

REPUBLIC OF KENYA



**OFFICE OF THE DEPUTY PRIME MINISTER AND
MINISTRY OF FINANCE**

**MEDIUM TERM
DEBT MANAGEMENT STRATEGY**

2009/10–2011/12

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List of Abbreviations

ADB	African Development Bank
AfDB	African Development Fund
ATM	Average Time to Maturity
ATR	Interest Rate Refixing
CBK	Central Bank of Kenya
DMD	Debt Management Department
DSA	Debt Sustainability Analysis
DX	Kenya shilling denominated debt
EEC	European Economic Community
EIB	European Investment Bank
FDI	Foreign Direct Investments
ESMID	Efficient Securities Markets Institutional Development
FLSTAP	Financial and Legal Sector Technical Assistance Project
FX	Foreign currency denominated debt
GDP	Gross Domestic Product
IDA	International Development Association
IFB	Infrastructure Bonds
IFC	International Finance Corporation
MTDS	Medium Term Debt Strategy
NSSF	National Social Security Fund
PFMR	Public Financial Management Reforms Project
SDR	Special Drawing Rights
USD	United States dollars

FOREWORD

The current global financial crisis and changing outlook for sources of external finance highlights the importance of developing domestic market. The high volatility of interest rates and exchange rates require that the cost of borrowing should be properly assessed and measures taken to mitigate risks.

The slowdown in economic growth witnessed during the financial year 2008/9 need to be reversed through counter-cyclical fiscal policies which entail additional Government borrowing to finance programs with higher multiplier effects on the economy. Reducing the vulnerability of debt portfolio to external shocks remains a key challenge in debt management.

The Government has re-evaluated the existing *ad hoc* debt management strategy as the financing options available in the past have different cost and risk characteristics. The 2009 Medium Term Debt Strategy (MTDS) prepared by the Debt Management Department at the Treasury provides a logical framework for evaluating the proposed financing option for the 2009/10 Budget. It highlights the optimal risk / cost trade-off adopted within a medium term context.

The 2009 MTDS will guide borrowing decisions on the basis of cost and helps to identify, monitor and manage key financial risks in the debt portfolio to ensure that debt remains at sustainable levels. It is observed that even in the worst case shock scenario, Kenya's public debt ratios are within the internationally set benchmarks. Furthermore, by encouraging transparency in debt management, the MTDS strengthens relations with external creditors, donors, investors and promotes development of the domestic debt market



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ACKNOWLEDGEMENT

The objective of Kenya's debt management policy is twofold: First, to meet the Government financing requirements at the lowest possible long term borrowing cost, subject to a prudent degree of risk. Second, deepen the domestic market for Government securities. In the current context of an increasingly challenging financing environment, debt management has become a topical issue in the public arena in Kenya today.

To achieve the core objective of meeting the financing needs of the Government, priority is placed on minimizing cost by accessing external concessional debt. However, given the unpredictable nature of concessional sources of financing, and in view of the fact that these sources may not be as forthcoming as previously thought, the Government has sought to diversify its sources of financing. Nevertheless, market conditions have proved significantly volatile. Moreover, the scope to substitute external sources with domestic resources may also be limited, and requires careful assessment given a more constrained liquidity environment and the associated risk of crowding out private sector investments.

Financing must be taken up in a balanced way such that debt is sustainable over the long term. On the one hand, debt must be contracted prudently, taking into account the cost and risk consequences. On the other hand, debt must be contracted to support expenditure in priority areas that will promote economic growth and reduce poverty over the long term. The 2009 MTDS addresses the former consideration, which is a core function of public debt management.

The 2009 MTDS has been prepared by staff of the Debt Management Department at the Ministry of Finance in consultation with Central Bank of Kenya and IMF/ World Bank staff. I wish to express my sincere gratitude to the core team involved in its preparation namely: John Murugu (Director), Harun Sirima (Deputy Director), Charles Kairu and Dunstone Ulwodi. Special thanks go to Ms Faith Njau for logistical support.



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EXECUTIVE SUMMARY

The Government has an *ad hoc* debt management strategy that seeks to maximize concessional external borrowing. Conscious of interest cost and refinancing risk, the Government carefully paced the accumulation of domestic debt while gradually extending its maturity profile. This strategy has been implemented since 2001.

Reflecting this strategy, the existing public debt portfolio displays an external debt composition that is dominated by multilateral and bilateral creditors. The proportion of external to domestic debt is about 53:47. Thus, there is significant exchange rate risk in the debt portfolio. The domestic debt portfolio consists of a range of instrument with maturities ranging from 3-months to 20-years. There is no floating rate exposure in the domestic portfolio, and refinancing risk, though still significant, has been gradually reduced with the introduction of increasingly longer tenors.

Kenya is vulnerable to external shocks. The global financial crisis has led to reduction in remittances from Kenyans in diaspora, FDI and capital inflows, and international reserves thereby exerting pressure on the Kenya shilling exchange rate. On the fiscal front, the same exogenous shocks are feeding into declining revenue and increasing expenditure needs, while drought has also necessitated emergency expenditures on food imports. On the monetary front, currency depreciation has led to inflationary pressures to pass through. All this suggest that macroeconomic and structural vulnerability have potential to translate into higher exchange rate and interest rate volatility, requiring mitigating actions.

Reliance on official sources of external financing has served Kenya well in the past. However, the Government has considered alternative sources of financing to accommodate higher infrastructure expenditure, consistent with Kenya Vision 2030, and to increase its independence from donor financing, which has proved volatile in the past. A debut USD 500 million sovereign international bond was contemplated before the significant deterioration in global liquidity conditions. Whereas in the 2009 MTDS the Government is considering substituting external with domestic sources of financing, this strategy will be pursued with caution given the risk of crowding out private sector investments.

In light of this background, the performance of the existing *ad hoc* strategy and the 2009 MTDS were considered under different interest and exchange rate scenarios. In general terms, the strategies considered reflected different combinations of domestic and external financing, with some different combinations of market based instruments and official sector financing. Their performance was evaluated under different scenarios including a parallel shift in the yield curve, which penalizes longer maturities of debt, a flattening of the yield curve, which penalizes the shorter maturities of debt, and an exchange rate shock, which penalizes foreign currency debt. The impact of a combined interest rate and exchange rate shock was also considered.

The cost associated with each strategy was evaluated using two specific measures: the ratio of interest payments to GDP, and of total public debt to GDP. The existing strategy characterized by higher external financing has lower cost but carry significant exchange rate risk. The 2009 MTDS characterized by a greater proportion of domestic financing higher cost and carry higher interest rate risk, but reduce the overall exchange rate exposure of the portfolio.

Overall, the choice of 2009 MTDS was made in the context of the Government's overall risk tolerance, and taking into account its objective to develop the domestic debt market. The Government is cautious of accessing the international financial market through sovereign bond issuance under the current global environment and the consequence of hardening of borrowing terms from official financing sources.

To implement the 2009 MTDS, the Government will continue to make further progress in institutional reforms in public debt management and strengthening of the domestic debt markets. Overall, the Government will continue to implement prudent macro-economic, a pre-requisite for sustainable domestic debt market.

I. EXISTING DEBT MANAGEMENT STRATEGY

1. The Government has an informal debt management strategy in operation, which guides the financing strategy. The objective of the external borrowing strategy has been to minimize costs by maximizing concessional borrowing. To achieve this, the Government contracts debt with grant element of more than 35 percent. However, the currency composition is determined by the lender. Borrowing on non-concessional terms was only envisaged in exceptional cases, for instance, to re-finance commercial debt. While maximizing concessional borrowing has been a priority, the need to diversify the sources of financing has also become important, given volatility in donor flows and the need to finance scaled up development expenditures to promote the growth necessary to achieve the goals set in *Vision 2030*. This has led to a strategy in financial year 2008/09 that included the consideration of sovereign bond issuance in the international capital markets. The intentions were that the proceeds of the bond issue would have been directed towards infrastructure investments.

2. The objective of domestic debt management strategy has been on reducing the refinancing risk, while taking due account of costs. The Government has intention has been to maintain the ratio of Treasury Bills to Treasury Bonds at 30:70. Reflecting the financial year 2008/09 budget objective to increase spending in development, the Government issued Ksh 18.5 billion “infrastructure” bonds to finance public investment in the roads, energy and water sector.

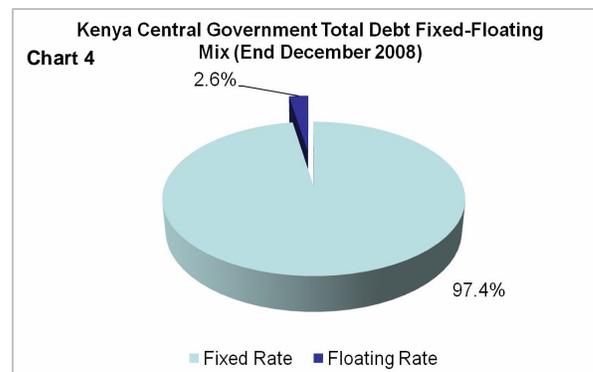
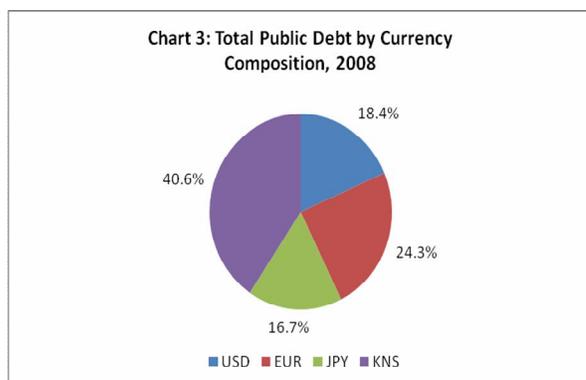
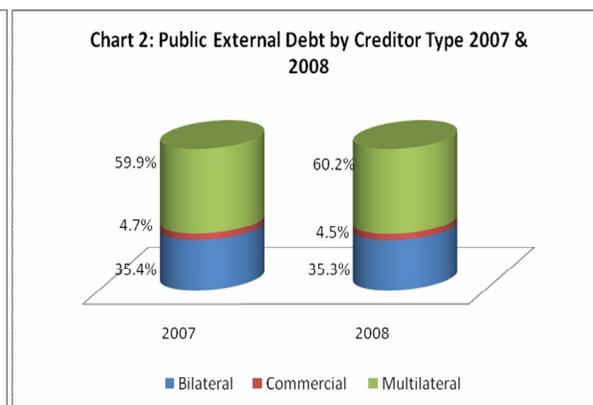
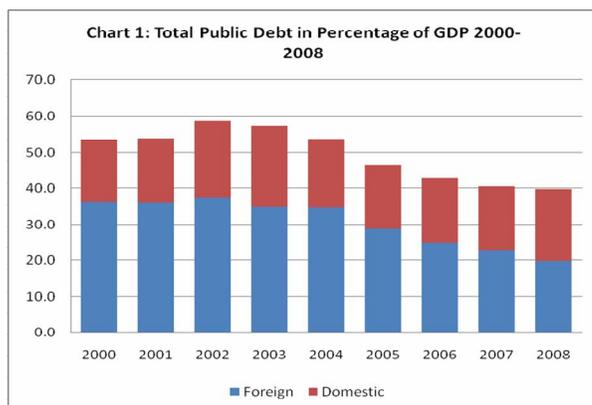
3. Whereas there has been a steady increase in total public debt, debt as a percentage of GDP has been declining (Chart 1) due to strong GDP growth. Indeed, the 2008 IMF-World Bank Debt Sustainability Analysis (DSA) suggests that Kenya has been at low risk of debt distress, although it was sensitive to sharp increases in borrowing. Going forward, the 2009 MTDS is designed to take into account a borrowing ‘shock’ of 10 percent to GDP growth as a stress-test to determine whether debt remain sustainable over the medium term.

II. COST AND RISK CHARACTERISTICS OF THE EXISTING DEBT PORTFOLIO

4. The existing Government informal debt management strategy has determined the structure of the current public debt portfolio. There has been a significant increase in the proportion of domestic debt over the years, reaching a 53% to 47% share of foreign to domestic debt, respectively, in 2008 (see Table 1). This reflects the desire of the Government to reduce its reliance on external sources, in light of their volatility, and move to increased reliance on domestic resources.

Table 1: External and Domestic Debt, End 2008

	USD Billion	Ksh Million	Percent of GDP	Share of total debt	Weighted avg. interest rate
External debt	6.6	515,310	25	53	2.5
Domestic debt	5.9	456,230	22	47	10.3
Total debt	12.5	971,540	47	100	8.2



5. The relative dominance of debt in foreign currency (53%) indicates a significant exposure of the debt portfolio to exchange rate fluctuations. This is an important consideration given the recent and historical experience where the Ksh has depreciated significantly. Within the foreign currency portfolio, the Euro, USD and Japanese Yen accounts for 41%, 31% and 29%, respectively (see Chart 3).

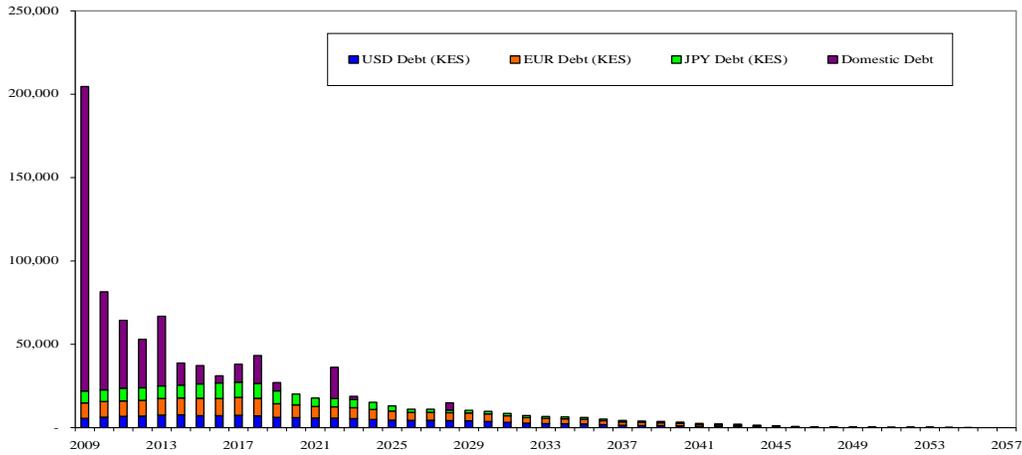
6. Table 2 highlights the cost characteristics of the existing external debt portfolio. The Government’s external borrowing policy specifies grant element of at least 35 percent as the main criteria for approval of loan agreement. This is reflected in the highly concessional terms on the outstanding loan agreements, with 90 percent of external debt on concessional terms. The residual external debt reflects those commercial arrears which have been in dispute; a review of these arrears has been recently completed and the Government intends to make payment on these arrears in the next fiscal year. The low cost nature of the external portfolio helps offset the high cost of domestic debt with the overall debt portfolio moderately costly at 8.2 percent.

Table 2: Average Terms for Outstanding External Loans

Terms	Jun-06	Jun-08
Interest rate (%)	0.6	0.8
Maturity (Years)	37.3	40.3
Grace period (Years)	10.0	9.3
Grant Element (%)	52.4	64.0

7. In terms of interest rate exposure, the portfolio is insulated by its relatively long average time to interest rate re-fixing (ATR) being 8.3 years. The minimal share of variable rate debt in the total debt portfolio (see Chart 4) means that interest rate exposure is not further aggravated. Similarly, on first inspection, refinancing, and rollover, risk appears relatively contained given that the average time to maturity (ATM) of the total debt portfolio is 8.3 years, with that of the domestic debt portfolio at 3.7 years. Nevertheless, an inspection of the repayment profile highlights that there is some significant refinancing and rollover risk, with over 40 percent of the domestic debt stock maturing in the next year.

Chart 5: Total Debt Repayment Profile (End of December 2008)



8. Therefore, the relevant considerations arising from the current debt portfolio (as summarized in Table 3) that influence the 2009 MTDS is based on seeking to reduce exchange rate exposure, and reduce refinancing exposure in the domestic market, while containing the cost of debt.

Table 3: Cost and risk considerations of the existing debt portfolio

Characteristics of Existing Portfolio	Ex ante Risks	Ex ante Cost
Currency composition (FX = 53%; DX=47%)		
External, mostly concessional	Exchange rate risk	Low
Domestic	No exchange rate risk	High
Maturity profile (ATM = 8.3 years)		
External, mostly concessional (ATM =12.9 years)	Low refinancing risk	Low
Domestic (ATM = 3.7 years)	Medium refinancing risk	High
Interest rate composition (Fix = 97%; Float = 3%)		
	Low interest rate risk	

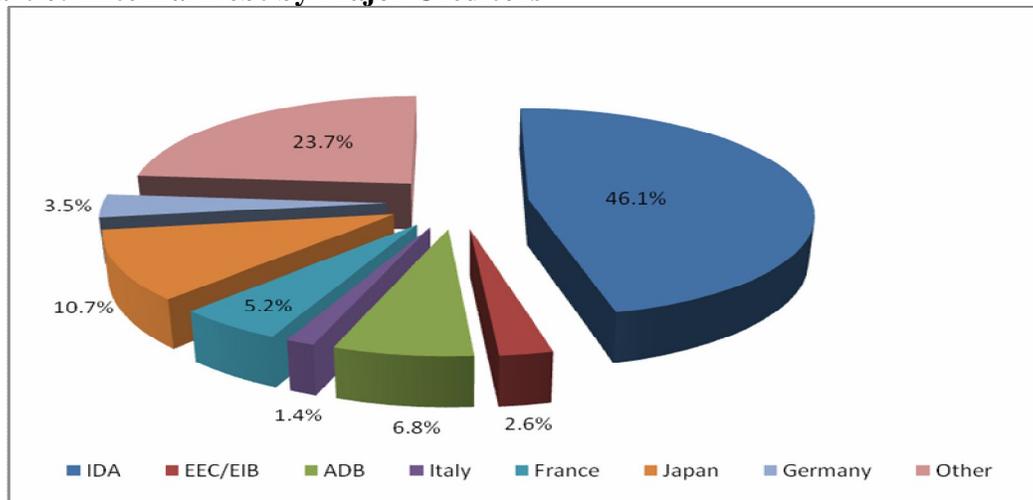
III. SOURCES OF FINANCING

A. External Sources of Financing

Official Sources

9. IDA, ADB/AfDB and EEC/EIB are the main multilateral creditors. They account for on average 94 percent of the outstanding multilateral credit as shown in Chart 6. IDA is the single biggest source of resources, accounting for 77 percent of the outstanding multilateral debt.

Chart 6: External Debt by Major Creditors



10. In terms of bilateral creditors, Japan, France and Germany are the main creditors. They account for 68 percent of the bilateral debt, with Japan the largest bilateral donor, accounting for 38 percent of the bilateral debt.

11. There has been a significant variance between commitments and disbursement of project and program loans from official sources. This development is attributed partly to the on and off suspension of inflows pending implementation of required reforms, particularly in the area of public financial management and oversight, and partly to weak capacity to absorb resources, both loans and grants.

12. Going forward, the Government will continue to access concessional project and program loans from both bilateral and multi-lateral donors. The focus will be to strengthen relationships with donors on more of a sector-

wide basis, which would reduce the transactions costs involved with negotiating individual loans. In addition, this approach would give the Government more flexibility in allocating resources within individual sector.

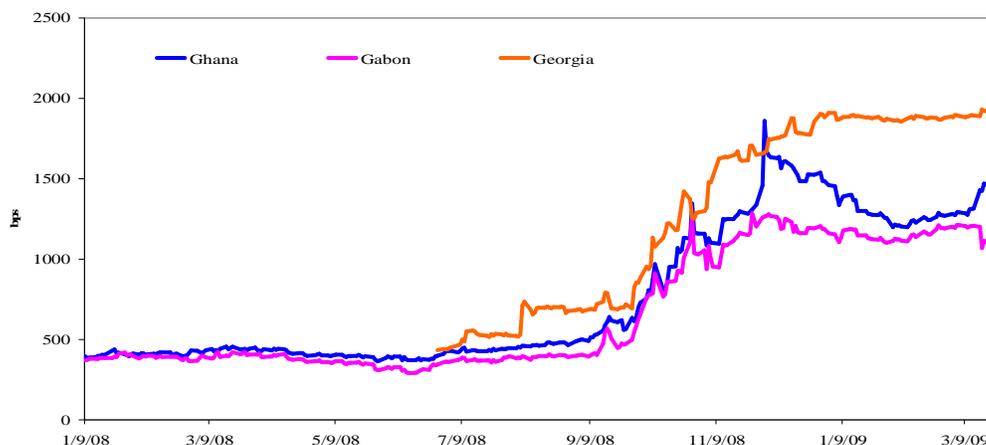
13. The Government takes into consideration the impact of accessing any non-concessional sources of financing on the availability of concessional financing. Both IDA and the AfDB, Kenya's main sources of concessional financing, have a non-concessional borrowing policy in place. Consequently, the Government recognizes that possible access to the international capital markets may lead to hardened terms on these sources of financing.

Commercial Sources

14. Kenya had planned to access the international capital markets in 2008 to raise USD 500 million. It had secured a credit rating which declined as a consequence of the recent economic challenges. Kenya is currently rated B+ by Fitch and Standard and Poor's. When preparations for international market access began, the Government anticipated it could access the market on similar terms to other debut issues from its peer group, i.e., at a spread of 350 basis points or yield of around 8 percent. However, developments in the global financial markets (see Chart 7) have resulted in these plans being temporarily put on hold until conditions improve.

15. In addition, Kenya maintains relationships with commercial banks that might in the future be prepared to provide financing, most likely through syndicated loans, for a variety of purposes. This would be subsequently refinanced in the event that the Government taps the international capital markets. More generally, syndicated commercial loans could provide a partial substitute to international capital markets financing to help meet the costs of projects which are not generally financed by official creditors.

Chart 7: Performance of peer debut sovereign bond issues



16. In the medium term, it is likely that international capital market access will re-open, although unlikely to be on terms as favorable as those that prevailed in the period 2007-08. Consequently, accessing international capital markets remains a possibility for the future, and could be considered as an element in the analysis of alternative debt management strategies.

B. Domestic Sources of Financing

17. Since 2003, the Government has taken a more focused approach to accessing the domestic debt market. Given its strategic target of building Treasury bonds to 70 percent of its domestic stock, it has taken conscious steps to move in this direction (see Table 4). As of end-December 2008, it had achieved that target. A broad range of maturities has been established along the yield curve out to 20-years. However, the bond market remains relatively fragmented with 68 separate issues outstanding with average size ranging from Ksh 4-9 billion, and secondary market liquidity remains very low.

Table 4: Evolution of the Treasury market

Fiscal Year	Treasury Bills	Treasury Bonds	Government Stocks	Securities Outstanding	% Growth
June 2003/2004	105,744.00	161,549.06	1,057.98	268,351.04	
June 2004/2005	99,835.75	188,625.99	1,057.98	289,519.72	8%
June 2005/2006	107,838.30	193,357.81	1,057.98	302,254.09	4%
June 2006/2007	130,308.36	218,357.33	1,057.98	349,723.67	16%
June 2007/2008	129,970.26	272,199.74	754.7	402,924.70	15%
December 2008	121,345.45	318,613.11	754.7	440,713.26	9%

18. In 2009, the Government innovated and launched an “infrastructure” bond (IFB). This was a large single issue (Ksh 18.5 billion), with an amortizing profile. In addition, it is tax exempt, unlike the more standard Treasury bonds which are subject to withholding tax. Given the extent of the incentive offered to investors, the issue was well oversubscribed, and post-issue, the bond has been relatively active in the secondary market. Market participants viewed the linking of the bond issue with the financing of specific projects as important, even though its repayment is not backed by the revenues directly generated by this investment.

19. The investor base remains dominated by the domestic banking sector, which represent about 50 percent of the investor base, holding Ksh 205 billion of Treasury bills and Treasury bonds outstanding (see Table 5). Pension funds and insurance companies are the next most significant investor group.

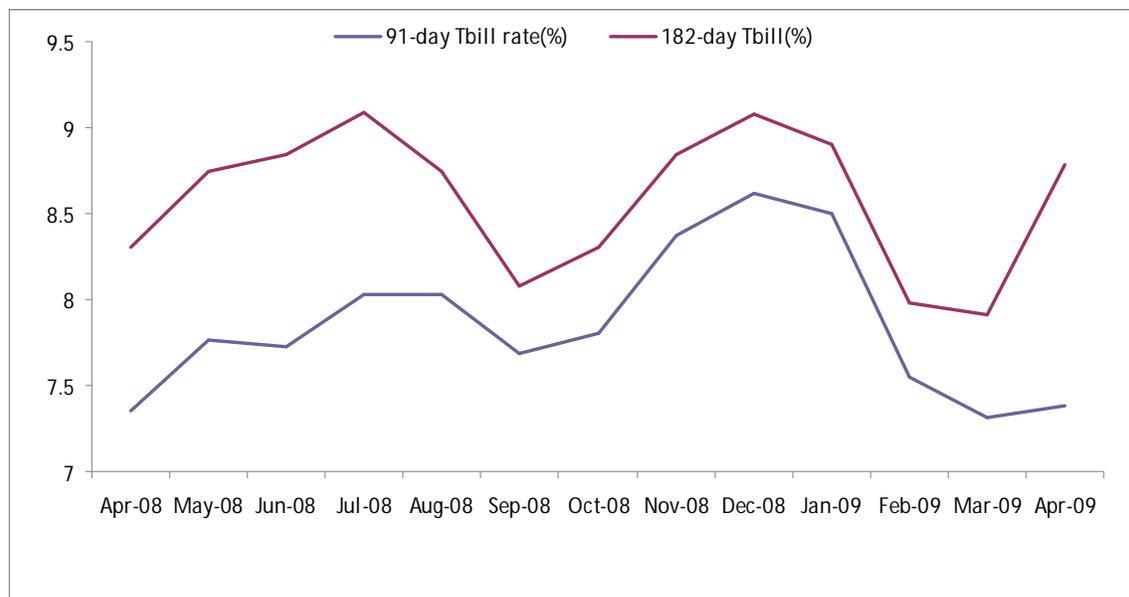
20. Data suggests that foreign investor participation remains very limited, at about 3 percent of the investor base. The negative real interest rates that prevail partly impeded greater foreign investor participation. On average inflation rose to 26.2 percent in 2008 from 9.8 percent in 2007 while the 91-

day and 182-day Treasury bill rates remained below 9% p.a. (see Chart 8). The participation of retail investors is a notable development reflecting in part the lowering of the threshold on bidding for Treasury bills to Ksh 100,000, the active marketing of the IFB, and the decline in the stock market.

Table 5: Investor base (as of end December 2008)

	Bills (Ksh bn)	Bonds (Ksh bn)	% of Bill Stock	% Bond Stock	Overall %
Banking Institutions	42.1	163.3	48.2	51.3	50.6
Central Bank	0	0	0	0	0.0
Comm. Banks	42.1	162.6	48.2	51	50.4
NBFIs	0	0.7	0	0.2	0.2
Insurance					
Companies	18.9	32.4	21.7	10.2	12.6
Parastatals	3.2	29.5	3.6	9.2	8.1
Of which: NSSF	0	12.5	0	3.9	3.1
Building Societies	0.5	0.6	0.6	0.2	0.3
Pensions Fund	8.5	37.6	9.7	11.8	11.4
Others	14.2	55.2	16.2	17.3	17.1
Total	87.4	318.6	100	100	100

Chart 8: Evolution of T-bill interest rates



21. The Government is actively working to develop the domestic debt market. In the medium-term, given the Government's concerns regarding the potential for "crowding out" the private sector, and their concern about containing interest costs, the MTDS does not envisage a significant increase in the size of the domestic market, in relation to GDP.

22. In terms of instruments, the Government will introduce benchmark bonds in the domestic debt market. The candidate tenors are the 2-, 5-, 10-, 15-, and 20-year maturities, and there would be scope to re-open these bonds to help build liquidity. In addition, the Government will continue to issue IFBs.

IV. 2009 MEDIUM TERM DEBT STRATEGY

23. The 2009 MTDS is consistent with the overall macroeconomic framework, and reflects the inter-linkages and feedback effects between the MTDS and the macroeconomic framework. Within a medium-term planning period, the Government will assess potential macroeconomic conditions and risks when implementing the MTDS. This section describes the existing debt management strategy macroeconomic assumptions underlying the analysis (Table 8) and highlights some of key structural and macroeconomic risks that may have implications for the choice of a preferred MTDS.

A. Macroeconomic Assumptions

24. After achieving a record rate of 7 percent real GDP growth in 2007, output contracted with real GDP growth falling to 1.7 percent in 2008. This reflects the impact of the post-election crisis, high food and fuel prices, and the global economic crisis. Real GDP growth is likely to recover gradually to 6.4 percent in 2013.

25. The current account has come under pressure due to increased food imports, high fuel import bill, decline in tourist receipts, and reduced remittances from Kenyan's in diaspora. Adverse global financial market conditions have also led to the postponement of the debut USD 500 million sovereign bond while donor flows are expected to slow down. Consequently there has been downward pressure on both the Kenyan shilling and foreign

exchange reserves. In the medium-term, as the economy recovers and project loans pick up, private and official capital inflows are expected to increase to cover the current account deficit and replenish foreign reserves.

26. Adverse exogenous shocks affected Government revenue collection and weakened the overall fiscal position. This, together with the postponement of sovereign bond issuance and shortfall in privatization receipts, led to suspension in Government spending.

27. In the financial year 2009/10, the overall budget deficit (including grants) is projected to be 6.6 percent of GDP largely due to a large stimulus package to 'pull the economy out' of recession. Whereas the budget deficit will be financed through borrowing, it is expected that as the economy recovers, the deficit will be reduced to 4.2 percent of GDP in financial year 2011/12 to reflect Government's commitment to bring down total Government debt to GDP.

28. Inflation has risen and remained high, initially as a result of the supply shock and accommodative monetary policy, and then sustained by rising world fuel and food prices and a poor harvest. The recent fall in world prices of fuel and food has helped ease inflationary pressures, and inflation is projected to decline and reach single digits in the medium-term.

B. Principal Risks to the debt portfolio

Real sector considerations

29. The economy is very susceptible to weather related exogenous shocks, especially drought. The ability of the Government to support the economy and vulnerable groups in the face of such shocks is an important consideration. Each year, the Government provides in the budget funds in the civil contingency fund to mitigate such risks. In the context of the 2009 MTDS, diversification of financing sources and deepening of the domestic debt market is critical to ensure that Government has more flexibility to respond to such shocks.

Balance of payments risks

30. Kenya's current account deficit could deteriorate further. If the current financial crisis is prolonged, the reduction in tourist receipts and remittances would be sustained for a longer period. Similarly, many of its exports, such as tea, coffee, and horticulture, are vulnerable to weaker external demand and lower world prices. Tightening of access to trade credit could constrain the export sector even further. The possibility of another drought cannot be ruled out, which could put further pressure on food import bills.

31. The implication of the current global financial crisis is that the available resources to finance current account deficits could shrink further. For example, FDI flows to Kenya are expected to shrink sharply as multinationals face lower profit margins and financing difficulties. If private capital inflows do not recover to the level seen before the crisis, the Kenya shilling will continue to face downward pressure and reserves will stay low.

32. These balance of payment risks imply substantial exchange rate risks going forward. From the perspective of the 2009 MTDS, this suggests borrowing in domestic currency to mitigate that exposure.

Fiscal risks

33. Government's fiscal position is vulnerable. Many of the balance of payments risks also apply to the fiscal position. The privatization process is expected to slow, and there is significant uncertainty regarding the potential extent of contingent liabilities. A bad harvest caused by drought would also increase spending pressures. Donor inflows could decline as a result of the worsening fiscal position of bilateral donors, and access to international capital market is uncertain.

34. This vulnerability suggests that the Government may need to increase borrowing to finance key expenditure priorities. Debt management considerations suggest the need to diversify financing sources and increase market capacity to help absorb such shocks. The Government will continue to improve its relationship with donors, prioritize expenditure, build cash buffers, and enhance implementation efficiency, while creating fiscal space to accommodate potential increases in debt. More importantly, it will

continue to strengthen the overall public financial management framework so as to control the scale of explicit contingent liabilities.

Monetary risk

35. Though the recent falls in the world prices of fuel and food will help ease inflationary pressure, risk still exist. If balance of payments risks were to materialize, sharp depreciations have the potential to feed through to inflation. Achieving low inflation will be essential for domestic market development so as to reduce volatility of exchange and interest rates.

36. The above macroeconomic and structural risks are summarized in Table 6

Table 6: Macro-Risks and Implications for Debt Management Strategy

		Implications for Debt Strategy Preferences		
Macroeconomic Factors	Impact	Target source	Currency	Other comments
Balance of Payment Risks				
Terms of trade shock	Exchange rate	Domestic	DX	Improve market capacity
FDI/Private capital flow volatility	Exchange rate	Domestic	DX	Improve market capacity
Remittance dependence	Exchange rate	Domestic	DX	Improve market capacity
Tourism receipts dependence	Exchange rate	Domestic	DX	Improve market capacity
Low foreign exchange reserves	Exchange rate		FX	Diversify trading partners
Fiscal Risks				
Potential volatility (revenues)	Expenditure volatility	Market	DX/FX	Create fiscal space, prioritize expenditure, and improve efficiency
Capital spending aid dependent	Growth volatility		DX/FX	Improve relationship with donors, improve absorptive capacity, and implementation efficiency
Contingent liabilities	Debt level increase	Market	DX/FX	Create fiscal space, and strengthen overall PFM framework
Monetary Risks				
High inflations	Impede market development, higher interest costs			Increase credibility of monetary policy, improve monetary operational framework, monetary transmission mechanism to reduce inflation premium
Negative real interest rate	Impact real money investors, and deposit growth			
Natural Disasters	Growth volatility	Market	DX/FX	Diversify economy, and explore the possibility of commodity hedge

C. Assumptions underlying the 2009 MTDS

i. External Borrowing

37. The following assumptions regarding the characteristics of external borrowing underlie the 2009 MTDS.

- All future concessional external loans are priced at a fixed rate of 0.75 percent, with a 40-year tenor and 20-year grace period. These loans are assumed to be denominated in SDRs.
- In the financial year 2010/11, the Government will tap quasi-concessional sources of financing, the assumption is that these loans will be variable rate, effectively priced at LIBOR + 100 basis points, carrying a tenor of 20-years with a 5-year grace period and denominated in USD.
- External commercial bank borrowing is also assumed to be variable rate and denominated in USD. It is assumed that these are bullet loans with a 5-year tenor. These loans will be priced off LIBOR plus the assumed country credit spread at 5-years.
- Quasi concessional, commercial borrowing including international sovereign bond is assumed to start 2011/12 and to remain capped at 10 percent of net financing.
- Concessional borrowing would remain at 30 percent of total net financing needs in the medium term.
- No international sovereign bond will be issued in the financial year 2009/10.
- The pipeline concessional debt that has been contracted but has yet to be disbursed is taken into account. These are assumed to disburse in the next three years, reducing the borrowing requirement by the relevant amount.

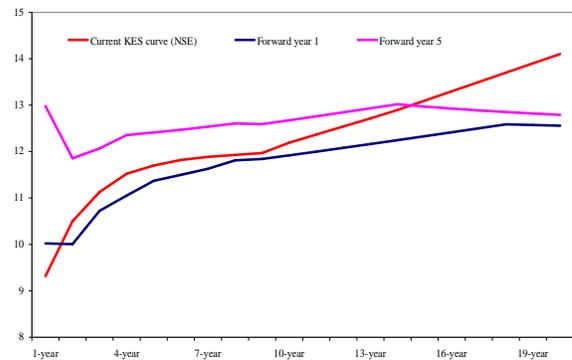
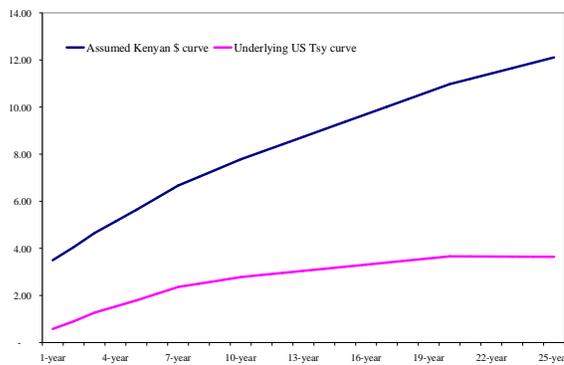
38. **Net external borrowing** for financial year 2009/10 is **2 percent of GDP** and expected to marginally increase to 2.2 percent of GDP in the financial year 2011/12.

ii. Domestic Borrowing

39. Pricing of new domestic borrowing is derived from the underlying forward US Treasury curves and taking into account anticipated inflation differential to adjust for the exchange rate differentials and the assumed premium to capture liquidity, inflation risk, and other risk effects. The alternative is to use the NSE yield curve to derive the forward curve. The applicable curves are shown in chart 9 and 10.

Chart 9: Assumed USD curves

Chart 10: Assumed Ksh curves



40. Domestic borrowing will be undertaken through issuance of Treasury Bills and Treasury Bonds at the ratio of 30:70 and ensuring that the maturity structure of the existing portfolio is lengthened to minimize refinancing risk.

41. Domestic borrowing is about 70 percent of total net borrowing in financial years 2009/10, 2010/11 and 2011/12 and drops to 60 percent in financial year 2012/13.

42. **Net domestic borrowing** for financial year 2009/10 is **4.3 percent of GDP** and expected to fall to 2.2 percent of GDP in 2011/12.

iii. 2009 MTDS: Cost and Risk Analysis

43. The robustness of the 2009 MTDS was assessed under the following four scenarios. It is assumed that shocks materialize at some point beyond the first year of the simulation, that is 2010:

- Scenario 1: A flattening of the yield curve, with short-term yields moving up by 6 percent in domestic currency, and 2 percent in USD, euro and yen.
- Scenario 2: A sustained 30 percent devaluation of the domestic currency vis a vis the other currencies by 30 percent, starting in 2010, with the exchange rate remaining at that level thereafter.
- Scenario 3: A cross currency shock scenario where the KES depreciates by 1 standard deviation against the USD, the euro, and against the yen, starting in 2010, with the exchange rate remaining at that level thereafter.
- Scenario 4: A combined shock scenario, whereby half the flattening of the yield curve and a devaluation of 15 percent vis a vis the other currencies takes place.

44. In the analysis, two definitions of cost are used. First, cost is defined as annual debt interest payments expressed as a share of nominal GDP; and second, cost is captured as the ratio of total debt /nominal GDP.¹ Risk is measured as the difference between the existing debt management strategy cost and the cost under an alternative (shock) scenario. In order to compare the performance of alternative scenarios, the maximum risk is used.

¹ The debt stock is being used as an alternative to a cost measure that adjusts interest payments for capital gains/losses arising from exchange rate changes. To consider Interest payments alone underestimates the cost of debt when there is foreign currency debt in the portfolio and the domestic currency is depreciating.

**Table 7. Cost and Risk Analysis: Existing debt strategy vis-à-vis 2009
MTDS Interest / GDP ratio**

Strategies	Existing debt strategy	2009 MTDS
Scenarios		
	(Interest in percent of GDP at end-2013)	
Baseline	3.0%	2.9%
Stress test 1: flatter yield curve	3.5%	3.5%
Stress test 2: 30% devaluation	3.1%	3.0%
Stress test 3: Cross-currency shock	3.1%	
Stress test 4: combined shock	3.4%	3.3%
Change under flatter yield curve	0.5%	0.6%
Change under 30% devaluation	0.1%	0.1%
Change under cross-currency shock	0.1%	0.1%
Change under combined shock	0.4%	0.4%
Maximum under stress	0.5%	0.6%

45. The cost and risk are computed for each period over a five year horizon, with the end result in 2013 used to compare the strategies. The results are summarized in Table 7 and Chart 11.

46. The results show that the existing debt strategy carries the lower risk but higher cost while the 2009 MTDS has a lower cost but a higher risk. The two strategies differ only in the maturity structure of external non-concessional financing. However, the scale of the difference between the two strategies is minimal because refinancing risk is not captured in this cost measure.

47. The existing strategy has the highest cost due to the issuance of long dated international debt at market rates. In terms of risk, the model picks up the maximum deviation among the alternative scenarios, and the greatest impact comes from the scenario in which the yield curve flattening, with the short term rates rising higher than the longer term rates. This penalizes domestic debt more than external debt, with the least effect felt by the

strategy that has higher proportion in long term external debt (i.e, the existing strategy).

48. In the analysis above, it is clear that the existing debt management strategy is the less favorable from a cost perspective but highly favorable risk-wise. Overall, the risk difference between the two strategies is only 0.1 percent of GDP, while the marginal difference in cost is 0.07 percent and do not appear to display significant differences in their trade-off. However, before reaching a firm conclusion, it is important to note that the analysis does not take into account benefits stemming from supporting the development of the domestic market. Furthermore, using the proportion of interest payments to GDP as a cost measure ignores capital losses stemming from a depreciation of the Kenyan shilling.

49. The results of the scenario analysis change when cost is measured using the stock of debt as a share of GDP. This measure captures the impact of any currency depreciation on the outstanding debt. Consequently, the cost-risk tradeoff between strategies more oriented toward external or domestic debt financing becomes more evident. The existing debt management strategy with a high share of foreign currency debt remains attractive from a cost perspective, but is much less attractive from a risk perspective. Thus, the 2009 MTDS is less risky, as it has a high share of domestic debt (Chart 12).

50. These results suggest that a strategy strongly relying on external financing could, in the event of a large exchange rate shock, prove quite risky. This suggests that 2009 MTDS is a viable alternative in the medium term given the Government's objectives for domestic market development.

Chart 11: Cost and Risk Analysis: Existing debt strategy vis-à-vis 2009 MTDS

Cost-Risk Measure: Interest in percent of GDP, at end 2013

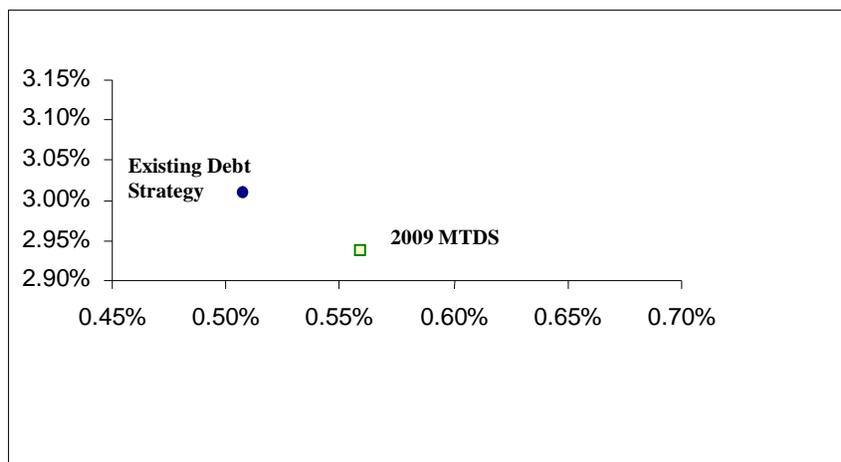


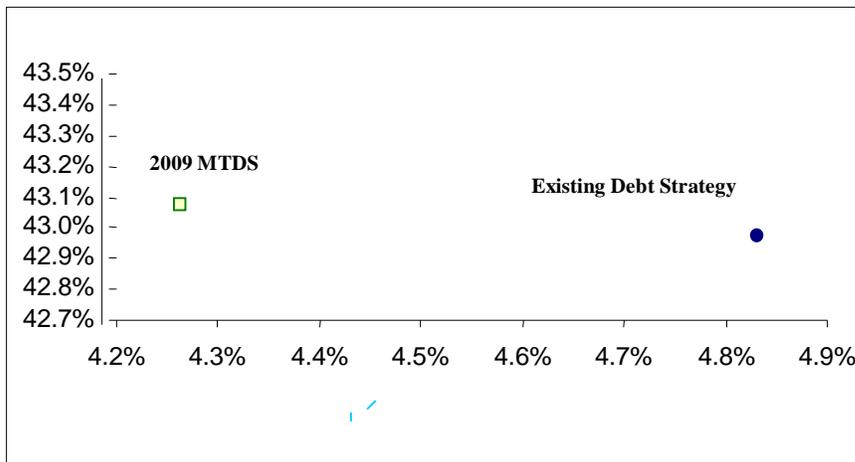
Table 8: Cost and Risk Analysis: Existing debt strategy vis-à-vis 2009 MTDS

Debt / GDP ratio

Scenarios	Strategies	Existing Debt Strategy	2009 MTDS
(Public debt in percent of GDP at end-2013)			
Baseline		43.0	43.1
Stress test 1: flatter yield curve		45.8	46.2
Stress test 2: 30% devaluation		47.8	47.4
Stress test 3: cross-currency shock		46.4	46.2
Stress test 4: combined shock		46.1	46.0
Change under flatter yield curve		2.8	3.1
Change under 30% devaluation		4.8	4.3
Change under cross currency shock		3.4	3.1
Change under combined shock		3.1	2.9
Maximum under stress		4.8	4.3

Chart 12: Cost and Risk Analysis: Existing debt strategy vis-à-vis 2009 MTDS MTDS

Cost Measure: Public debt in percent of GDP, at end 2013



51. The use of the scenario analysis tool allowed detailed comparison of existing debt management strategy and 2009 MTDS. The results of the scenario analysis suggest the following:

- The existing debt strategy has the most favorable cost properties, but assumes Kenya would be able to tap the international capital market with a long tenor Eurobond and to have continued access to concessional financing
- When cost is measured in terms of interest as a share of GDP, that is, a cost indicator with a strong budget-focus, existing strategy seems less favorable cost-wise but more favorable risk-wise over 2009 MTDS;
- The analysis illustrates the risk of relying on only one cost indicator when performing scenario analysis. Using outstanding debt as a share of GDP provides a somewhat different result. In particular, while the existing strategy remains least costly, it become more risky and specifically susceptible to exchange rate shocks compared to 2009 MTDS. Consequently, given the extent of exchange rate exposure facing the Kenyan economy, 2009 MTDS is preferable to

existing strategy over the long-run especially if domestic debt market development is an objective;

- In addition, the analysis must be complemented by examining other risk indicators, such as the maturity profile at the end of the time period (2013), to ensure that other vulnerabilities, such as refinancing risk, are not being built-up in the debt portfolio. Issuing longer-term domestic debt rather than short-term domestic debt could help control exposure to refinancing risk and cushion the debt portfolio from adverse shocks. The additional cost of longer-term issuance can be viewed as the “insurance premium” the Government pays to hedge against refinancing risk.
- Finally, other considerations or objectives, such as a desire to develop diversified financing sources to mitigate general fiscal risks, or minimize the risk of being dependent on specific creditors,² should be brought to bear on the decision.

V. DEBT SUSTAINABILITY

52. The most recent debt sustainability analysis carried out under the joint World Bank-IMF debt sustainability framework concludes that Kenya’s risk of debt distress remains moderate. Debt sustainability is assessed in relation to policy-dependent debt burden thresholds. Kenya is classified as a medium performer in terms of quality of its policies and institutions as measured by a three year average of Kenya’s score on the World Bank’s Country Policy and Institutional Assessment (CPIA) index.

53. The current debt-to-GDP ratio is low and debt sustainability is not a serious concern³. Under stress tests using different scenarios which consider significant fall in real GDP, rise in primary balance, 30 percent depreciation in Kenya shilling and 10 percent of GDP increase in borrowing, Kenya’s level of debt remain within sustainable.

² In Kenya’s case, the dominance of IDA multilateral and Japanese bilateral financing would be a source of concern if there is any risk that access to these donors would be curtailed.

³ (see *Kenya: Third Review under the Poverty Reduction and Growth Facility Arrangement*, January 22, 2009, IMF).

54. In Table 9, a worse case scenario, a “borrowing shock” scenario is presented which assumes Government borrowing 10 percent of GDP in 2009. The results indicate that in the medium term (by 2012), the debt burden indicators will marginally breach two debt sustainability benchmarks.

Table 9. Sensitivity Analysis for Key indicators of public debt

	Benchmark for ‘medium performer’	Actual 2008	Provisional 2009	Impact of 10% of GDP increase in borrowing in 2009 Debt indicators in 2012
NPV of debt as % of				
GDP	40	34	32	41
Revenue	240	150	140	179
Debt service as % of				
Revenue	30	25	25	32

55. In the financial year 2009/10, borrowing limit is set at **6.3 percent of GDP but expected to decline to 4.4% of GDP in 2011/12.**

56. Caution is warranted to ensure that the favorable public debt situation persists over the medium-term. Larger recourse to domestic debt financing could further increase the domestic interest rate, and put pressure on this position. Recourse to non-concessional external financing could also prove difficult and may increase the risk of debt distress. The borrowing envisaged under the 2009 MTDS will be undertaken with caution taking into account these factors.

VI. IMPLEMENTING THE 2009 MTDS

57. To support the development of an MTDS, reforms to improve the enabling environment will be implemented.

58. The development and implementation of debt management strategy needs a robust legal framework. The present legislation does not include

anything on debt management strategy and the long-term objectives the strategy should be based on. Provisions on long-term debt management objectives, requirement of debt management strategy development, annual reporting to the National Assembly on the debt management strategy and the debt management activities, and the purposes for which the Government can borrow need to be included in the legal framework.

59. The institutional arrangement for public debt management will be strengthened. The DMD at the Ministry of Finance will remain the focal point in developing a comprehensive medium-term debt management strategy for the entire debt, regularly updating this strategy, and monitoring that all borrowings and debt-related transactions are within the guidelines and risk parameters of the strategy. In addition the DMD is responsible for the official debt recording system.

60. Prudent management of the Government debt portfolio requires a high caliber workforce. In this regard, Government is committed towards strengthening capacity building and retention of skilled staff in debt management. Suitable risk mitigation strategies are being considered to preserve the skills level within the DMD.

61. Integration of the domestic and external debt database is a priority. During the financial year 2009/10, both the domestic and external debt databases at the Central Bank of Kenya and Ministry of Finance will be linked through the fiber-optic cable.

62. A more detailed borrowing plan that takes into account the likely timing of cash flows across Exchequer accounts throughout the fiscal year will be developed. In addition, the borrowing plan will take account of, and be adjusted where necessary, as market conditions change. Nevertheless, any significant deviation from the strategy will need clear justification, and the Government will find an appropriate balance between meeting its own objectives and those of the market.

63. The publication of the 2009 MTDS is a key component of enhancing transparency in the market, especially the domestic market. Mechanisms for regular monitoring of its implementation are also in place. At a minimum, the strategy will be reviewed once a year to determine whether key

underlying assumptions remain valid. In addition, if there are significant changes in market conditions, the strategy will be reviewed.

64. Supporting the Government to achieve its domestic market development objectives, a number of donor funding programs are in place. For example, the U.S. Treasury has a resident adviser in place with the CBK to support the development of the Government debt market, and the World Bank / IFC have projects [FLSTAP and ESMID)] in place which support a wide range of activities, including Government and corporate bond market development. The multi-donor project, PFMR has been supporting a wide range of public financial reforms including capacity building in debt management.

VII. CONCLUSION

65. The 2009 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 2009/10, taking into account both cost and risk. **The cost-risk trade-off of the 2009 MTDS has been evaluated within the medium term context.**

66. The debt strategy complements the debt sustainability framework which is concerned with long-term sustainability of debt. Whereas Kenya's current debt level is sustainable, long-term debt sustainability depends on a number of factors such as real GDP growth, sound macro-economic policy mix, including prudent debt management.

67. The 2009 MTDS has considered the macro-economic, and global and domestic market environment and related vulnerabilities and **recommends a shift in the composition of debt towards long term domestic debt over the medium term.**

68. This is the first time that Treasury is formally presenting the Medium Term Debt Strategy as part of the Budget. This initiative will be implemented going forward with the aim of enhancing the transparency of the borrowing process.