDA-financed Kenya railways concessionairing (US\$45.0 million) as well as to investment projects financed by the governments of Canada (US\$3.8 million) and Japan (US\$396.6 million).

23. **Domestic public debt comprises predominantly of marketable securities.** 23 percent (US\$3.2 billion) of the domestic debt was in T-bills with maturities of 91, 182, and 364 days and 77 percent (US\$10.5 billion) in medium and longer term T-bonds, including infrastructure bonds (IFB).⁸ The government's Pre-1997 debt accounted for US\$0.3 billion.

Table 4: Kenya: Coverage of Public Debt in the MTDS, End-June 2015

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	318,929	3.2	5.6
Banking Institutions	217,742	2.2	3.8
Others	101,187	1.0	1.8
Treasury Bonds	1,035,662	10,499	18.2
Banking Institutions	510,228	5,173	8.9
Others	525,434	5,327	9.2
Pre-1997 Government Debt	26,676	270	0.5
Sub Total	1,381,267	10,772	24.2
II. External debt (included in MTDS)			
African Development Fund	159,030.1	1,612	2.8
International Development Association	424,265.1	4,301	7.4
Other Multilaterals	127,634.0	1,293	2.2
Bilateral	409,922.2	4,156	7.2
Non-Performing Guarantees	3,575.76	36	0.1
Commercial Banks (Floating rate)	5,969.7	61	0.1
Commercial Banks (Fixed rate)	407.4	4	0.0
Eurobond	271,258.4	2,750	4.8
Sub Total	1,402,062.7	14,213.00	24.6
III. Excluded from MTDS			
Suppliers Credit	13,956.1	141.5	0.2
CBK Overdraft	36,494	370	0.6
Guarantees	40,357.8	409.1	0.7
Sub Total	90,807.9	920.6	1.5
TOTAL DEBT Included in MTDS (I+II)	2,783,330.7	24,985.2	48.8
TOTAL DEBT (I+II+III)	2,874,138.6	25,905.8	50.3

Source: National Treasury and CBK.

⁸ Government securities consisted of T-bills, T-bonds and Infrastructure Bonds.

Table 5: Kenya: Outstanding Government Guaranteed Debt End-June 2015.
(In millions of Kenya Shillings and U.S.Dollars)

Beneficiary Entity	Lender	Ksh million	USD million
Telkom Kenya Ltd	Canada	375	4
Kenya Broadcasting Corporation	Japan	2,404	24
KenGen Tana and Athi River	Japan	18,230	182
Development Authority	Japan	1,172	12
East African Portland Cement	Japan	1,457	15
Kenya Ports Authority	Japan	15,856	161
Kenya Railways	IDA	4,439	45
TOTAL		43,934	445

Source: National Treasury.

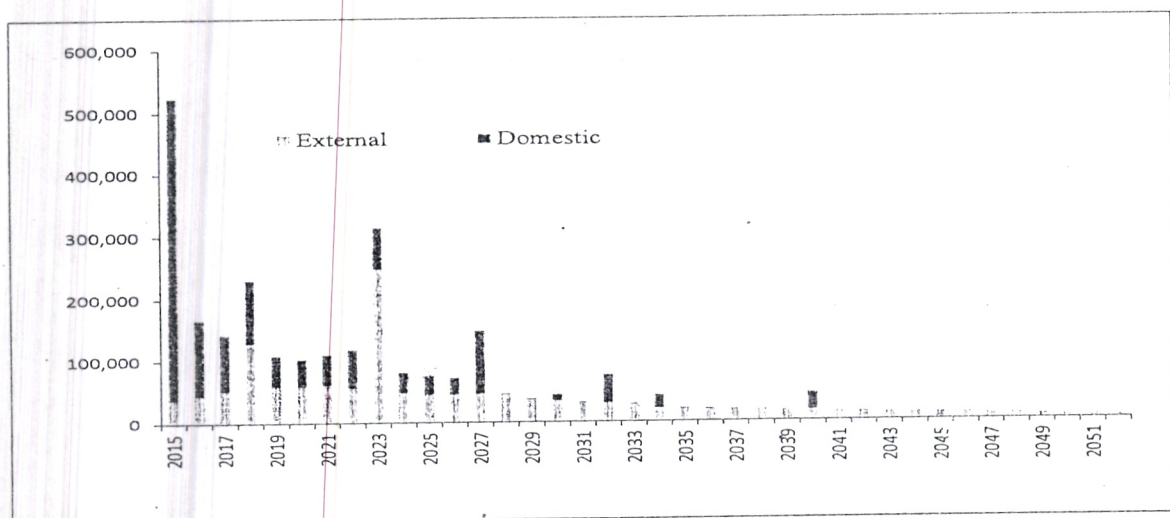
V. COST AND RISK OF THE EXISTING CENTRAL GOVERNMENT DEBT PORTFOLIO, AS AT END- FY2014/15

24. **Kenya's cost of public debt is low.** Annual interest payment was 3.5 percent of GDP, with interest payment on external debt accounting for 0.6 percent and interest payment on domestic debt at 2.9 percent of GDP. The low interest payment is due to the large share (approximately 80 percent) of external concessional financing in the existing public debt portfolio. At end-FY 2014/15, the weighted average interest rate on the total debt portfolio was 7.3 percent. The weighted average interest rate of external debt portfolio was 2.6 percent, and for the domestic debt it was 11.9 percent.

25. **The exposure to refinancing risk is significant.** As at end- FY 2014/15, the main refinancing risk is associated with large domestic debt repayments falling due in FY2015/2016. US\$ 4.9 billion (or 35.2 percent) of domestic debt will mature in FY2015/16. Of this amount, 66 percent (or US\$ 3.2 billion) consists of maturing T-bills and the remaining US\$ 1.7 billion are maturing medium- and long-term T-bonds. 50 percent of total existing domestic debt will mature in the next 3 years (See Table 6). The average time to maturity (ATM) for domestic debt portfolio is 5.3 years. The ATM of external debt portfolio is 12.1 years (See Table 7). The long ATM of the external debt portfolio is explained by a large concessional component of the external debt, which has relatively long maturities in the existing portfolio. Nevertheless, there are large refinancing needs falling due in FY2018/19 (US\$ 1.3 billion) and in FY2023/24 (US\$ 2.5 billion), mainly associated with a repayment of the international bond. The ATM for the total debt portfolio is 8.7 years. See Figure 1.

Figure 1: Kenya: Debt Redemption Profile, as at end-FY2014/15

(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- FY2014/15

Remaining Maturity in Years	In Percent of Total	In million US\$
< 1 Y	35%	4,927
<i>between</i>		
2 - 3 Y	15%	2,156
4 - 5 Y	11%	1,561
6 - 10 Y	18%	2,581
11 - 15 Y	12%	1,641
> 15 Y	8%	1,138
Total	100%	14,003

Source: National Treasury

26. **The interest rate risk is similar to the refinancing risk.** Although 94 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 FY2015/16. The weighted average time to re-fixing (ATR) for external debt portfolio is 10.9 years. 14.5 percent of outstanding external debt will re-fix 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 35.2 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 5.3 years.

27. **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 percent of the total external debt portfolio), followed by the Euro (23 percent), and the GBP and JPK each accounting for 6 percent. Recent depreciation of KSH against the US\$ highlights 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. See Figure 2

28. **In sum, the existing debt portfolio as at end-FY2014/15 exhibit low cost but embodies significant risks (See 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 the volume of T-bills issuance had been increased in the past year, and significant volumes of external commercial

debt will come due in FY2018/19.⁹ Exchange rate risk is significant, but it is assisted by the low cost of the public debt, 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 debt on commercial financial terms.

Table 7: Kenya: Cost and Risk Indicators of Existing Debt, as at end-FY2014/15

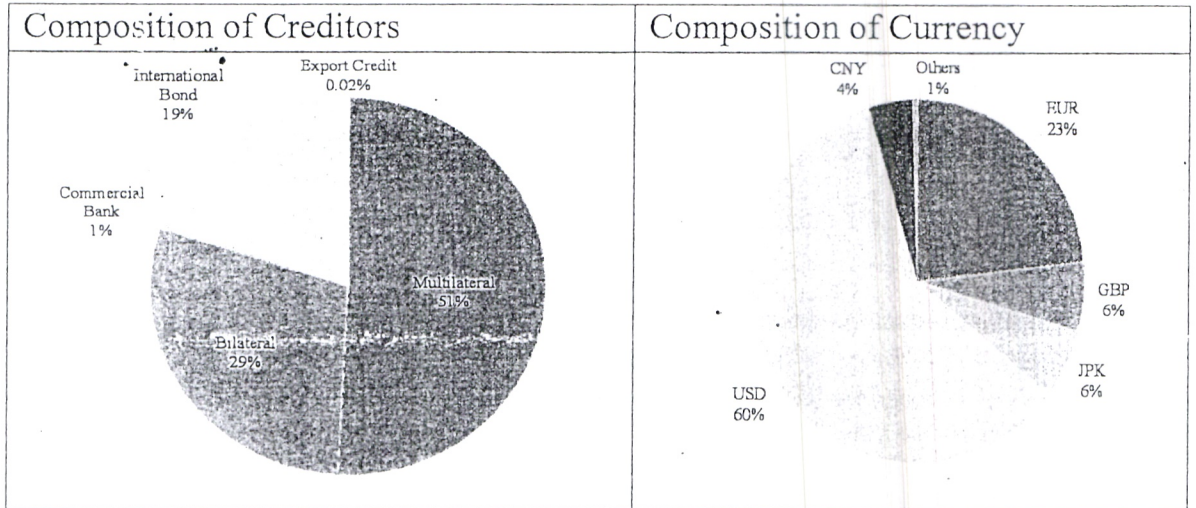
Risk Indicators	External debt	Domestic debt	Total debt	
Central government debt (in billions of KSH)	1,400.7	1,381.2	2,780.0	
Central government debt (in billions of USD)	14.2	14.0	28.2	
Central government debt as percent of GDP	24.6	24.2	48.8	
Present value of debt as percent of GDP	18.5	24.2	42.7	
Public and publicly guaranteed debt (in billion USD)	14.7	14.0	28.7	
<i>Of which</i> guaranteed debt ¹⁰ (in billion USD)	0.5	-	-	
Public and publicly guaranteed as percent of GDP	25.4	24.2	49.7	
<i>Of which</i> Guaranteed debt as percent of GDP	0.8			
Cost of debt	Interest payment as percent of GDP	0.6	2.9	3.5
	Interest payments as percent of revenues	2.7	12.6	15.3
	Weighted average interest rate in percent	2.5	11.9	7.2
	Average time to maturity (ATM in years)	12.1	5.3	8.7
Refinancing risk	Debt maturing in 1 year as percent of total	2.7	35.2	18.8
	Debt maturing in 1 year as percent of revenues	2.9	37.1	40.0
	Debt maturing in 1 year as percent of GDP	0.7	8.5	9.2
	Average time to re-fixing (ATR in years)	10.9	5.3	8.1
Interest rate risk	Debt re-fixing in 1 year as percent of total	14.9	35.2	25.0
	Fixed rate debt as percent of total debt	87.7	100.0	93.8
Exchange rate risk	Foreign currency debt as percent of total debt			50.3
	Short term foreign currency debt as percent of reserves			5.4

Source: National Treasury

⁹ 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.

¹⁰ This includes performing guarantees. Non-performing guarantees are included in the central government external debt stock.

Figure 2: Kenya: External Public Debt, as at end-FY2014/15



Source: National Treasury

VI. BASELINE MACROECONOMIC ASSUMPTIONS AND KEY RISKS

A. Baseline Macroeconomic Assumptions¹¹

29. **The medium-term macroeconomic framework is anchored on 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 of cost of unemployment and strengthening devolution.

30. **The 2016 BPS covering the period FY2016/17-FY2018/19 operationalizes the medium-term fiscal framework.** The baseline assumptions are summarized below (See Table 8).

Real Sector

31. **Economic activity is expected to slow down in the short run, but still remains robust.** Economic growth is estimated at 5.8 percent for the FY 2015/16, revised down from 7.0 percent in the Budget. On the production side, growth is driven by electricity generation, constructions, services, and rebound in agriculture. Ongoing infrastructure projects have catalytic impact on economic activities. The performance of the tourism sector is stable, although persistence of security threats could have an adverse effect for this sector over the medium term.

32. **Over the medium term, economic expansion is again expected to pick up.** Growth rate of 6.1 percent is expected to be achieved in FY 2016/2017, reflecting GOK's commitment to reform process and expected fiscal consolidation, before accelerating to 6.3 percent and 6.5 percent in FY2017/18 and FY2018/19, respectively, driven by positive effects emanating from infrastructure investments, further strengthening of construction and tourism sectors, as well as robust growth in agriculture, supported by significant irrigation programs.

Fiscal policy

33. **The expansionary fiscal policy of the last two years is being reversed.** The primary deficit increased from 2.7 percent in FY2012/13 to 5.5 percent in FY2014/15, but is projected to fall to 5.1 percent in FY2015/16. The completion of the SGR project is expected to reduce fiscal pressures on the central government's budget, as well as boost economic activities due to improved transportation means. The devolution has put additional fiscal pressures on the budget execution, but main reasons behind the sharp increase in fiscal gap are linked to

¹¹ The macroeconomic assumptions are based on the Government's medium-term macroeconomic framework embodied in the draft 2016 BPS published on January 27, 2016 for public consultation.

deceleration in tax revenues (such as VAT and customs tax collections) and significant infrastructure investments by the central government.

34. **Over the medium term, the primary deficit is projected to narrow significantly.** By FY2017/18, the primary deficit is projected at 3 percent of GDP and at 1.8 percent of GDP by FY2018/19. Fiscal consolidation is expected to be driven by: (i) further improvement of revenue collection, as well as continuous tax reforms, including higher petroleum levy; (ii) expenditure measures, including elimination of overlapping functions at the central and county levels, as well as continuation of civil service reform.

External balance

35. **The current account deficit is expected to decline gradually.** The current account deficit peaked at 9 percent in FY2013/14, driven by expansionary fiscal and monetary policies, but is projected to decline to 7.5 percent in FY2015/16. Exports of goods and services continue to lag imports, reflecting on Kenya's subdued performance in merchandise exports, while imports are driven by robust demand in machinery and equipment. Recent declines in oil prices so far had limited impact on external balance, but are expected to be more visible over the medium term. With expected tightening of fiscal and monetary policies, the current account deficit is forecast to improve to 5.8 percent of GDP in 2017/18.

Monetary policy

36. **Inflationary pressure is expected to persist over the short term.** Inflation reached 7.3 percent in November 2015 and 8 percent in December 2015, driven by rising tax rates for processed food and import prices due to the depreciation of local currency. In 2015, CBK's efforts to contain inflation through increases in the policy rate and reserve requirements for deposit money banks led to tightening the growth of private sector credit. Following CBK commitment to achieve price stability, inflation is expected to moderate in 2016 and stabilize at 5 percent over the medium term.

Table 8: Kenya: Baseline Macroeconomic Assumptions

<i>BPS 2016/17</i>	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	Long term
(billions of Kenyan shillings)							
GDP(current prices)	5,044	5,703	6,443	7,260	8,153	9,148	
(% Change)							
Real GDP	5.5	5.5	5.8	6.1	6.3	6.5	6.5
GDP Deflator	6.3	7.2	6.8	6.2	5.6	5.4	5.5
Consumer Price Index (av.)	7.1	6.6	5.6	5.0	5.0	5.0	
(% of GDP, unless otherwise indicated)							
Current Account Balance (incl. grants)	-9.0	-8.9	-7.5	-6.0	-5.8	-6.2	
Gross international Reserves (mn of import cover)	4.1	4.6	4.8	5.1	5.3	5.4	
Revenue	19.3	19.4	20.3	20.8	21.1	21.4	
Expenditure	25.8	28.7	29.6	28.5	27.7	26.5	
Overall Fiscal Balance	-5.9	-8.6	-8.1	-6.9	-5.8	-4.3	
(billions of Kenyan Shillings)							
Revenue	974.4	1,106.4	1,311.1	1,511.1	1,721.3	1,955.7	
Expenditure	1,300.6	1,639.2	1,906.8	2,071.9	2,257.1	2,423.2	
Primary fiscal balance	-164.4	-315.9	-329.2	-281.2	-242.8	-160.2	
Overall Fiscal Balance	-326.2	-532.8	-595.7	-560.8	-535.8	-467.5	

Source: BPS FY2016/17

B. Risks to the Baseline Macroeconomic Assumptions

37. The macroeconomic framework is exposed to significant downside risks (Table 9). Major risks to the macroeconomic framework include:

- **Fiscal risks.** Another round of security and/or weather related shocks could negatively impact revenues, while postponement of fiscal consolidation reduces policy buffers to respond to exogenous shocks.
- **Growth deterioration.** Macroeconomic risks emanating from the FX market volatility, also affected by expected tightening by the US Fed and fiscal policy concerns could feed into further inflationary trends, reducing the consumption and investment spending. Lower growth would reduce revenue collection and create demands for new expenditures to protect the poor, expanding financing needs. Downside risks to growth could also emanate from adverse weather / droughts, security concerns and commodity price shocks.
- **Inflation risks.** Supply side shock, such as deterioration in agricultural output or exchange rate pass through, may lead to increased inflation expectations and

accelerating inflation, which could increase domestic debt service costs. Fiscal slippages could also feed into increased inflationary expectations.

- **Contingent liability risks.** The portfolio of explicit and implicit guarantees to counties and state-owned enterprises (SOEs) generates fiscal risks. Realization of contingent liabilities would increase central government debt stocks and servicing costs.
- **PPPs** Following the shift in the 1990s from concessionary funding for power projects toward private sector participation in infrastructure and a wave of sector reforms, Independent Power Producers (IPPs) first began to be introduced in Kenya in 1996 to meet Kenya's energy demands totaling to the current thirteen (13) active IPPs. To increase investor confidence and accelerate the financial closure of these private sector investment deals.

The Government has in the past used multiple instruments of support, and in particular, binding Letters of Support (LOS). 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. Consequently, the government in collaboration with the World Bank and the PPP unit, has established a FCCL unit within the Directorate of Public Debt Management Office to implement the FCCL management framework for managing and evaluating these fiscal risks for the Government.

38. **GOK's macroeconomic program with its risks tilted towards the downside suggests the need for a prudent debt management strategy.** In the short term, the priority to achieve macroeconomic stabilization will require steady fiscal consolidation. This should be coupled with increasing average maturity of domestic securities over the medium term, which will reduce the pressures on the domestic debt market. With the winding down the US monetary stimulus, the flow of cheap capital is expected to reduce further, and the cost of borrowing at the international capital markets is expected to rise. Thus, debt portfolio composition has to be planned taking into account changing market conditions.

Table 9: Kenya: Macroeconomic Risks and Implications for Debt Management Strategies

Risks	Likelihood of Risk Event	Implication for Debt Management
Fiscal Sector		
Weather related shock, high corruption and weak tax collection, inefficient transfer system to county governments lead to unsustainable deficits	High	Continued expansionary fiscal policy increases financing needs and drives up domestic debt service costs
Real Sector		
Slower growth due to reduced confidence and security concerns or external shocks.	Medium	Reduced confidence or external shocks slow growth, reducing revenues, increasing demand for social expenditures, and expanding the fiscal deficit.
Inflation		
Supply side shock lead to accelerating inflation and currency depreciation	Medium	A higher inflation rate increases nominal debt servicing costs. A higher depreciation increases external debt service burden.
Balance of Payments		
Declines in foreign direct investment and commodity price shocks	Medium	Balance of payments shocks may increase external borrowing need to support foreign exchange reserves
Financial System		
Overall condition, coupled with pace of US policy for exiting from unconventional monetary policy and raise interest rates; Increased FX exposure of the corporate sector	Low	Any deterioration in the stability of the domestic financial sector reduces the domestic investor base and increases borrowing costs.
Contingent Liabilities		
Realization of contingent liabilities associated with explicit lending or implicit guarantees to county governments and SOEs	Medium	Realization of contingent liabilities would increase debt stocks and servicing costs

Source: National Treasury

VII. POTENTIAL SOURCES OF FINANCING

A. External Sources

39. **Official sector creditors are expected to 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 10). During the last four financial years (FY2011/12 – FY2014/15), disbursements from IDA increased to US\$1,025 million, from USD266 million, accounting for an average of one-third of total official disbursements annually. Other multilateral and bilateral Paris Club creditors have also contributed to the GOK's external financing, accounting for about 32 percent and 13 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 23 percent of total official creditors per annum during the period. The disbursements of about US\$1.6 billion by China to finance the construction of the Standard Gauge Railway (SGR) in FY2014/15 increased the proportion from these creditors to 50 percent of total official disbursements (Figure 3).

Table 10: Disbursements by Official Creditors (Millions of US\$)

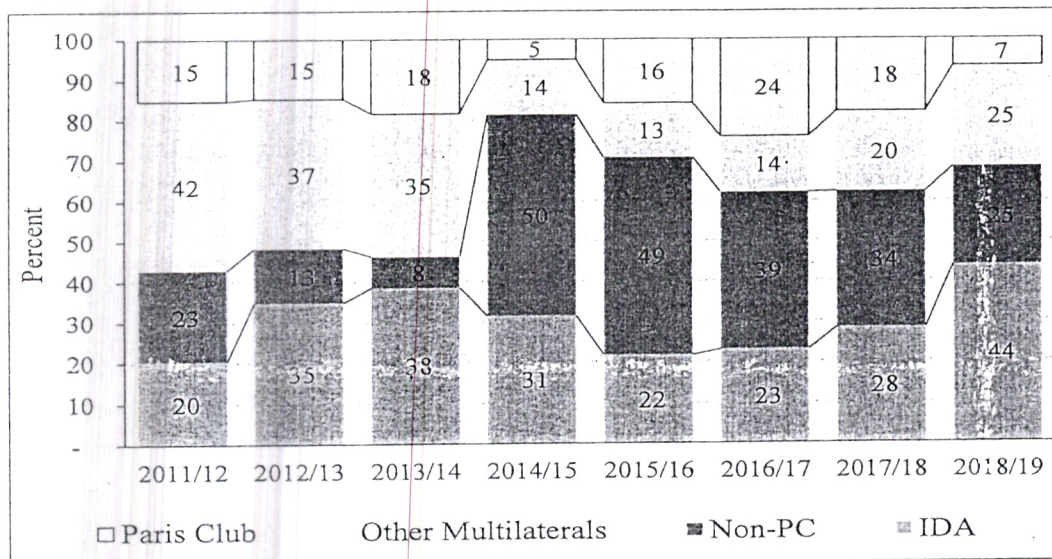
Creditor category	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
	<i>Actuals</i>				<i>Projections*</i>			
IDA	266	467	482	1,025	645	765	527	126
Non-Paris Club	298	181	98	1,626	1,476	1,302	633	71
Other								
Multilaterals	551	498	445	444	401	459	368	72
Paris Club	201	198	230	166	478	804	337	20
Total (USD)	1,317	1,345	1,255	3,260	3,000	3,330	1,866	289

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

Source: The National Treasury.

40. **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 (FY2015/16 – FY2017/18) disbursements from bilateral non-Paris Club creditors will account for about 40 percent 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 will continue to contribute to an average of 24 percent and 19 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

41. **GOK successfully issued its debut Eurobond in the international sovereign debt markets in 2014.** The issuance comprised a US\$ 500 million 5-year maturing June 2019 with a coupon rate of 5.875 percent and a US\$ 1.5 billion 10-year maturing June 2024 with a coupon rate of 6.875 percent. The issue received over 500 per cent subscription with total demand amounting to USD 8,800 million. Part of the proceeds from the issuance was used to refinance a maturing US\$600 million syndicated loan originally contracted in 2012.

42. **GOK subsequently re-opened the 5-year and 10-year Eurobonds in November 2014.** The 5-year was reopened for US\$ 250 million at a yield of 5.0 percent and the 10-year was re-opened for US\$ 500 million at a yield of 5.90 percent. The re-opening operation increased the outstanding stock of 5-year and 10-year bonds to US\$ 750 million and US\$ 2 billion, respectively.

43. **In October 2015, GOK accessed the international syndicated loan market.** The terms of the loan are a US\$ 750 million 2-year maturity with a floating rate priced as a credit spread of 520bps over the 6-month LIBOR rate.

44. **GOK intends to maintain its presence in the external sovereign bond markets as a source of financing.** The government plans to refinance the 5-year Eurobond maturing in FY2018/19, in the international capital markets. A further objective is to build up and develop the government's international yield curve so as to provide a benchmark for pricing credit worthy Kenyan corporate and state owned enterprise's potential debt issuance in the international capital markets. Syndicated loans will also continue to be part of the menu of financing options. Alternative sources of financing, through the sukuk market, the Samurai market, Panda bonds and diaspora bonds are contemplated over the medium term.

B. Domestic Sources

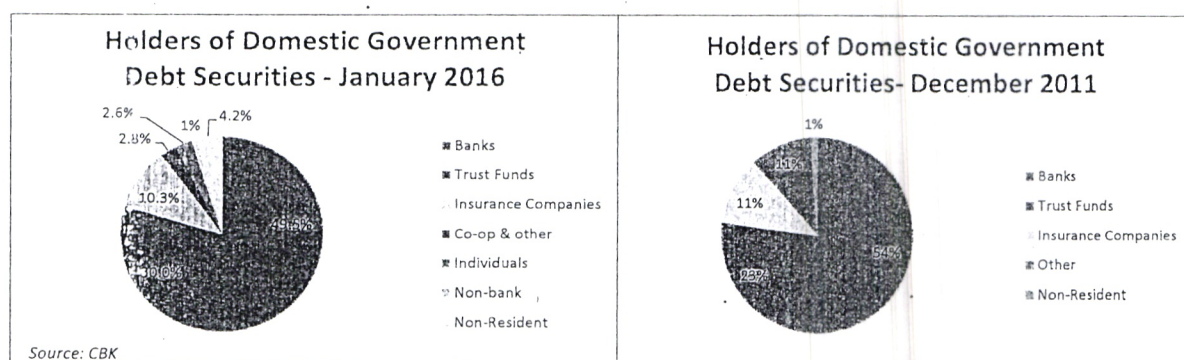
45. Kenya's domestic debt market is currently shallow and constrains GOK access to domestic savings. Deepening the domestic debt market is a priority. Heightened volatility in emerging market debt has increased the uncertainty of access to and costs of external borrowing at market rates. Increased use 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

46. Commercial banks dominate the domestic investor base for government securities. As at end-January 2016, commercial banks owned 49.5 percent of total outstanding T-bonds and T-bills. Other main holders are pension and trust funds, and insurance companies at 30 percent and 10.3 percent, respectively. Non-resident and individual holdings contributed 4.2 percent and 2.6 percent, respectively.

47. However, over the past 4 years, there has been progress in investor diversification. Commercial bank holdings as a proportion of total government domestic debt have declined marginally since 2011, as holdings of pension and other trust fund assets have grown more rapidly. Commercial bank holdings of government bonds and bills have grown at an average annual rate of 14 percent over the past four years, marginally slower than the domestic marketable debt stock (16 percent).

Figure 4: Kenya: Holders of Domestic Government Debt Securities



Source: CBK.

48. Pension and other trust funds currently hold 30 percent of the outstanding stock of government securities. This compares with 23 percent in 2011. 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 24 percent.

49. **Insurance company net holdings of government bonds and bills have grown broadly in line with the domestic debt stock over the past 4 years.** Growth has been supported by annual increases in insurance premiums, averaging 15 percent in life insurance and 18-20 percent in non-life.

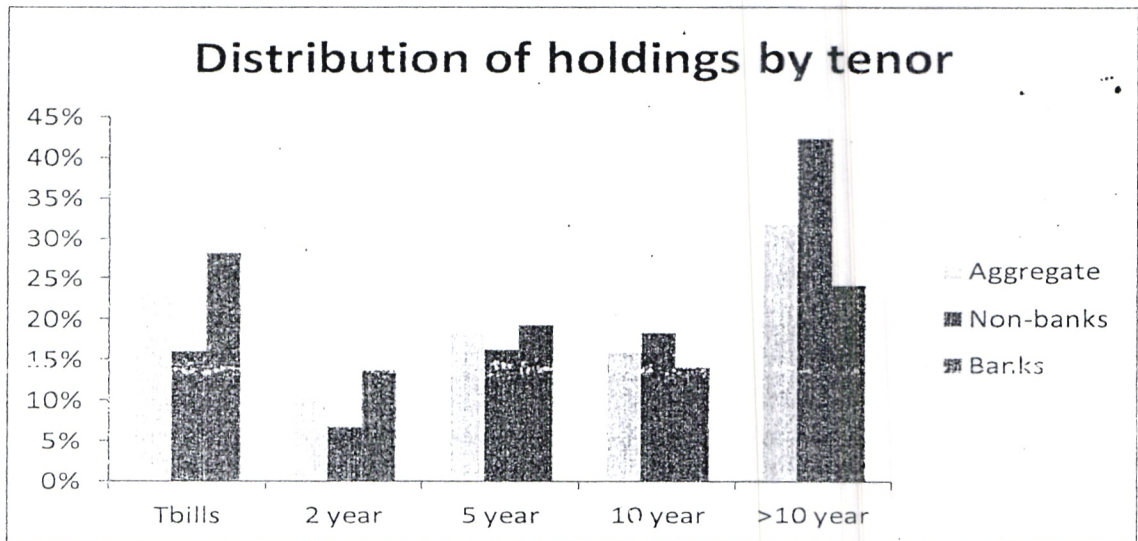
50. **Foreign investors have a relatively small presence in Kenya.** Foreign investor holdings of T-bills and T-bonds accounted for 4-5 percent of the total outstanding, although this has grown significantly from 1 percent in 2011. Foreign investors hold bonds in nominee accounts at the commercial banks, so a detailed analysis of the distribution of holdings is unavailable. CBK statistics show holdings to be predominantly (97 percent) in government bonds, with only Ksh1.8 billion in T-bills.

Domestic Financing Prospects

51. **The Kenyan banking sector is expected to generate continued new demand for government securities.** Rising customer deposits are expected to support robust growth in bank assets. However, the share of assets held in liquid instruments may gradually decline over the medium term. Over the longer-term, however, as the level of domestic retail banking penetration begins to plateau, customer deposit growth may be expected to slow more in line with the growth in employment earnings, which over the past 3 years has averaged 15.2%. Continued strong growth in credit to the private sector, at 19.5% in the year to October 2015 following 23.6% the previous year is also likely to lead to a reduction in the share of new deposits that are backed with government bonds. These effects may result in a slowing in the rate of growth of bank net new purchases of government securities from the recent 14% annual pace.

52. **Banks typically prefer government bills and bonds up to 5-year maturities though they will buy longer dated securities to generate higher interest income.** In the Kenyan banking sector, approximately one third of all private sector deposits are at call and so are best matched by short-dated securities such as T-bills. The remainder is time and savings deposits, typically matched by longer dated bonds. CBK data shows commercial bank holdings distributed in broadly even parts between T-bills, under 5 year Treasury bonds and longer than 5 year bonds.

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



Source: CBK

53. Occupational and individual pension funds are expected to continue to show robust growth in the medium term, with new voluntary schemes opening each year. The estimates for potential annual net new pension fund demand for government bonds is conservatively assumed at 15 percent in the MTDS period, in excess of nominal GDP growth but slower than the 24 percent annual expansion seen in the past 4 years.

54. Pension fund natural demand is for long maturity bonds. However, funds have been buying shorter dated paper owing to the relative scarcity of long dated issuance and to avoid the mark-to-market volatility of longer dated bonds. Fund managers suggest that the lack of secondary market liquidity and dearth of traded prices in long maturity bonds creates pricing and portfolio valuation uncertainty which act as disincentives to holding long bonds.

55. Net new demand from insurance companies is expected to continue to grow broadly in line with the growth in domestic debt. Growth of insurance premiums remains particularly buoyant in the non-life sector, which accounts for a little more than half of total premiums written. Future premium growth is expected to be at least as fast as the growth in nominal GDP, supported by new products and new technology.

56. Demand from non-life insurance companies will be skewed towards bills and shorter bonds out to 5 years. General insurance will have contingent liquidity needs and so will look to meet these by holding shorter dated, more liquid securities. Life insurance companies typically have structural demand for longer dated government bonds, though

market penetration in the life sector remains low at approximately 1% and is growing slowly relative to non-life premiums.

57. **Non-resident demand**, though growing from a very low base, is unlikely to provide a significant source of demand for government bonds over the MTDS period. Poor liquidity and lack of price transparency in the secondary market raises the costs of transacting in Kenyan domestic debt and acts to dissuade foreign investors from participating.

58. 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 11). Residual financing requirements are expected to be financed through additional T-bills:

Table 11: Kenya: Sources of Net New Potential Demand (Ksh million)

	2016	2017	2018
Treasury Bills	40,000	55,000	60,000
Treasury Bonds	170,000	185,000	190,000
<i>Banks</i>	75,000	75,000	75,000
<i>Pensions</i>	65,000	80,000	85,000
<i>Insurance Cos.</i>	20,000	20,000	20,000
<i>Other</i>	10,000	10,000	10,000

Source: National Treasury

VIII. COST-RISK ANALYSIS OF ALTERNATIVE DEBT MANAGEMENT STRATEGIES

A. Baseline-Pricing Assumptions and Description of Shock Scenarios

59. 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 country¹².
- 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.
- Commercial borrowings utilizing the international syndicated loan market are priced at 6-month LIBOR¹³ 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. This is discussed below.

60. **Future baseline interest rates are projected based on the observed U.S. Treasury interest rates in FY2015/16.**

- 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 yield curve, and the forward yield curve is derived using the same methodology described above.¹⁴
- 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

¹² The new financial terms from IDA will be 2 percent interest rate, 25 year final maturity and 5 year grace period

¹³ London Interbank Offered Rate.

¹⁴ Based on secondary market spreads of the 2019 and 2024 Eurobond as at February 1, 2016.

7.0 percent in 2015 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.

61. **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 2016, 2017, and 2018, which is consistent with the macroeconomic framework.

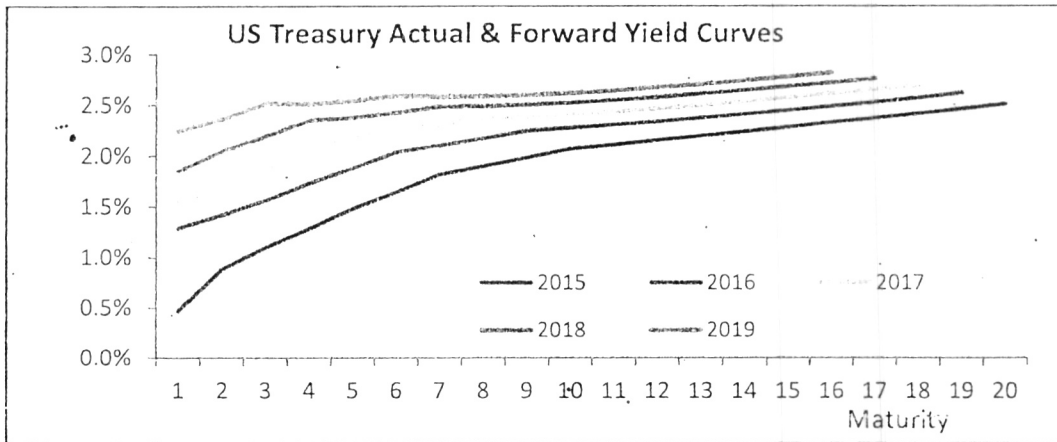
62. **The interest rates may increase unexpectedly relative to the baseline projections.** For example, the U.S. interest rates could increase faster than expected, Kenya's credit risk premium could increase, or the inflation expectation may not be anchored. The robustness of the strategies must therefore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

63. **The following interest rate and exchange rate shock scenarios for FY2016/17–FY2018/19 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 2016, it increases by a moderate shock of 2% percent and remains constant thereafter (Chart 3). Domestic interest rates also receive a moderate shock of: (i) 10 percent for T-bills; (ii) 4 percent for 2-year; (iii) 3 percent for 5-year; and (iv) 2.5% for 10-year and longer (Chart x). This interest rate risk scenario is combined with the 15 percent exchange rate depreciation.
- The second risk scenario assumes U.S. Treasury rates increases faster than expected by 2016, it increases by an extreme shock of 4% over the baseline projections and remains constant thereafter (Chart 4). Domestic interest rate also increases in an extreme shock of: (i) 15 percent for T-bills; (ii) 6 percent for 2-year; and (iii) 5 percent for 3-year and longer bonds.
- A stand-alone exchange rate risk shock scenario is applied where by the Ksh declines by an aggressive depreciation shock of 30 percent against the US\$ in 2017 compared to the baseline exchange rate projections. (Chart 6)

64. **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.

Chart 1: US Treasury Actual & Forward Yield Curves



Source: US Treasury

Chart 2: Kenya US\$ Projections & Forward Yield Curves

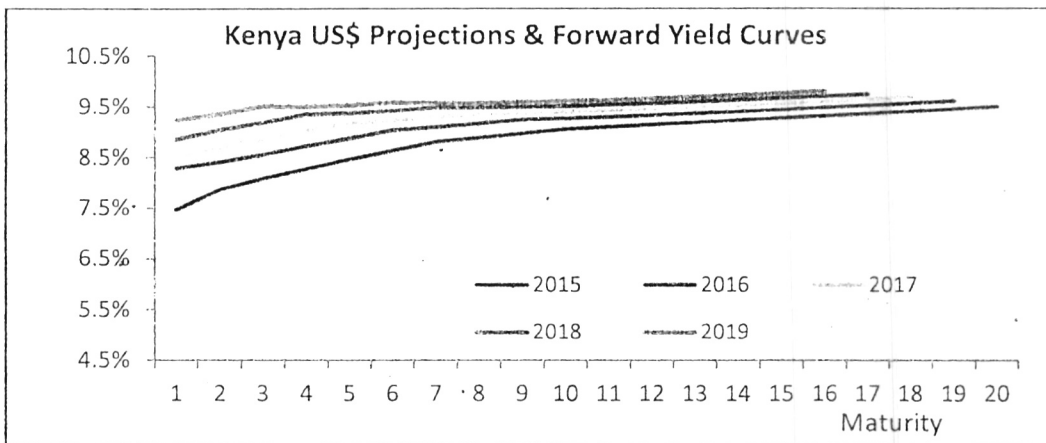


Chart 3: Kenya Domestic Projections & Forward Yield Curves

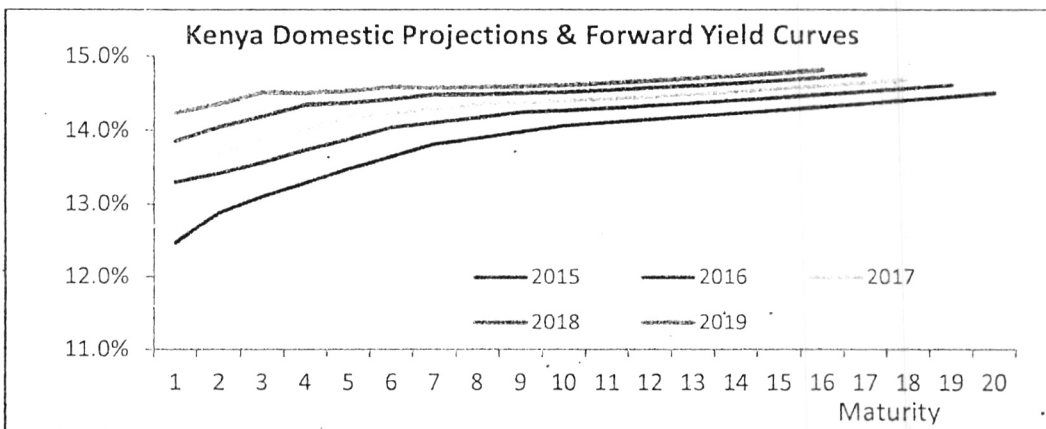


Chart 4: Kenya US\$ Projections & Forward Yield Curves (Shock Scenario 1)

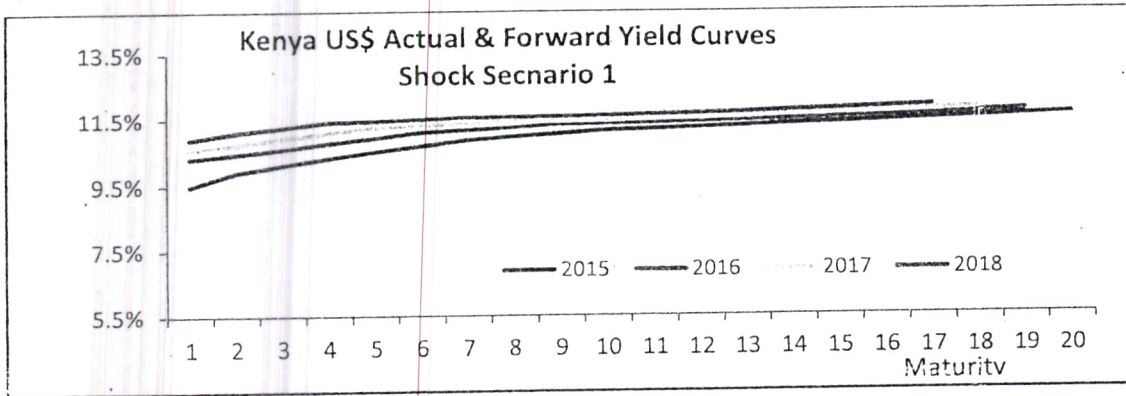


Chart 5: Kenya Domestic Spot & Forward Yield Curves (Shock Scenario 2)

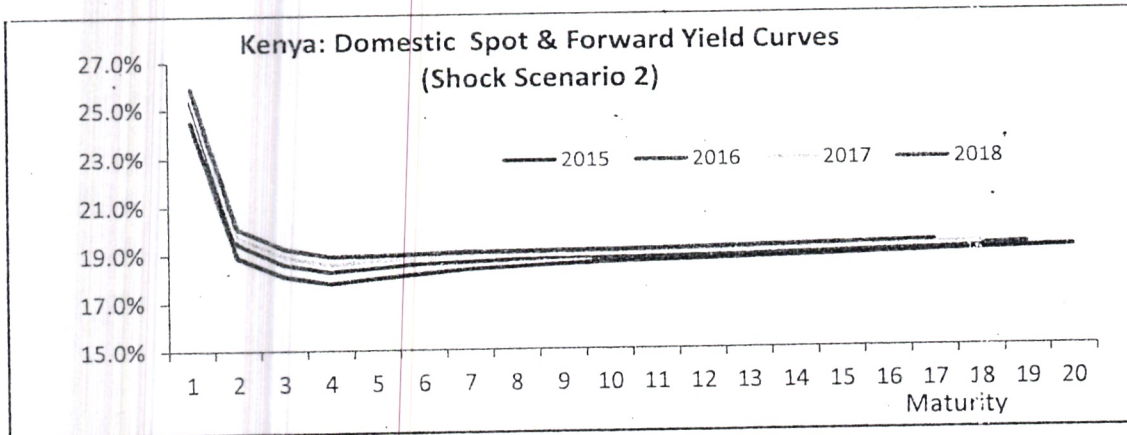
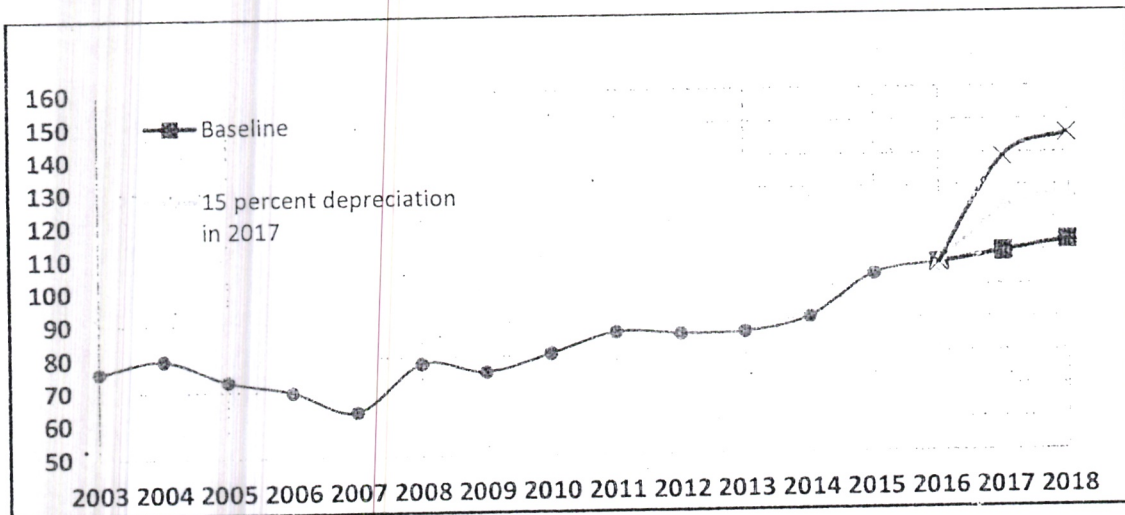


Chart 6: Kenyan Shilling Exchange Rate Projected Depreciation & Shock Scenarios



Source: Central Bank of Kenya

B. Description of Alternative Debt Management Strategies

65. Four strategies were considered for the 2016 MTDS. These strategies reflect alternative ways to meet the borrowing requirement during FY2016/17–FY2018/19. The strategies combine different mix of stylized instruments that reflect the potential sources of financing outlined in Section VII. Common to all strategies is the amount of borrowing from concessional and semi-concessional sources. The strategies are built first on the split between net external and domestic financing (Table 12), and then on the share of T-Bills used for net domestic financing (Table 13)

Table 12: Net Borrowing (In percent of GDP)

	Strategies	2015	2016	2017	2018
Fiscal Deficit	S1	8.0%	7.6%	6.9%	5.9%
	S2	8.0%	7.6%	6.9%	5.8%
	S3	8.0%	7.6%	6.9%	5.9%
	S4	8.1%	7.4%	6.7%	5.7%
External net borrowing	S1	5.4%	4.8%	4.0%	3.9%
	S2	5.4%	5.5%	4.7%	4.6%
	S3	5.4%	4.0%	3.3%	3.3%
	S4	5.4%	4.8%	4.0%	3.9%
Domestic net borrowing	S1	2.6%	2.8%	2.9%	1.9%
	S2	2.6%	2.0%	2.1%	1.2%
	S3	2.6%	3.5%	3.6%	2.7%
	S4	2.7%	2.6%	2.7%	1.8%

- 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 2016 BPS, over the next three fiscal years, around two-thirds of the fiscal deficit will be met by net external borrowing on average. Considering shorter maturities of the domestic debt, this is equivalent to a split of 40-60 between external and domestic borrowing in gross terms. This composition is to be achieved by external commercial borrowing of issuing US\$ 1 billion in FY2016/17 and us\$1.25 billion in FY2017/18 and FY2018/19, in addition to the contracting of credit from concessional and semi-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 FY2016/17 mimicking the issuance outcome in FY2015/16, at a T-bill to T-bond financing mix of 60:40. In a three year period, the share of T-Bills in net domestic financing is to be reduced to a level around 9 percent from the current level of 45 percent. This corresponds to a share of T-bills in gross domestic financing increasing to around 65 percent by FY2018/19 from a level of 60 percent in FY2015/16.

- **Strategy 2 (S2): Increased Issuance of Eurobonds.** This strategy increases the size of external commercial borrowing by US\$ 500 million in each of the three years, as compared to S1. Other external borrowing provisions remain the same as in the baseline. The increase in external borrowing helps reduce the issuance of T-Bills, while the nominal issuance volumes for T-Bonds are the same as S1. In this strategy, T-Bills are rolled-over without providing net financing.
- **Strategy 3 (S3): Decreased Issuance of Eurobonds.** As opposed to S2, this strategy reduces the volume of external commercial borrowing by US\$ 500 million every year. The resulting financing gap is to be met mainly by T-Bills, keeping their share in net domestic borrowing to around 40 percent.
- **Strategy 4 (S4): Increased Issuance of T-Bonds.** This strategy assumes the same external borrowing volumes as in S1, while accelerating the issuance of T-Bonds, maintaining their share in net domestic financing at 80 percent in each year of the strategy, in order to improve the refinancing risk profile.

66. **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.

Table 13. Composition of Net Domestic Borrowing (In percent of total net borrowing)

	Strategies	2015	2016	2017	2018
Share of T-Bills	S1	45%	62%	42%	9%
	S2	45%	34%	23%	-25%
	S3	45%	58%	49%	32%
	S4	45%	20%	23%	10%
Share of T-Bonds	S1	55%	38%	58%	91%
	S2	55%	66%	77%	125%
	S3	55%	42%	51%	68%
	S4	55%	80%	77%	90%

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

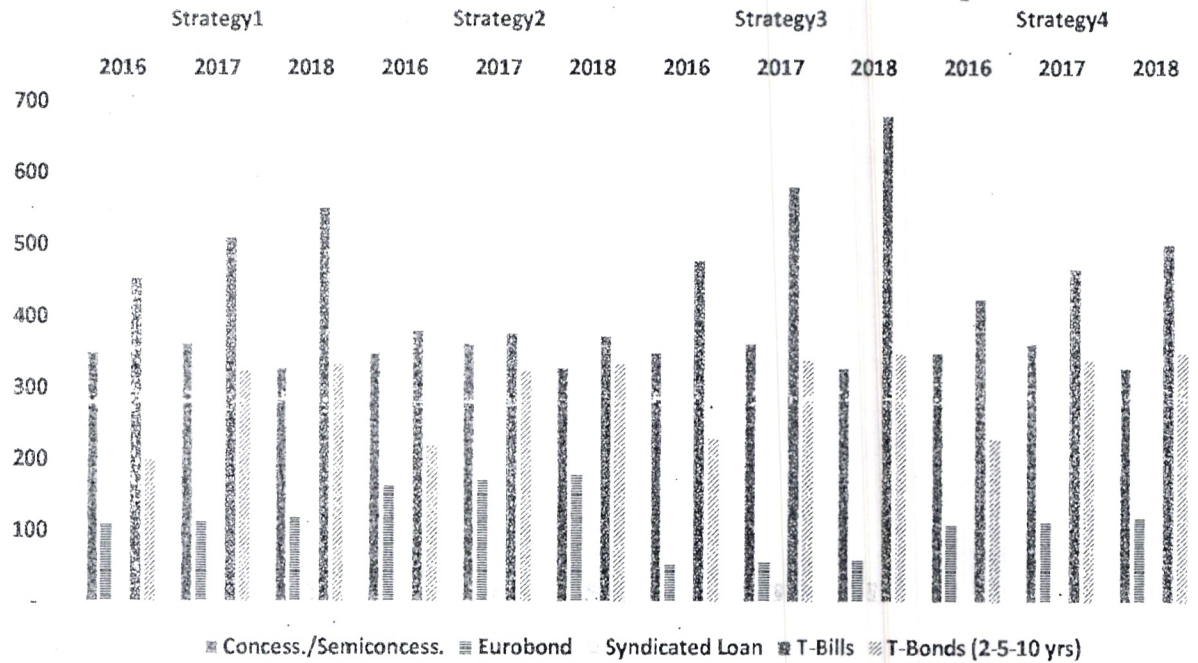
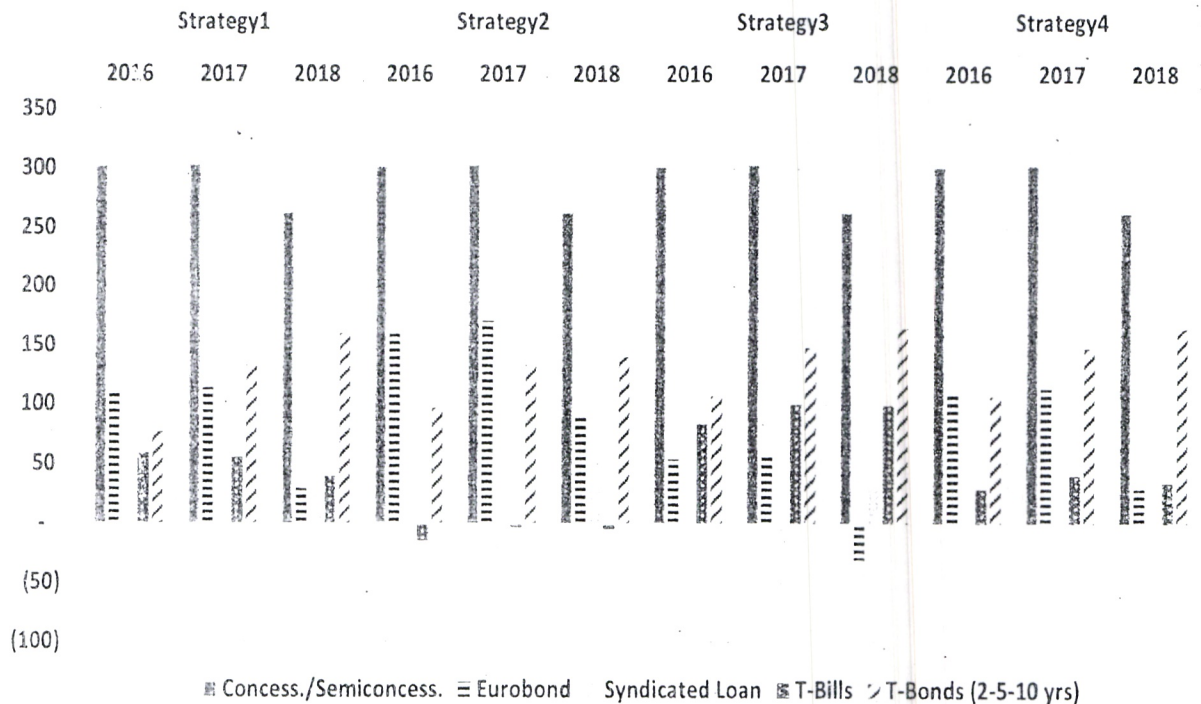


Figure 7: Net Issuance by Instrument, by Strategy, by Year (In billions of Kenyan Shilling)



C. Cost-Risk Analysis of Alternative Debt Management Strategies

67. 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 FY2016/17-FY2018/19.

Baseline results

68. The financing policies to be pursued during FY2016/17-FY2018/19 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 2018/19 is presented in Table 14. The table shows the ultimate impact of the borrowing policies, such as the shift in domestic debt from T-Bills to T-bonds.

Table 14: Composition of Debt by Instrument under Alternative Strategies, as at end-FY2018/19 (in percent of outstanding portfolio)

Instrument	FY2014/15	FY2018/19			
	Existing debt	S1	S2	S3	S4
Concessional	23	23	23	23	23
Semi-concessional	18	23	23	23	23
External Commercial	10	14	17	10	14
T-Bills	11	12	9	14	10
T-Bonds	38	29	29	30	31
External	50	60	63	57	60
Domestic	50	40	37	43	40
Total	100	100	100	100	100

Source: National Treasury

69. 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, dominated by 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 for net domestic debt. This will eventually lead to an increase in the portion of external debt. The

volume of external commercial borrowing will be the main driver of the increasing share of external debt in the total portfolio.

70. **Demand for longer term T-Bonds can only increase gradually and is a hard constraint.** The sizes of the external commercial borrowing will therefore determine the share of T-bills in the debt portfolio. In S3, where foreign bond issuance is reduced, T-Bills will meet the financing gap. Hence, their share will be higher compared to S1 and much higher compared to S2 at the end of the time horizon. In S2, 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. If the foreign bond issuance is not to be increased above the level in S1, the reliance on T-Bills can be still be reduced if they are replaced with longer term bonds, as in S4.

71. **As the portfolio composition changes, the cost and risk indicators will also be affected.** Table 15 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 15: Cost and Risk Indicators under Alternative Strategies (End-FY2018/19)
(Baseline Scenario)**

Risk Indicators		FY2014/15	As at end FY2018/19			
		Existing Debt	S1	S2	S3	S4
Nominal debt as % of GDP		48.8	58.2	58.2	58.2	58.2
Present value debt as % of GDP		42.7	50.2	50.2	50.1	50.2
Interest payment as % of GDP		3.5	3.8	3.8	3.9	3.8
Implied interest rate (%)		7.2	7.5	7.4	7.6	7.5
Refinancing risk	Debt maturing in 1yr (% of total)	18.8	17.5	14.2	20.1	15.2
	Debt maturing in 1yr (% of GDP)	9.2	10.2	8.3	11.7	8.9
	ATM External Portfolio (years)	12.1	11.7	11.5	12.2	11.7
	ATM Domestic Portfolio (years)	5.3	3.7	4.0	3.6	4.1
	ATM Total Portfolio (years)	8.7	8.6	8.9	8.6	8.8
Interest rate risk	ATR (years)	8.1	8.4	8.7	8.4	8.6
	Debt refixing in 1yr (% of total)	25.0	21.1	17.7	23.6	18.7
	Fixed rate debt (% of total)	93.8	96.3	96.3	96.3	96.3
FX risk	FX debt as % of total	50.3	59.9	63.3	56.6	59.9

Source: National Treasury

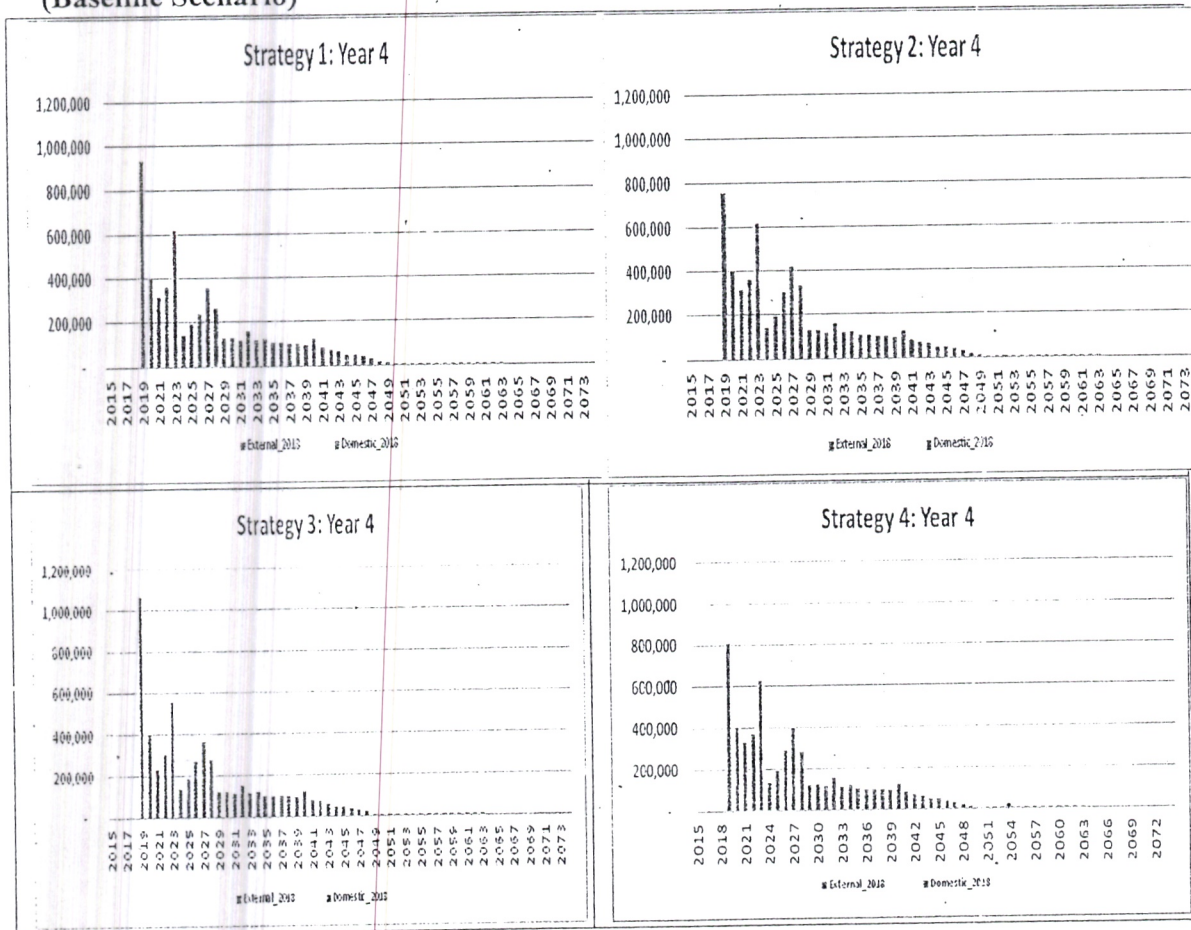
72. **Should the domestic interest rates increase, the cost of financing will be immediately reflected on the T-Bills.** In such a case, Strategy 2 can be more resilient, as there will be less debt to be re-fixed in one year compared to other strategies. Strategies 1 and 4 also

provide improvements, compared to the current portfolio. Strategy 3 does not yield much progress in this regard. It does, on the other hand, assist in slowing down the growth rate of the share of external debt, already increasing. This would lead to a lower exchange rate risk.

73. **Refinancing risk will still be dominated by the short maturities of domestic debt.** Strategy 2, encompassing increased foreign bond issuance, has one the longest average-time-to-maturity (ATM), and the lowest ratio of debt maturing within the next year. Strategy 4, with a slight shift from bills to bonds, also helps reduce the near term refinancing requirement.

74. **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). Issuing longer term T-Bonds will also lead to improvement, although to a lesser extent, given the demand side constraints (Strategy 4).

Figure 8: Redemption Profiles for Alternative Strategies (End-FY2018/19)
(Baseline Scenario)



Source: National Treasury

Impact of market shocks

75. **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, two key cost 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.

76. **The debt/GDP ratio illustrates changes in the size of the outstanding debt under the baseline and market shock scenarios¹⁵.** The variations are mainly due to exchange rate changes and the cumulative impact of higher interest payments, primary deficit, and refinancing of maturing debt at higher interest rates. Foreign currency debt can be issued at lower coupon rates, therefore the real effect of an increase in the exchange rates would be better captured by looking at 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.

77. **Interest payments/revenue assesses each strategy in terms of direct interest costs.** This measure typically captures the results of rising interest rate levels, as reflected in the actual cash-flows. The level of interest divided by revenues reflects the burden of interest service on the budget. However, this measure does not reveal the full cost associated with exchange rate variations.

78. **Interest payment to GDP assesses each strategy in terms direct interest costs to GDP.** This measure typically captures the results of rising interest rate levels, as reflected in the actual cash-flows. The level of interest divided by GDP reflects the burden of interest service on the economy. However, this measure does not reveal the full cost associated with exchange rate variations

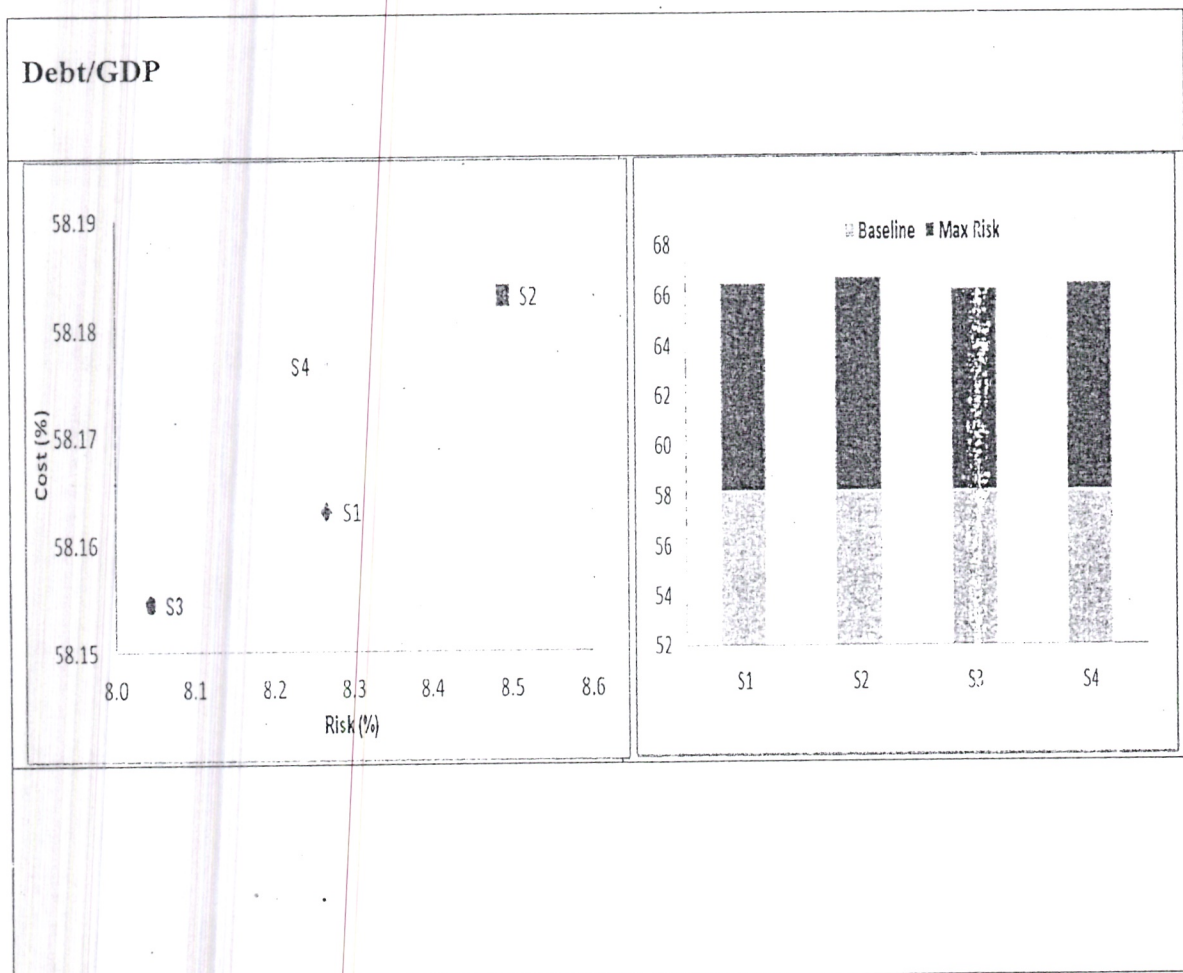
79. **The results would ideally identify the trade-offs between cost and risk, nevertheless they can also present more and less efficient strategies.** This means that a better result can be achieved in either cost or risk without losing on either. The results with

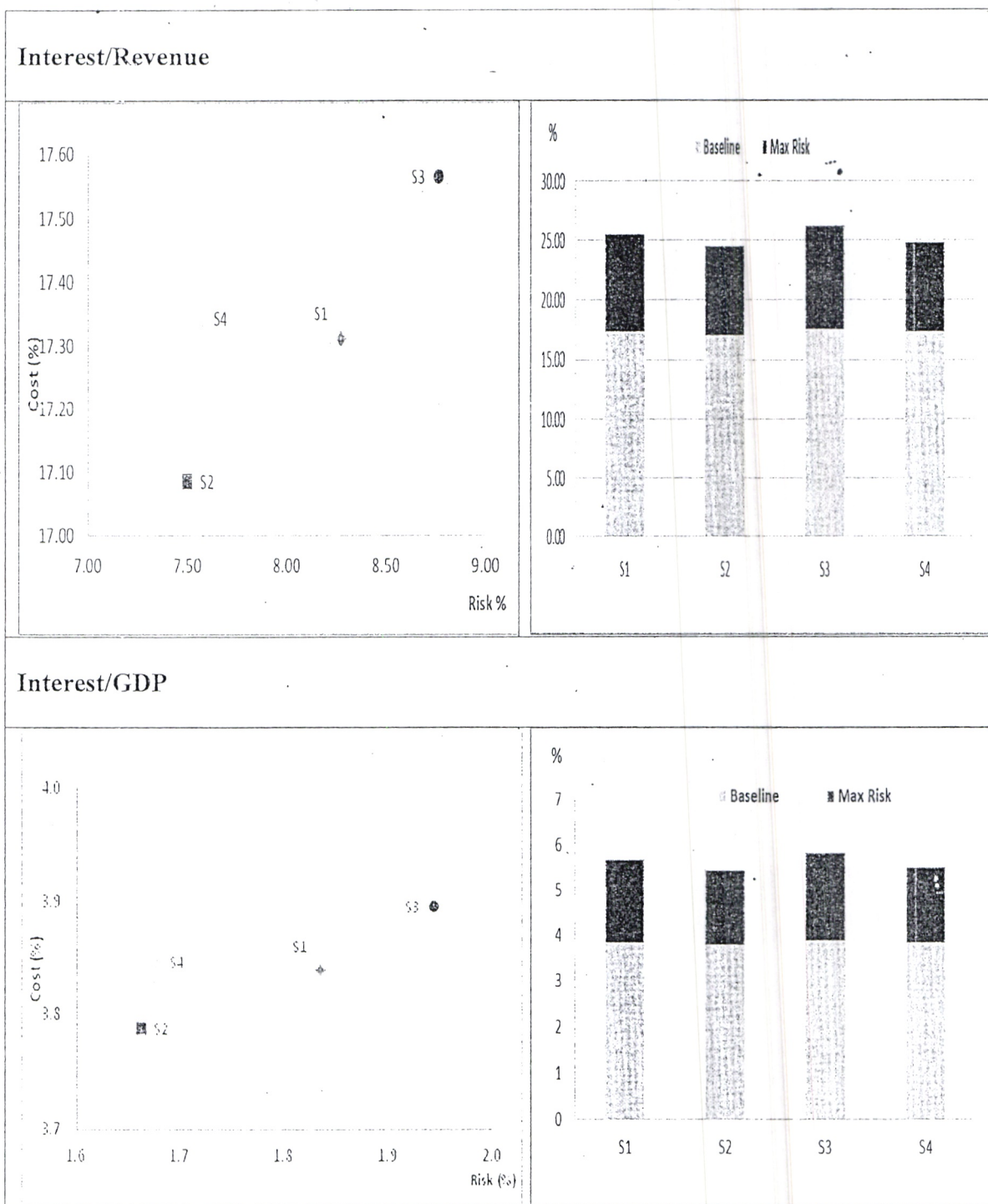
¹⁵ The MTDS Analytical Tool is capable of computing several other cost-risk indicators. External debt-to-GDP provides for measure of external vulnerabilities and exposure to exchange rate shocks. Interest payments can also be expressed as a proportion of GDP, to help assesses potential impacts on the government's budget. Total debt service, including interest and principal payments, as a proportion of GDP provides information regarding overall affordability of debt service obligations.

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 were used together to enable a more complete evaluation of costs and risks. The results are depicted in Figure 9.

80. **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 ratio. Reduced foreign borrowing decreases the level of exchange rate risk, but the resulting increase in the issuance of T-Bills makes the Treasury more exposed to interest rate risk. The opposite argument holds for S2, while S1 and S4 are comparable. It should also be emphasized that the strategies are close in terms of the risks, therefore other considerations, including the redemption profile, market outlook etc., also need to be taken into account in making a decision.

Figure 9: Cost-Risk Representation of Alternative Borrowing Strategies (End-FY2018/19)





Source: National Treasury

81. Given the constraints in the domestic market, Kenya will have to rely on external debt to mitigate refinancing risk. In this regard, the Government should maximize the utilization of concessional financing. The utilization of available multilateral loans help reduce refinancing and interest-rate risk, without adding to the cost

82. **Containing the increase in the share of external debt would help to mitigate the exchange rate risk.** While increasing the size of external commercial borrowing (S2) leads to a lower interest cost due to the lower coupon rates, this would increase the exposure of the debt portfolio to fluctuations of foreign exchange rates. In the event of a shock, the debt/GDP ratio will increase, which may amplify the risk perception in the markets with regard to debt sustainability.

83. **A well-managed external commercial borrowing program will help alleviate the pressures in the domestic 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. 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 better borrowing conditions. The preparation of such a program should be accompanied by improved market investor relations. This includes enhanced communication with current and potential investors and improved information disclosure policies with regard to the debt strategy, fiscal and macro outlook etc.

84. **Gradually reducing the 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. Maintaining a certain volume of presence in the foreign bond market will also help achieve this objective.

85. **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 and ability to implement the strategy, the 2016 MTDS proposes Strategy 4 (S4) as the best strategy.** Indeed, the results of the cost and risk analysis (Tables 16, 17 and 18; Figures 10, 11 and 12) reveal that the 2015 MTDS is less favorable going forward compared to the 2016 MTDS.

86. **Strategy 4 involves increased Issuance of Domestic Bonds.** This strategy increases the size of domestic bond issuance in each of the three years, as compared to S1. Other external borrowing provisions remain the same as in the baseline - The external debt comprising 60 per cent of gross borrowing while 40 per cent comprise of the domestic borrowing. On the external front concessional is proposed at 23 per cent, semi-concessional 23 per cent and commercial 14 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.

Table 16: Cost and Risk Analysis: 2015 MTDS vis-à-vis 2016 MTDS: Interest to GDP

Scenarios	2015 MTDS	2016 MTDS
	%	%
Baseline	3.84	3.85
Exchange rate shock (30%)	4.13	4.14
Interest rate shock 1 (Moderate Shock)	4.96	4.86
Interest rate shock 2 (Extreme Shock)	5.67	5.53
Combined shock (15% depreciation and interest rate shock 1)	5.14	5.03
Max Risk	1.84	1.68

Source: National Treasury

Figure 10: Interest Payments to GDP Ratio as at end 2018

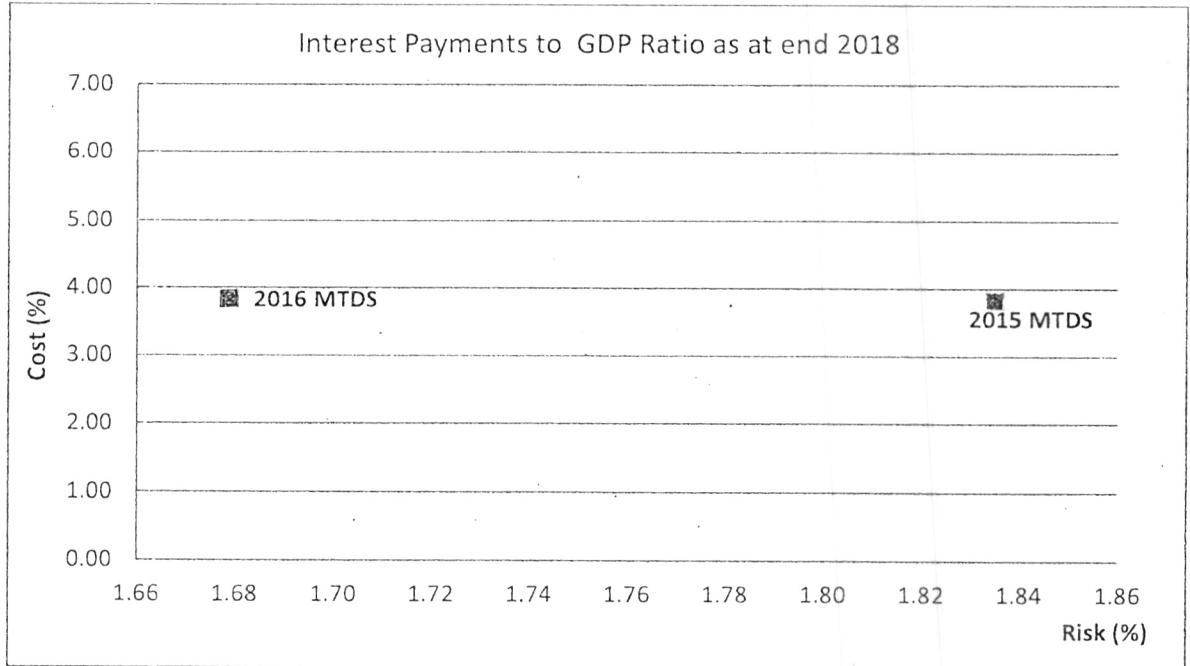


Table 17: Cost and Risk Analysis: 2015 MTDS vis-à-vis 2016 MTDS: PV of to GDP

Scenarios	2015 MTDS	2016 MTDS
	%	%
Baseline	50.15	50.17
Exchange rate shock (30%)	56.78	56.79
Interest rate shock 1 (Moderate Shock)	51.85	51.70
Interest rate shock 2 (Extreme Shock)	52.91	52.69
Combined shock (15% depreciation and interest rate shock 1)	55.20	55.05
Max Risk	6.63	6.62

Source: National Treasury

Figure 11: PV of Debt to GDP Ratio as at end 2018

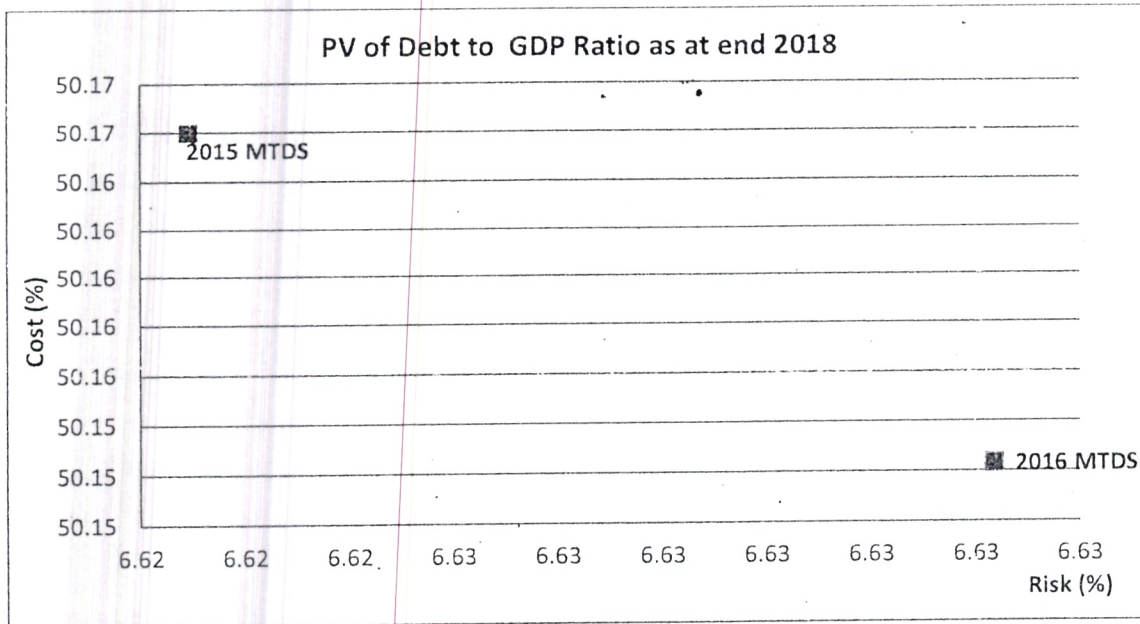
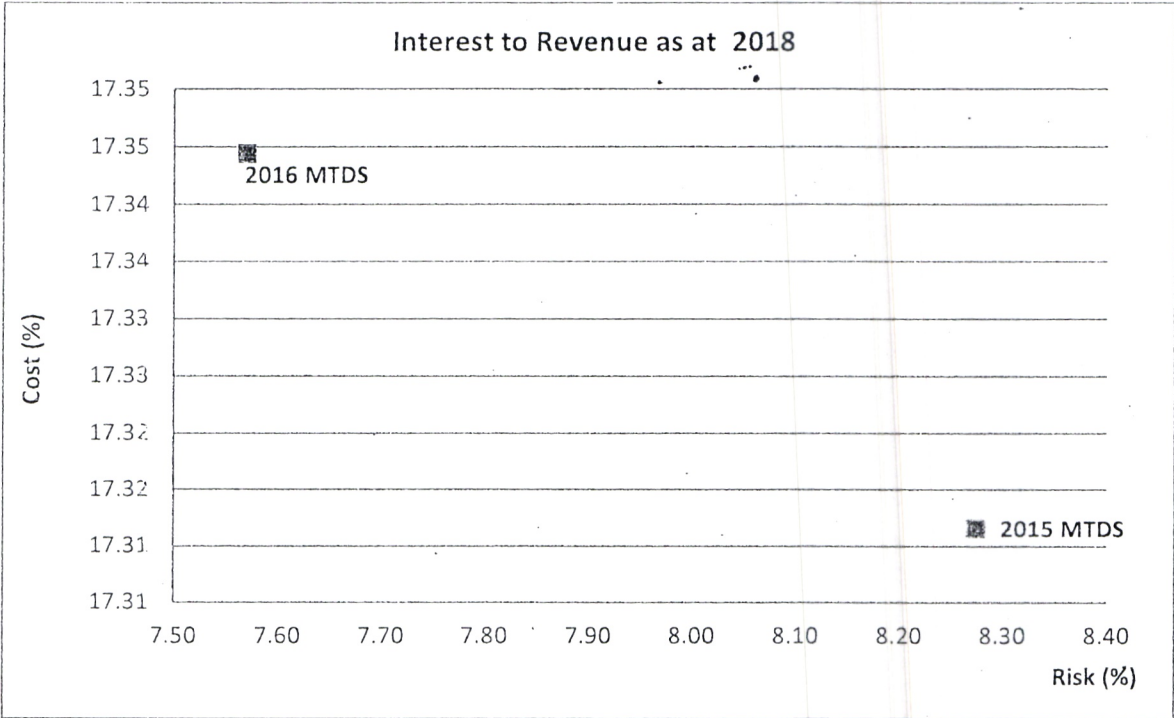


Table 18: Cost and Risk Analysis: 2015 MTDS vis-à-vis 2016 MTDS: Interest to Revenue as at 2018 of to GDP

Scenarios	2015 MTDS	2016 MTDS
	%	%
Baseline	17.31	17.34
Exchange rate shock (30%)	18.63	18.66
Interest rate shock 1 (Moderate Shock)	22.36	21.89
Interest rate shock 2 (Extreme Shock)	25.59	24.91
Combined shock (15% depreciation and interest rate shock 1)	23.16	22.67
Max Risk	8.27	7.57

Source: National Treasury

Figure 12: Interest to Revenue as at 2018



Source: National Treasury

IX. DEBT SUSTAINABILITY

87. 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.

88. The latest (September 2015) 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.

89. 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 19: Kenya: External Debt sustainability thresholds

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

Source: IMF Country Report No. 15/269, September 2015

a. External debt sustainability

90. Given the above thresholds, under the baseline scenario, Kenya's debt ratios listed in Table 20 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 20: External debt sustainability

Indicator	2014	2015	2016	2017	2019	2024
PV of debt-to-GDP ratio (50)	19.6	22.1	22.1	21.8	21.2	18.2
PV of debt-to-exports ratio (200)	107.7	120.4	123.4	123.2	122.3	110.3
PV of debt-to-revenue ratio (300)	102.2	110.9	103.6	99.1	94.8	81.3
Debt service-to-exports ratio (25)	27.8	29.9	31.9	32.7	39.0	41.4
PPG Debt service-to-exports ratio	9.0	6.5	8.0	8.7	14.0	17.1
Debt service-to-revenue ratio (22)	8.6	6.0	6.7	7.0	10.9	12.6

Source: IMF Country Report No. 15/269, September 2015

b. Public debt sustainability

91. 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 GDP¹⁶.

92. Under the baseline scenario shown in Table 21, the PV of public debt-to-GDP, increases from **45.8 percent** in 2014 to **48.5 percent** in 2015 and to **44.4 percent** of GDP by 2019. In the long term, the PV of public debt-to-GDP is expected to decline to about 37.3 percent by 2024. Given Kenya's relatively strong revenue performance, the PV of public debt-to-revenue ratio would gradually decline from around 238.7 percent in 2014 to be around 199.2 percent in 2019. Going forward, the debt service-to-revenue ratio is expected to decline from 34.0 percent in 2014 to about 26.6 percent in 2017. Overall, the results from the DSA indicate that Kenya's public debt remain sustainable over the medium term.

Table 21: Public debt sustainability

Indicator (Threshold)	2014	2015	2016	2017	2019	2024
PV of public sector debt to GDP ratio (74)	45.8	48.5	48.1	47.3	44.4	37.3
PV of public sector debt-to-revenue ratio	238.7	243.3	225.9	214.8	199.2	166.6
Debt service-to-revenue ratio	34.0	29.7	28.1	26.6	27.9	26.4

Source: IMF Country Report No. 15/269, September 2015

¹⁶ The EAC public debt convergence criterion for PV of Debt/GDP is 50 percent.

93. In Table 22, a worst-case scenario, a “borrowing shock” scenario is presented which assumes Government borrowing 10 percent of GDP in FY2015/16. The results indicate that in the medium term, the debt burden indicators do not breach any of the debt sustainability thresholds.

Table 22: Sensitivity Analysis for Key Indicators of Public Debt

Indicator	Threshold	2015 ratios	<i>Impact of 10% of GDP increase in borrowing in 2015 on debt indicators in 2017</i>
PV of Debt as % of GDP	74	49	54
PV of Debt as % of Revenue	300	238	237
Debt Service as % of Revenue	30	29	29

Source: IMF Country Report No. 15/269, September 2015 and National Treasury

94. It is also noteworthy that the 10 percent shock is way above the planned borrowing. In FY2016/17, the Government plans to borrow, on a net basis amount equivalent to 6.9 percent of GDP to finance the budget. The net borrowing is expected to decline to 4.3 percent of GDP in FY2018/19.

95. 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 2016 MTDS will be undertaken with caution taking these factors into account.

X. IMPLEMENTING THE 2016 MTDS

96. The Government will prepare a borrowing plan to accompany the *2016 MTDS* (Strategy 4) and meet the financing requirement for the financial year 2016/17. 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)*.

97. The *2016 MTDS* provides a clear set of assumptions and some information on key risk parameters that are associated with the Strategy (S4) (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.

98. 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.

99. 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.

100. 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 will be upgraded and integrated with IFMIS, additional skilled staff posted to PDMO while training in debt management techniques will be scaled up.

XI. CONCLUSION

101. **The 2016 MTDS 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 2016/17, taking into account both cost and risk. The cost-risk trade-off of the 2016 MTDS has been evaluated within the medium term context.

102. **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.

103. **The 2016 MTDS 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.

104. **This is the eighth time that the Government is formally presenting the Medium Term Debt Management Strategy and the third 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.
