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THE NATIONAL TREASURY

**Medium Term Debt Management Strategy
for FY2018/19- F Y2020/21**

February 2018

**Medium Term Debt Management Strategy
for FY2018/19- F Y2020/21**

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FOREWORD

As required by the PFM Act, 2012 section 63 (c), the National Treasury prepares the Medium Term Debt Management Strategy (MTDS) every year. The Public Finance Management (PFM) Act , 2012 (64 (a)) also requires that the MTDS be consistent with the Budget Policy Statement. This MTDS is consistent with the macroeconomic indicators in the 2018 Budget Policy Statement. The MTDS is designed to ensure that the Government's strategy of financing the fiscal deficit is feasible, and represents the financing option that minimizes costs with some acceptable level of risks.

The MTDS is prepared in accordance with international best practice. Several alternative financing options are evaluated under specific macroeconomic assumptions, economic outlook and shock scenarios to ensure that the selected financing option is feasible. The 2018 MTDS is prepared taking into account the terms of any anticipated borrowing, the type of borrowing and the attendant risks or shocks that may impact on the government's ability to meet its debt obligations, taking into account global and domestic economic and financial developments.

The objective of the 2018 MTDS is to ensure that projected borrowing to finance annual budget deficits is procured from sources that minimize costs and risks. The aim is to ensure that over the medium term government's financing requirements and payment obligations are met at the lowest possible cost with prudent degree of risk in line with the requirements of Public Finance Management (PFM) Act, 2012

The diversification of funding sources has been subjected to cost and risk review. In this 2018 MTDS there are four financing options considered, and the preferred option is selected through evaluating all the options under the macroeconomic environment and projected outlook outlined in the Budget Policy Statement. The selected option prescribes the proportion of the fiscal deficit to be funded through domestic borrowing and external borrowing and in both cases; the mix of borrowing instruments is indicated.

The MTDS has been prepared with recognition of the fact that Kenya was recently categorized as a lower middle income country with hardened

borrowing terms and less concessional borrowing. In this regard, the country has made deliberate efforts to diversify its sources of external borrowing by accessing International Bond and syndicated loans market.

To support the development of domestic debt market so as to allow more future borrowing in Kenya shillings, a host of reforms continue to be implemented in the local debt market aimed at broadening Kenyan debt markets. The domestic debt market reform strategy recognizes that borrowing from local currency sources mitigates debt stock from exchange rate risks and volatilities in international capital markets. Furthermore, a deeper local currency debt market minimizes refinancing risks.

Lastly, I underscore the fact that regular preparation and publication of the MTDS promotes transparency in the conduct of budget financing and public financial management. The National Treasury commits to funding annual budget deficits from sources characterized by lower costs and minimal risks to ensure that Kenya's public debt remains within sustainable levels.

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CABINET SECRETARY/ THE NATIONAL TREASURY

ACKNOWLEDGEMENT

The tenth Medium Term Debt Management Strategy (MTDS 2018) is to be tabled in Parliament and is the fifth to be prepared within the requirement of Public Finance Management (PFM) Act, 2012 (PFMA). The 2018 MTDS plays an important role of presenting the optimal borrowing strategy identified through evaluating the risks and costs of various optional sources of financing budget deficit to support service delivery. The 2018 MTDS will guide debt management operations in FY2018/19 and over the medium term.

Preparation of the Medium Term Debt Management Strategy (MTDS 2018) involved collaborative efforts and inputs from two key Directorates of the National Treasury, namely: the Public Debt Management Office (PDMO) and the Budget, Fiscal and Macroeconomic Affairs (BFEA).

I thank the 2018 MTDS preparation team at the Public Debt Management Office for their dedication to the exercise. Likewise, I thank the staff from the collaborating departments in the National Treasury and the Central Bank of Kenya who have provided data inputs to the MTDS preparation. I too would like to thank every individual, be it from the members of the public or public institutions who may have provided valuable comments and contributions to enrich the 10th Medium Term Debt Management Strategy.

I thank members of development partner institutions who have been providing technical assistance to boost capacity in the area of MTDS preparation.

The MTDS 2018 will be available in the National Treasury Website: www.treasury.go.ke for reference.

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

Legal Basis for the Publication of the Debt Management Strategy

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

- 1) On or before 15th February in each year, the Cabinet Secretary shall submit to Parliament a statement setting out the debt management strategy of the national government over the medium term with respect to its actual liability in respect of loans and guarantees and its plans for dealing with those liabilities.
- 2) The Cabinet Secretary shall ensure that the medium term debt management strategy is aligned to the broad strategic priorities and policy goals set out in the Budget Policy Statement.
- 3) The Cabinet Secretary shall include in the statement the following information:-
 - a) The total stock of debt as at the date of the statement;
 - b) The sources of loans made to the national government and the nature of guarantees given by the national government;
 - c) The principal risks associated with those loans and guarantees;
 - d) The assumptions underlying the debt management strategy;
and
 - e) An analysis of the sustainability of the amount of debt, both actual and potential.
- 4) Within fourteen days after the debt strategy paper is submitted to Parliament under this section, the Cabinet Secretary shall submit the statement to the Commission on Revenue Allocation and the Intergovernmental Budget and Economic Council, publish, and publicize the statement.

ABBREVIATIONS AND ACRONYMS

ADB	African Development Bank
ADF	African Development Fund
ATtM	Average Time to Maturity
ATR	Average Time to Re-fixing
BoP	Balance of Payments
BROP	Budget Review and Outlook Paper
BPS	Budget Policy Statement
CBK	Central Bank of Kenya
CBR	Central Bank Rate
CPI	Consumer Price Index
CPIA	Country Policy and Institutional Assessment
DSA	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
DX	Domestic currency denominated debt
EAC	East African Community
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
IMF	International Monetary Fund
IFC	International Finance Corporation
ISB	International Sovereign Bond
Ksh	Kenya Shilling
KenGen	Kenya Electricity Generating Company

LIC	Low Income Country
LMIC	Lower Middle Income Countries
MTDS	Medium Term Debt Strategy
MEFMI	Macro Economic and Financial Management Institute
NPV	Net Present Value
NSE	Nairobi Securities Exchange
NT	National Treasury
PFM	Public Finance Management
PPP	Public Private Partnerships
PPG	Public & Public Guaranteed Debt
PV	Present Value
T-Bills	Treasury Bills
T-Bonds	Treasury Bonds
US	United States
USD	United States Dollars
QEBR	Quarterly Economic and Budget Review

EXECUTIVE SUMMARY

The Kenyan economy has remained resilient in the midst of shocks on weather conditions, a prolonged electioneering period as well as subdued credit growth in 2017. The economy registered an average growth rate of 4.7 percent in the first three quarters of 2017 and the growth forecast remains positive. The overall inflation is projected to remain within single digits in the medium term. Foreign exchange reserves also remained adequate at 4.6 months of imports cover.

The government plan over the medium term is to focus on the “Big Four” that will ensure increase in investments in key strategic areas: Food security and nutrition, Manufacturing, Universal Health Coverage and Affordable Housing. The 2018 MTDS will support these initiatives aimed at creating the right business environment, create jobs and ultimately promoting broad based inclusive growth. The 2018/19 MTDS covering the period FY2018/19-FY2020/21 will be implemented with government’s plan over the medium term to achieve a desired composition of the government debt portfolio.

Kenya’s public and publicly guaranteed debt remains sustainable and as at end December 2017, as it stood Ksh 4,571.6 billion equivalent to 53.1 per cent of GDP in nominal terms. However, the scope of the 2018 MTDS analysis is National government debt and called up guaranteed debt amounting to Ksh 4,375.5 billion or US\$42.4 billion as at end-December 2017, equivalent to 50.8 per cent of GDP. This takes into account; external debt amounting to 25.6 percent of GDP (US\$21.4 billion) and domestic debt to 25.2 percent of GDP (US\$ 21.0 billion) but excludes CBK overdraft, commercial bank advances and Tax Reserve Certificates. The projected debt portfolio as at June 2018 is characterized by;

- Low but with a marginal increase in interest payments as a share of GDP
- Rollover risk.
- Stable relative exposure to exchange rate risk.

After the rebasing of the economy in 2014, Kenya graduated into a lower middle income economy. The status ushered in a new class of financing terms commonly referred to as “blend” which is a mixture of commercial and concessional financing terms. As official development assistance is limited, and as the domestic market faces credit volume the credit flows from the external private sector has started to increase.

Kenya’s open-economy model exposes the country to risks in the global economy. These risks emanate from the international capital markets and institutional relationships between Kenya and the global markets. These may affect the Kenyan economy especially during periods of volatility and uncertainty.

However, Kenya has over the years developed structures necessary to prudently manage its growing debt portfolio. The Medium Term Debt Strategy (MTDS) informs investors and the general public of the strategic financing plan to meet the government’s financing needs at the lowest possible cost and at a prudent level of risk.

The 2018 Budget Policy Statement (BPS 2018) envisages continued fiscal consolidation agenda which will bolster Kenya’s debt sustainability position. Fiscal consolidation supported by ongoing revenue reforms and completion of key infrastructure projects (such as SGR), containing the growth of recurrent expenditures in favor of capital investment so as to promote sustainable and inclusive growth are expected to result in reduction of the overall fiscal balance.

The government will continue maximizing absorption of external concessional and semi-concessional sources of funding. The domestic debt market will continue playing a critical role in local currency funding of the budget supported by ongoing financial market reforms are expected to expand the investor base. In addition, the reforms will involve automation of processes in order to improve in the pricing of financial instruments as well as improve efficiency.

The 2018 MTDS evaluated the alternative fiscal deficit funding strategy under four alternative debt management strategies examined as follows:

Strategy 1 (S1): This strategy represents current borrowing mix, and will be referred to as the baseline strategy. Under this strategy, as part of the 2018 BPS, the fiscal deficit will be met by borrowing from domestic and external borrowing. This composition is to be achieved by external commercial borrowing of US\$ 2.79 billion in FY2018/19 and US\$ 0.97 billion FY2019/20, in addition to the contracting of credit from concessional sources. On the domestic front, the objective is to lengthen the maturity profile of domestic debt by reducing the share of T-Bills in total net domestic financing ratio of 35:65 strategy as at June 2017. In a three year period, the share of T-Bills in net domestic financing is to decrease to a level around 13 percent in 2020/21 from the current level of 35 percent.

Strategy 2 (S2): More domestic borrowing each year. This strategy increases the size of domestic borrowing by increasing the amounts to be issued in the domestic market as compared to S1. The increase in the amounts will improve liquidity in the market and help develop domestic debt market.

Strategy 3 (S3): Increased issuance of domestic medium to long- term debt. As opposed to S2, this strategy increases the quantum on external borrowing while the domestic issuance concentrates on the medium to long term tenors. This is aimed at reducing the refinancing risks associated with the short-term debt and also improve trading in the secondary market through increased volumes.

Strategy 4 (S4): Commercial borrowing. This strategy assumes accelerated borrowing from international capital markets or other commercial sources, while maintaining presence in the domestic market through sustained issuance of T bills and T-Bonds.

The optimization criteria embedded in the MTDS presents a binary solution requiring choice of either risks or cost, but not both, the implied quantity of gross borrowing, the need to develop the domestic debt market , the need to diversify the funding sources and ability to implement the strategy. The 2018

MTDS proposes Strategy 1 (S1) as the optimal strategy. This strategy is realistic in terms of managing the large repayments falling due for both domestic and external debt in the medium term. The strategy also provides an opportunity to extend the debt maturities by improving the average time to maturity of the overall debt. The strategy comprises the following actions in gross terms:

- 57 per cent external borrowing and 43 per cent domestic borrowing to finance the national government budget in gross terms. On the external debt, concessional is proposed at 23 per cent, semi-concessional 12 per cent and commercial 22 per cent while on the domestic side, it recommends issuance of long term instruments (more borrowing through medium term to long term treasury bonds and less through treasury bills).

The 2018 *MTDS* will be implemented through a borrowing plan anchored on government cash flow requirements and market conditions. Implementation will be monitored actively against key macroeconomic indicators and interest rates assumed in the analysis and the prevailing. Any significant and sustained change will trigger the need for revision of the strategy.

The Government will also seek to widen dissemination of the 2018 *MTDS* consistent with the principles of public finance in the Constitution of Kenya, 2010 (Section 201).

I. INTRODUCTION

1. The government budget deficit arise due to budgeted expenditures that surpasses the revenues raised by way of taxes and other income sources necessitates bridging of this deficit by borrowing from both domestic and external sources. Accordingly, to raise the required funding through borrowing, achieve its costs and risks objectives, and meet any other debt management objectives, a debt strategy is required. The Government manages its debt through a Medium Term Debt Strategy (MTDS). The MTDS provides a framework for an effective public sector deficit financing strategy that aims to achieve a desired composition of the public debt portfolio that reflects a cost-risk objective and captures the government's preferences with regard to the cost-risk trade-off.

2. This MTDS is prepared in accordance with the international best practice and within the framework developed by the IMF and the World Bank, customized to suit the Kenyan context. It helps in evaluating and managing risks involved in different debt compositions; facilitate coordination of the fiscal and monetary policies; and enhance government borrowing transparency. The strategy ensures that the government's financing needs and debt payment obligations are met at the lowest possible cost consistent with a cautious degree of risk.

3. In developing this MTDS report, an eight step process was followed that comprised of: identifying the objectives and scope; reviewing costs and risks of existing debt; identifying potential sources of financing; review of the macroeconomic framework and medium-term projections and risks; review of key structural factors; analysis of the cost and risks of alternative debt management strategies; review of preferred strategies for policy consistency; and, recommendation of the strategy for approval.

4. The MTDS report therefore is organized as follows: Section II presents the background; Section III reviews the performance of the MTDS for the FY2016/17 and part of FY 2017/18. 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-December 2017. In Section VI, the baseline macroeconomic assumptions underlying the

analysis and key risk to the macroeconomic projections are discussed. Section VII deliberates the potential external and domestic sources of financing. Section VIII presents the cost and risk analysis of alternative debt management strategies; Section IX is on debt sustainability; Section X is on implementing the MTDS and lastly; Section XI provides a conclusion.

II. BACKGROUND TO MEDIUM TERM DEBT STRATEGY

5. The 2018 Medium Term Debt Management Strategy comes at a time when Kenya's macroeconomic stability was really put into test after a period of electioneering that basically slowed down economic activities in for better period 2017. The economy registered an average growth of 4.7 percent in the first three quarters of 2017 which is a weaker growth rate compared to the 5.7 percent in 2016 as a result of spillover effects of adverse weather conditions experienced in 2016, the prolonged electioneering period and the subdued credit growth.

6. Despite the decelerated growth during the period, the macroeconomic fundamentals remained largely stable. The overall month on month inflation was at 4.5 percent in December 2017 from 6.4 percent in December 2016 and a high of 11.7 percent in May 2017 attributed to food prices due to adverse weather conditions.

7. In doing business, Kenya's attractiveness to investors has improved by 12 places as ranked by the World Bank's Doing Business Indicators which ranked Kenya position at 80 out of 190 economies compared to position 92 in 2016. This reflects continued improvement in process that gives confidence to international investors who have continued to inject huge resources into our economy. Further, the Standards and Poor's Global ratings affirmed its 'B+/B' long and short term foreign and local currency sovereign credit ratings on Kenya with a stable outlook.

8. Kenya's public debt, including publicly guaranteed debt, in nominal terms as at end-December 2017 amounted to Ksh 4,571.6 billion, estimated at 53.1 percent of GDP. The public debt as at end December 2017 remained well within sustainable levels and also within the 50 percent of GDP in NPV limit in line with the PFM Act regulations 2015 and the East African Community Monetary Union convergence criteria as at the year 2021.

9. According to the latest Debt Sustainability Analysis (DSA) (February 2017), debt sustainability indicators show that Kenya faces a low risk of debt

distress. The PV of public debt-to-GDP¹ increased from 48.7 per cent in 2016 to 49.0 per cent in 2017 and is projected to decline to 47.1 per cent of GDP by 2019. Overall, the results from the DSA indicate that Kenya's public debt is sustainable and expected to remain sustainable in the medium term.

¹ Threshold of PV of public sector debt to GDP ratio is 74 per cent

III. REVIEW OF THE FY 2016/17 MTDS AND IMPLEMENTATION OF FY2017/18 MTDS

10. The MTDS for the financial year 2016/17 emphasized on the need to develop the domestic market by increasing issuance of Treasury bonds over the medium term. The strategy targeted a mix of 60 percent and 40 per cent for external and domestic financing, respectively. Considering the domestic debt market environment, issuance of medium term papers through benchmark bonds was recommended in order to improve the refinancing risk profile. Short-term debt issuances (T-bills) was limited to 20 percent, whereas medium to long term maturities (5 – 30 years T-bonds) was to account for 80 percent of total domestic government borrowing. However, as at end June 2017, the actual proportion for Treasury bills and bonds stood at 35 percent and 65 per cent respectively and the actual financing through concessional, semi concessional and commercial borrowing stood at 18 per cent, 16 per cent and 26 percent against the proposed 23 percent each for concessional and semi concessional and 14 percent for commercial respectively.

11. The realized external financing has translated to external debt Average Time to Maturity and Grace Period of 17.5 years and 4.5 years as at end-June 2017. This compares unfavorably with 20.3 years and 6.2 years as at end-June 2016. The weighted average interest rate increased to 2.97 per cent from 2.6 percent, reflecting increased commercial borrowing during the year.

Table 1: Kenya: Average Terms of New Loan Commitments, as at June 2015-2017

	Jun-15	Jun-16	Jun-17
Average Maturity (years)	21.0	20.3	17.5
Grace Period (years)	6.4	6.2	4.5
Weighted Average Interest Rate (%)	2.5	2.6	2.97

Source: National Treasury

Of the total external debt, 8.5 percent (or US\$ 1.8 billion) consists of debt maturing in less than one year and 91.5 per cent (US\$ 19.5 billion) are maturing in the medium to long-term.

12. The planned budget financing as presented in the Annual Budgets, most times vary with the MTDS. Specifically, the proportions of external and domestic financing in the budget plan have varied with what is presented in the respective MTDS documents. However, in the 2016/17 MTDS, proportions of actual external and domestic financing had a slight difference against the budget plan. The MTDS envisaged a ratio of 60:40 (Table 2) but the budget had 57:43 for external and domestic financing respectively.

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

Financing Source		2013/14	2014/15	2015/16	2016/17
External	MTDS	40	45	45	60
	Budget	68	64	61	57
	Deviation	-28	-19	-16	3
Domestic	MTDS	60	55	55	40
	Budget	32	36	39	43
	Deviation	28	19	16	-3

Source: MTDS, Budget Policy Statement, National Treasury.

13. The financing outturns relative to the budgetary financing targets have deviated in the recent past (Table 3). The annual outturns for external net financing fell short of the budgeted amounts by an average of Ksh 21 billion or 6 percent of total net financing during the period FY2011/12 – FY2016/17. Consequently, actual domestic net financing increased by an annual average of Ksh 20 billion or 6 percent of total net financing. Overall, the period experienced total annual net financing outturn below budget plans by Ksh 1 billion on average.

14. The first quarter of the FY2017/18 overall financial outturn is on course despite having below target of Ksh 10 billion or 17 per cent of total net external financing. However, these figures may not be representative of the full year outturn and will be revised.

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

Financing Source	Units	Average (FY2011/12-FY2016/17)			FY2017/18(1 st Quarter) September 2017		
		Budget	Actual	Deviation from budget	Budget	Actual	Deviation from budget
External	KSH (Billion)	179	158	-21	17	8	-10
	<i>Percent</i>	50	44	-6	30	13	-17
Domestic	KSH (Billion)	180	200	20	39	49	10
	<i>Percent</i>	50	56	6	70	87	17
Total	KSH (Billion)	359	358	-1	56	57	1

Source: QEBR, National Treasury.

IV. DEBT MANAGEMENT OBJECTIVES AND SCOPE

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

16. At operational level the MTDS is linked to cash management to support liquidity management around targeted level.

17. The time horizon of the analysis is the medium term spanning three years from FY2018/19 through FY2020/21, consistent with the government's 2018 BPS. The starting point for the analysis is the existing debt portfolio as at end- December 2017 and the medium term projected debt.

18. The scope of the 2018 MTDS analysis is National government debt and called up guaranteed debt. The MTDS analysis thus covers total National government external and domestic debt amounting of Ksh 4,375.5 billion or US\$42.4 billion as at end-December 2017, equivalent to 50.8 per cent of GDP. External debt amounted to 25.6 percent of GDP (US\$21.4 billion) and domestic debt to 25.2 percent of GDP (US\$ 21.0 billion).²

19. External public debt stock comprises principally loans from multilateral, bilateral and commercial creditors. Multilateral debt accounted for 9.7 percent of GDP, out of which, IDA accounted for 6.0 percent, followed by AfDB 2.3 percent, and others 1.4 percent. Bilateral debt accounted for 8.3 percent of GDP. The US\$6.3 billion of the external debt was held by commercial creditors.

² This amount excludes US\$488 million in CBK overdraft, Pre-1997 commercial bank advances and Tax Reserve Certificates.

Table 4: Kenya: Coverage of Public Debt in the MTDS, End-December 2017

Instrument	Amount		
	In millions of Kenyan Shilling	In millions of U.S. dollars	In percent of GDP
I. Domestic Debt (included in MTDS)			
Treasury Bills	684,723	6,632.87	7.9
Banking Institutions	363,928	3,525.35	4.2
Others	320,795	3,107.52	3.7
Treasury Bonds	1,461,246	14,155.02	17.0
Banking Institutions	783,512	7,589.84	9.1
Others	677,734	6,565.18	7.9
Pre-1997 Government Debt	23,840	230.94	0.3
Sub Total	2,169,809	21,018.82	25.2
II. External debt (included in MTDS)			
International Development Association	514,417	4,983.13	6.0
African Development Fund	200,417	1,941.43	2.3
Bilateral	715,273	6,928.81	8.3
Multilateral	121,079	1,172.89	1.4
Commercial Bank	367,337	3,558.37	4.3
Buyers Credit	3,287	31.84	0.0
Fixed Coupon	283,887	2,750.00	3.3
Sub Total	2,205,697	21,366.47	25.6
III. Excluded from MTDS			
Suppliers Credit	16,003	155.02	0.2
CBK Overdraft	42,316	409.91	0.5
Guarantees	129,670	1,256.11	1.5
Bank advances	8,117	78.63	0.1
Sub Total	196,107	1,899.68	2.3
TOTAL DEBT Included in MTDS (I+II)	4,375,506	42,385.30	50.8
TOTAL DEBT (I+II+III)	4,571,613	44,284.97	53.1

Source: National Treasury and CBK.

20. Domestic public debt comprises mainly of Treasury bills and bonds. Short term debt with maturities of 91, 182, and 364 days account for 7.9 percent of GDP (US\$ 6.63 billion) while the long term debt mainly medium and longer term Treasury bonds, including infrastructure bonds (IFB) account for 17.0

percent of GDP (US\$ 14.15 billion). The Pre-1997 government debt accounted for US\$ 0.2 billion.

Table 5: Kenya: Outstanding Government Guaranteed Debt (End-December 2017)

(In millions of Kenya Shillings and U.S. Dollars)

Beneficiary Entity	USD	Kes
Kenya Broadcasting Corporation	10,013	1,033,625
Tana & Athi Rivers Dev. Authority	6,511	672,110
East Africa Portland Cement	8,093	835,495
Kenya Electricity Generating Company (KenGen)	251,256	25,937,569
Kenya Railways(IDA Concessionaire)	40,000	4,129,268
Kenya Ports Authority	230,237	23,767,748
Kenya Airways	750,000	77,423,775
Total	1,296,110	133,799,590

Source: National Treasury.

21. The MTDS analysis excluded government guaranteed debt portfolio that is performing which amounts to 1.5 per cent of GDP (US\$1.27 billion). These refers to loan guarantees issued to Kenya railways on an IDA-financed concessionairing (US\$40 million), Kenya Airways (US\$ 750 million), Kenya Ports Authority (US\$ 230 million) and KenGen (USD251,256). The non performing guarantees include loans to Kenya Broadcasting Corporation, Tana and Athi River Development Authority and East Africa Portland Cement. (Table 5).

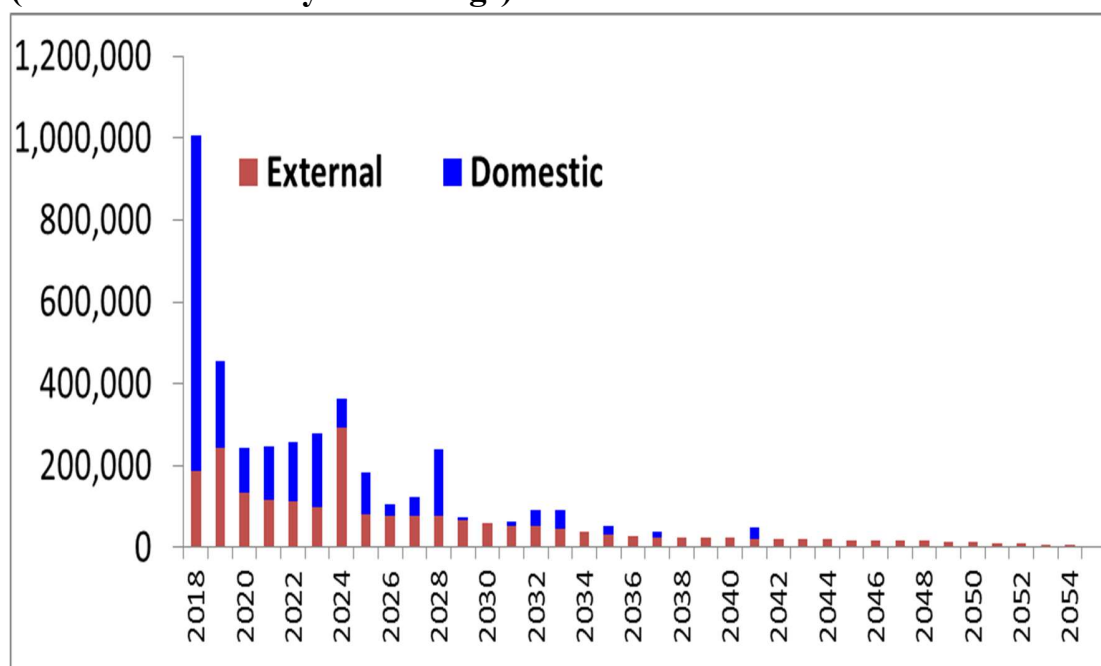
V. COST AND RISK OF THE EXISTING NATIONAL GOVERNMENT DEBT PORTFOLIO, AS AT END FY2017/18

22. Overall, Kenya's cost of public debt is low and stands at 17.9 percent in relation to interest payments to revenue. The overall interest payment is projected to be 3.9 percent of GDP, with interest payment on external debt and domestic debt accounting for 1.0 percent and 2.9 per cent of GDP respectively. The low interest payment is attributed to the large proportion of external concessional financing in the existing public debt portfolio. As at end-FY 2017/18, the weighted average interest rate on the total debt portfolio is projected to be 7.5 percent of GDP, an increase from 6.9 percent in FY2016/17. The external and domestic debt portfolios weighted average interest rates were 3.7 per cent, and 11.4 per cent respectively.

23. The government is exposed to refinancing risk. As at end- FY 2017/18, the main refinancing risk is associated with high domestic debt repayments (at 37.7 per cent falling due within the year largely comprised of Treasury bills. The average time to maturity (ATtM) for domestic debt portfolio stands at 4.4 years while that of external debt portfolio stands at 9.7 years. (Table 7). The ATtM for external debt portfolio has been declining due to the growth of the short tenor commercial debt proportion as a result of Kenya's graduation to the lower middle income country. The ATtM for the total debt portfolio is 7.1 years (Table 7).

24. However, the refinancing needs falling due in FY 2018/2019 is US\$ 1.8 billion, in FY2023/2024 is US\$4.4 billion and in FY2024/25 is US\$ 2.8 billion, mainly associated with a repayment of the Syndicated loans, commercial loans, international bonds and other external repayments. (Figure 1).

**Figure 1: Kenya: Debt Redemption Profile, as at end-FY2017/18
(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- FY2017/18

Remaining Maturity in Years	In Percent of Total	In million US\$
< 1 Y	37.7%	7,920.96
2 - 3 Y	14.8%	3,117.48
4 - 5 Y	12.6%	2,655.59
6 - 10 Y	19.8%	4,169.17
> 11 Y	15.0%	3,155.63
Total	100.00%	21,018.83

Source: National Treasury

25. Even though most (83.1 per cent) of the public debt portfolio has a fixed interest rate, 37.1 per cent will re-fix in FY2018/19. The weighted average time to re-fixing (ATR) for external and domestic debt portfolio is 8.0 years and 4.4 years respectively. The main exposure to interest rate re-fixing, is attributed to

variable rate loans, the share of external and domestic debt maturing in the next twelve months. All the domestic debt has 100 percent fixed interest rate with an ATR of 4.4 years (same as the average time to maturity).

26. Approximately 50 per cent of the total government debt portfolio is exposed to exchange rate risk. The main exposure is to the U.S. dollar (67.3 percent), followed by the Euro (16.6 percent), then JPY and GBP at 6.3 percent and 2.9 per cent respectively. (Figure 3)

27. Generally, the outstanding debt portfolio as at end-FY2017/18 is characterized by low cost but high exchange rate and refinancing risks (Table 7). The low cost is due to the high proportion of existing portfolio of concessional external loans. However, the terms of new disbursements have changed and therefore, the cost is expected to increase over the medium term. Refinancing risk is significant as debt maturing in 1 year as a percentage of revenue 54.4 percent. Exchange rate risk is also important risk to monitor, but it has been offset by the low cost of the concessional. The debt management strategy strives to reduce refinancing risk, while being mindful of exchange rate exposures, mainly on external commercial debt.

28. Instrument risks: Most syndicated loans carry an acceleration clause in case the government settles for an international debt capital market issuance during or after the fiscal year. This has the implication of repaying syndicated loan amounts in full before their full term.

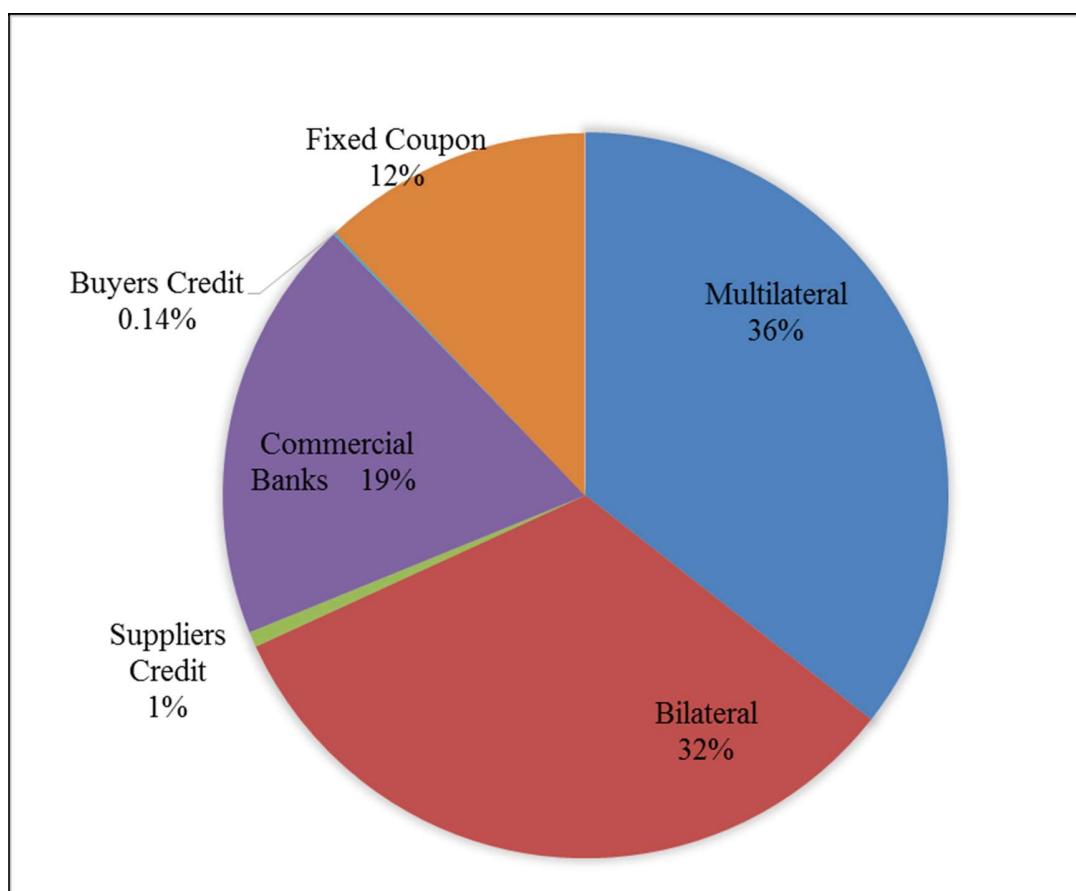
Table 7: Kenya: Cost and Risk Indicators of Existing Debt, as at end-FY2017/18

Risk Indicators		External debt	Domestic debt	Total debt
Amount (in millions of KSH)		2,205,826	2,169,809	4,375,635
Amount (in millions of USD)		21,368	21,019	42,386
Nominal debt as % GDP		25.6	25.2	50.8
PV as % of GDP		21.2	25.2	46.4
Cost of debt	Interest payment as % GDP	1.0	2.9	3.9
	Interest payment as % Total Revenue	4.5	13.3	17.9
	Weighted Av. IR (%)	3.8	11.4	7.5
Refinancing risk	ATM (years)	9.7	4.4	7.1
	Debt maturing in 1yr (% of total)	8.5	37.7	23.0
	Debt maturing in 1yr (% of total revenue)	10.2	44.2	54.4
	Debt maturing in 1yr (% of GDP)	2.2	9.5	11.7
Interest rate risk	ATR (years)	8.0	4.4	6.2
	Debt refixing in 1yr (% of total)	36.5	37.7	37.1
	Fixed rate debt (% of total)	66.6	100.0	83.1
FX risk	FX debt (% of total debt)			50.4
	ST FX debt (% of reserves)			19.4
Funding risk	Gross financing needs (% of GDP)			16.0

Source: National Treasury

29. Creditor composition of external public debt as at FY2017/18 mainly include the multilateral institutions, bilateral and commercial as shown in Figure 2

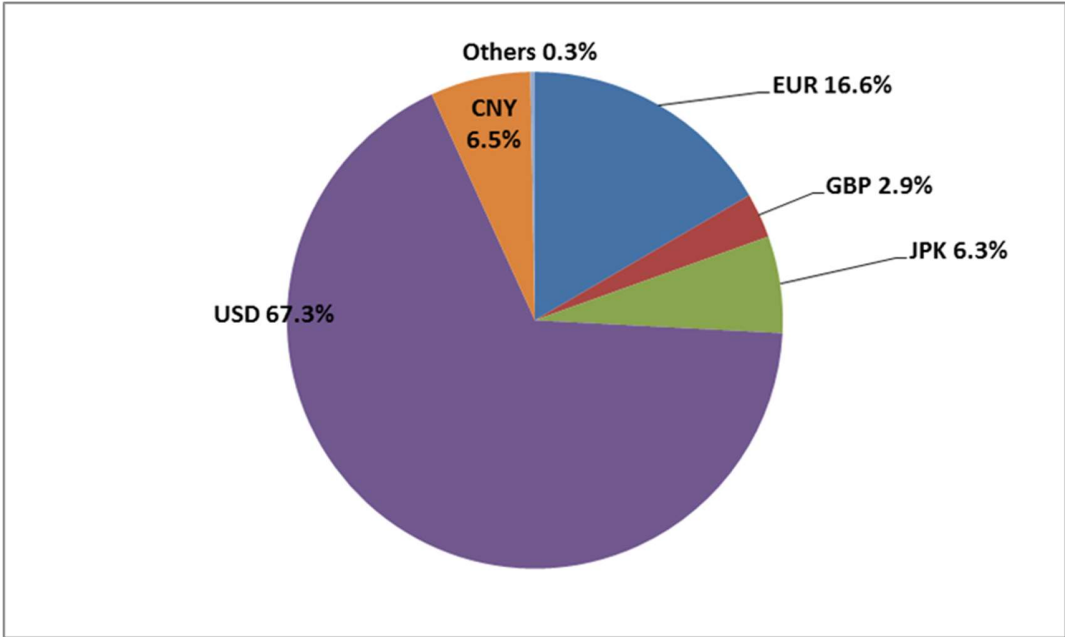
Figure 2: Kenya: External Public Debt, Creditor composition as at end-FY2017/18



Source: National Treasury

30. The currency mix reflects the currency of borrowing. Kenya’s external debt is well diversified in terms of currency and creditor. This helps in hedging against exchange rate risks. Efforts are being made to further diversify and sustain Kenya’s debt currency mix. The National Treasury strategy to manage the currency exposures is by seeking to match currency of external liabilities with currency composition of Kenya’s forex inflows, international reserves, and cost of borrowing in each currency.

Figure 3: Kenya: External Public Debt, currency composition as at end-FY2017/18



Source: National Treasury

VI. BASELINE MACROECONOMIC ASSUMPTIONS AND KEY RISKS

A. Baseline Macroeconomic Assumptions³

31. The Medium Term Debt Strategy recognizes the medium-term macroeconomic framework as provided in the 2018 Budget Policy Statement (BPS) whose targets are anchored on the priorities of Jubilee Administration second term (2018-2022) as anticipated in the Third Medium Term Plan of the Vision 2030. The key priorities of the Government in the medium term are grounded on four pillars namely: food security through expansion of food production and supply; affordable housing by providing at least five hundred thousand affordable new houses by 2022; creating jobs by expanding manufacturing sector; and providing affordable healthcare for all.

32. The baseline assumptions as tabulated in the 2018 BPS are summarized below (See Table 8)

Table 8: Kenya: Baseline Macroeconomic Assumptions

	Unit	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
		Actual	Prel. Act	Projected				
Real GDP	Per cent	5.8	5.3	5.3	5.9	6.3	6.9	6.9
GDP Deflator	Per cent	8.8	8.4	7.3	6.8	6.5	6.4	6.4
CPI (av.)	Per cent	6.4	6.9	6.3	5.0	5.0	5.0	5.0
Revenue	Per cent of GDP	18.4	18.3	19.0	18.9	19.0	19.2	19.4
Expenditure	Per cent of GDP	26.6	27.6	26.8	25.5	23.8	23.0	22.5
Overall Fiscal Balance	Per cent of GDP	-7.4	-8.9	-7.2	-6.0	-4.3	-3.4	-3.0
Primary	Per cent of	-4.2	-5.4	-3.7	-2.3	0.9	0.0	0.4

³ The macroeconomic assumptions are based on the Government's medium-term macroeconomic framework embodied in the 2018 BPS published for public consultation.

	Unit	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
		Actual	Prel. Act	Projected				
budget balance	GDP							
Revenue	KSh billion	1232.6	1400.6	1643.1	1849.4	2105.6	2417.8	2747.6
Expenditure	KSh billion	1781.9	2110.0	2323.1	2488.4	2639.8	2897.5	3239.4
Overall Fiscal Balance	KSh billion	-497.3	-683.1	-620.8	-598.5	-482.6	-427.2	-437.4
Primary budget balance	KSh billion	-282.0	-411.9	-316.7	-217.7	-98.8	4.1	53.7
GDP (current prices)	Kshs billion	6,710	7,658	8,655	9,791	11,101	12,621	14,364

Source: National Treasury, 2018 BPS

33. Over the medium term, real GDP growth is projected at 6.9 percent in FY 2021/22 while the primary deficit is projected at 2.3 percent of GDP in FY2018/19 and a surplus of 0.9 percent of GDP by FY2019/20. Inflation is expected to remain within the current allowable margin of 2.5 per cent on either side of the target band of 5.0 per cent in the medium term.

B. Risks to the Baseline Macroeconomic Assumptions in the 2018 MTDS

34. As articulated in the BPS 2018, the macroeconomic framework is exposed to a number of downside risks. Major risks to the macroeconomic framework include:

- i. Risks from the global economies relate to: declining long term growth as a result of expected slow productivity growth and aging workforces, rebalancing and convergence; uncertainties in the global financial markets particularly with regard to the U.S. economic and trade policies,

normalization of monetary policy in the advanced economies and the Brexit outcome. The recent geopolitical tensions building around production and use of nuclear weapons may weigh down global growth with negative impact on trade and financial flows.

- ii.** The framework is exposed to economic growth and fiscal risks. The projected growth assumes favourable weather conditions and therefore any adverse weather conditions will have negative impact on the growth. Further, public expenditure pressures especially recurrent expenditures pose a challenge to the framework.
- iii.** Direct and indirect guarantees to state-owned enterprises (SOEs) and the likely issuance of guarantees to counties pose fiscal risks to the government. Realization of contingent liabilities would increase National government debt stocks and servicing costs hence sustainability.
- iv.** Support for Public Private Partnerships (PPPs) projects through issuance of Letters of Support constitutes an implied fiscal risk to the government. This form of government support to PPPs has in turn created the need to more explicitly manage fiscal risks in the form of Fiscal Commitments and Contingent Liabilities (FCCL) for the GOK.
- v.** The government will, however, continue to monitor the above risks and take appropriate measures to safeguard macroeconomic stability.
- vi.** The macroeconomic outlook under the MTEF anticipates prudent debt management. This will be achieved through issuance of medium to long term domestic securities to lengthen the average maturity, which will reduce the pressures on the domestic debt.
- vii.** The graduation of Kenya to a lower middle income country in 2014 has resulted in a shift from concessional funding to blend financing from both World Bank and African Development Bank. In addition, the cost of borrowing in the international capital markets is expected to rise should the USA Federal interest rates increase. As a result of the changing international market conditions, Kenya will put in place more emphasis on the domestic debt market development.

VII. POTENTIAL SOURCES OF FINANCING

A. External Sources

35. The Government will continue sourcing funds from the official sector (Multilateral and Bilateral) and commercial creditors. The key external official multilateral sources in the past have been World Bank and African Development Bank, through the concessional windows of International Development Association (IDA) and African Development Fund (ADF). However, this has changed since the Kenya's graduation to the Lower Middle income economy and now the government is accessing the commercial windows of these multilateral institutions to finance development projects and programs (Table 9). Disbursements from IDA are expected to be US\$713 million in the FY 2017/18 of total official disbursements. Other multilateral and bilateral Paris and non-Paris Club creditors have also contributed to the GOK's external financing, the non-traditional creditors continue to gain significance in financing development projects in Kenya. (Figure 4).

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

	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	<i>Actuals</i>			<i>Projections*</i>		
IDA	1,025	647	1,199	712.70	1,003.74	99.79
Non-Paris Club	1,626	1,181	1,239	640.16	803.34	610.42
Other Multilaterals	444	230	373	235.88	213.29	28.59
Paris Club	166	1,106	774	389.99	908.68	326.96
Total (USD)	3,260	3,164	3,586	1,978.73	2,929.05	1,065.76

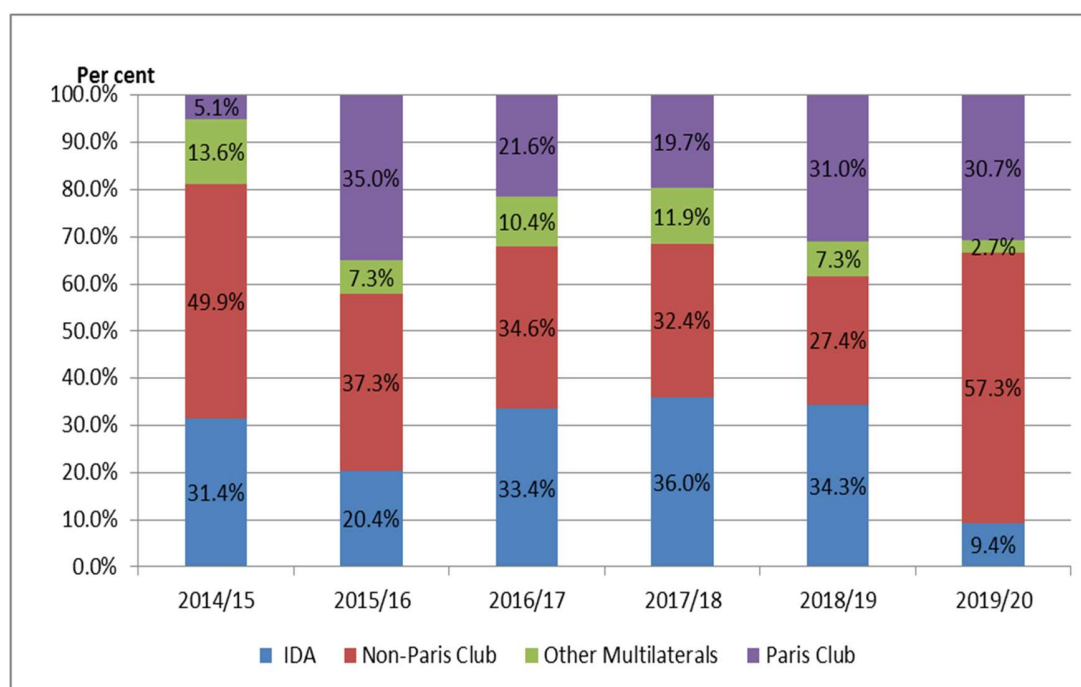
*Projections only include credit that is contracted but is not yet disbursed. It does not include new pipeline credit.

Source: The National Treasury

36. Based on commitments, the bilateral Paris and non-Paris Club creditors will continue to contribute significantly to the financing of projects over the medium term. During the next three years (FY2017/18 – FY2019/20)

disbursements from bilateral non-Paris Club creditors will on average account for about 39 per cent of annual disbursements to finance 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.

Figure 4: Kenya: Composition of Official Financing



Source: National Treasury

37. In December 2016, the Government contracted a 2 year syndicated loan of US\$ 250 million priced at a 520 bps above 6-months LIBOR. In addition, in March 2017, a 5 and 7 years commercial loan of US\$ 500 million was contracted from Trade Development Bank (former PTA Bank) priced at 660 bps and 715 bps above 6-month LIBOR and a 2 and 3 years tranche commercial loan of US\$ 1,000 million from a syndicate of Banks at a floating rate of 6months LIBOR plus a margin of 500 bps and 540 bps.

38. In the FY 2017/18, the GoK contracted USD 750 million to refinance the repayment of the 2015 syndicated loan at 670 bps above 6-month LIBOR.

39. In FY2018/19, the GOK anticipates to continue accessing the international capital markets to raise funds to finance its development budget as it diversifies its sources of financing. The government also intends to refinance the 5-year Eurobond maturing in FY2018/19, through issuance of bonds in the international capital markets. Other sources of financing, such as the Islamic financing instruments, Samurai market and Panda bonds and diaspora bonds continue to be explored as possible financing options over the medium term.

B. Domestic Sources

40. Kenya's domestic debt market is growing to be a vibrant as deepening continues to be a priority to the Government. A lot of reforms spearheaded by a Joint Technical Working group are on course and the government is keen on debt market development as one of its keys priority objectives.

41. Increased reliance on domestic debt helps mitigate government exposure to foreign currency risk. Issuance of long dated instruments reduce the domestic rollover risk and create liquidity in the government securities market thus providing consistent pricing references for other risk assets within the Kenyan economy .

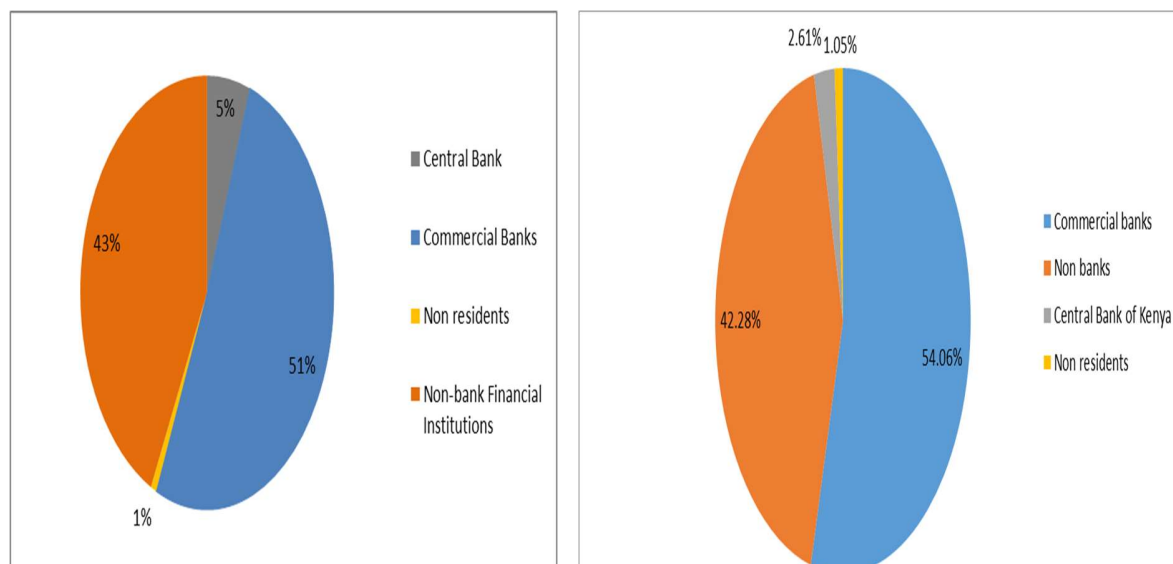
42. Even though the domestic debt market investor base is diversified, commercial banks are the major players. Through the market reforms, the government is committed to introducing various products and tenors that takes care of the investor preferences for both ends of the market.

43. The domestic debt market is dominated by commercial banks as the main investors for government securities. As at end-June 2017, commercial banks held 54 percent of total outstanding securities. Non-banks which comprises of pension funds, insurance companies, building societies, financial institutions and parastatals held 42 percent while the rest was held by non-residents and Central bank of Kenya at 3 per cent and 1 percent, respectively.

Figure 5: Kenya: Holders of Domestic Government Debt Securities

June 2016

June 2017



Source: Central Bank of Kenya

44. The uncertainties associated with the elections in 2017 led to a shift to the short to medium term maturities.

45. Nonresidents` holdings continue to be small since most of them don't invest directly but through their nominee accounts at various commercial banks.

Domestic Financing Prospects

46. The financial sector particularly commercial banks and other financial institutions are expected to continue providing demand for government securities. The capping of interest rates has led to low levels of credit to the private sector; government securities provide an opportunity for investment to commercial banks in a bid to secure risk free income streams. The increase in customer deposits due to adoption of agency banking model and use of technological innovations to mobilise funds also provide an opportunity for government`s financing prospects.

47. Commercial banks prefer short to medium term securities compared to pension and insurance companies which prefer longer term securities to best match their cash flow requirements

48. Pension funds are a potential source of domestic finance. It is expected to continue to show resilience over the medium term, with increase uptake of 15 to 30 years tenors in the domestic debt market. Also the introduction of new products such as post- retirement medical schemes and new asset classes like real estate investments trusts (REITs), private equity and venture capital are expected to see the industry grow in future and hence make the sector more vibrant.

49. Demand for government securities from the insurance sector continues to grow with increased capital requirements introduced by Insurance Regulatory Authority (IRA). Non-life insurance demand for securities is expected to be in the short and medium term bonds while the general insurance will be skewed to short term papers due to the nature of their liquidity requirements. Life insurance demand is picking due to the nature of their products.

50. Non-residents are not expected to be a major source of demand due to incomplete information about them and the high costs of transaction in the secondary markets due to non-transparency in pricing thus discouraging them from participating in the domestic debt market.

51. The secondary market in Kenya continues to develop. Trading of Government bonds has increased significantly since fiscal year. Most activities concentrated on the medium to long term securities with the bulk being the 5 to 10 years maturities. The turnover was Ksh 366,923 million in FY/2017 compared to Ksh 311,660 million in FY2016. This is as a result of success in the implementation of the benchmark bonds and Infrastructure bonds programs.

52. The government is committed to its objective of developing the financial market through introduction of new products aimed at ensuring financial inclusion and also promoting the saving culture for its people. In this regard the National Treasury introduced a retail based product M-Akiba an initiative aimed at providing an avenue for investing in Treasury Bonds through mobile phone platforms. The government will continue to issue this product to provide

an opportunity to all Kenyans willing to cultivate a culture for savings. This is in line with the Second Medium Term Plan objectives of stimulating long term savings.

53. The Government is committed to providing the required information to the market, issuing the borrowing calendar, providing an electronic trading platform of government securities and a vibrant over the counter Government bond market.

54. The government is also in the process of segmenting the securities market into retail and wholesale in order to develop a strong base for primary dealership and aid in the pricing of financial instruments as well as improve efficiency.

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

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

Fiscal Year	2018/19	2019/20	2020/21	2021/22
Treasury Bills	111,000	77,000	60,000	64,000
Treasury Bonds	259,000	179,000	139,000	149,000
Banks	114,000	79,000	61,000	66,000
Pensions	99,000	68,000	53,000	58,000
Insurance Cos.	30,000	21,000	17,000	17,000
Other	16,000	11,000	8,000	8,000

Source: National Treasury

VIII. COST-RISK ANALYSIS OF ALTERNATIVE DEBT MANAGEMENT STRATEGIES

A. Baseline-Pricing Assumptions and Description of Shock Scenarios

56. 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 have hardened due to Kenya's graduation from a low income to lower middle income country.
- Semi-concessional loans are assumed to be contracted from official creditors. These loans have a fixed interest rate of 2.0 percent, a maturity of 20 years including a grace period of up to 10 years.
- Commercial borrowings refer to the international syndicated loans market and the Export Credit Financing priced at 6-month LIBOR⁴ plus a margin.
- Access to 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 and inflation differentials.

57. Future baseline interest rates are projected based on the observed U.S. Treasury interest rates as at December 2017.

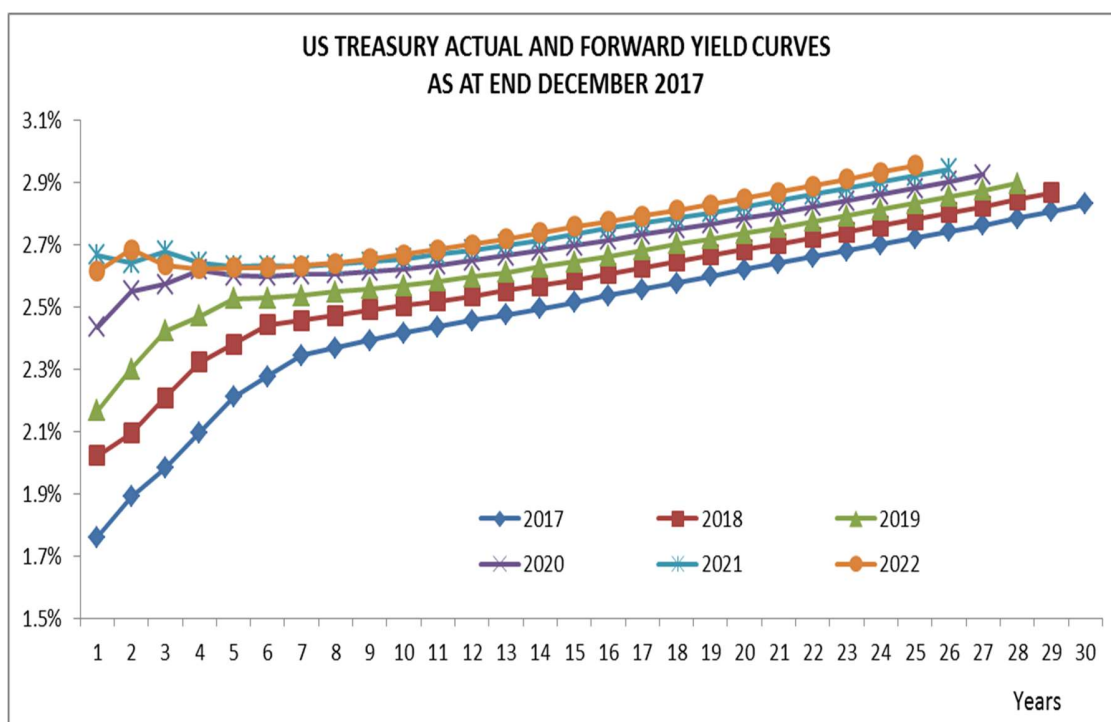
- The future interest rates are calculated by projecting the implied forward rates from the observed rates, assuming no arbitrage conditions. This methodology is applied to determine the future reference rates.
- The future interest rates of market-based fixed-rate debt instruments in the international capital markets are based on the currently prevailing interest rates, which are derived by first adding a credit spread of 233 bps

⁴ London Interbank Offered Rate.

to the U.S. Treasury spot yield curve, and the forward yield curve is derived using the same methodology described above.⁵

- 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 3 per cent as at December 2017. The Ksh yield curve as of end-December 2017 is gently upward sloping.

Chart 1: US Treasury Actual & Forward Yield Curves

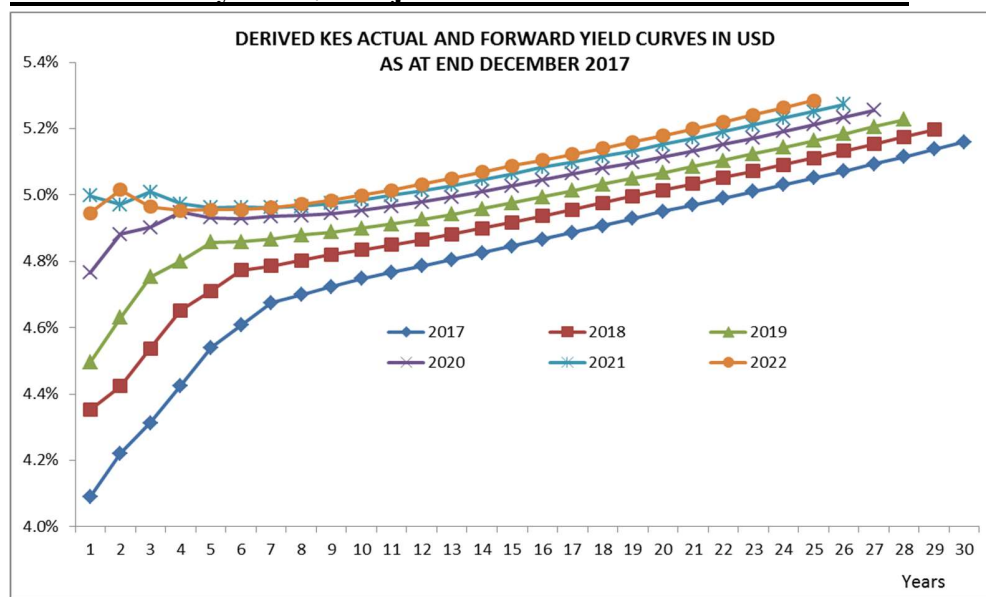


Source: US Treasury

58. On the exchange rate assumptions; under the baseline scenario, Ksh is assumed to depreciate at 5 percent against the U.S. dollar from 2018, 2019, 2020 and 2021 to ensure there is stability and competitiveness to support Kenya's exports.

⁵ Based on secondary market spreads of the 2024 Eurobond as at December, 2017.

Chart 2: Kenya USS Projections & Forward Yield Curves



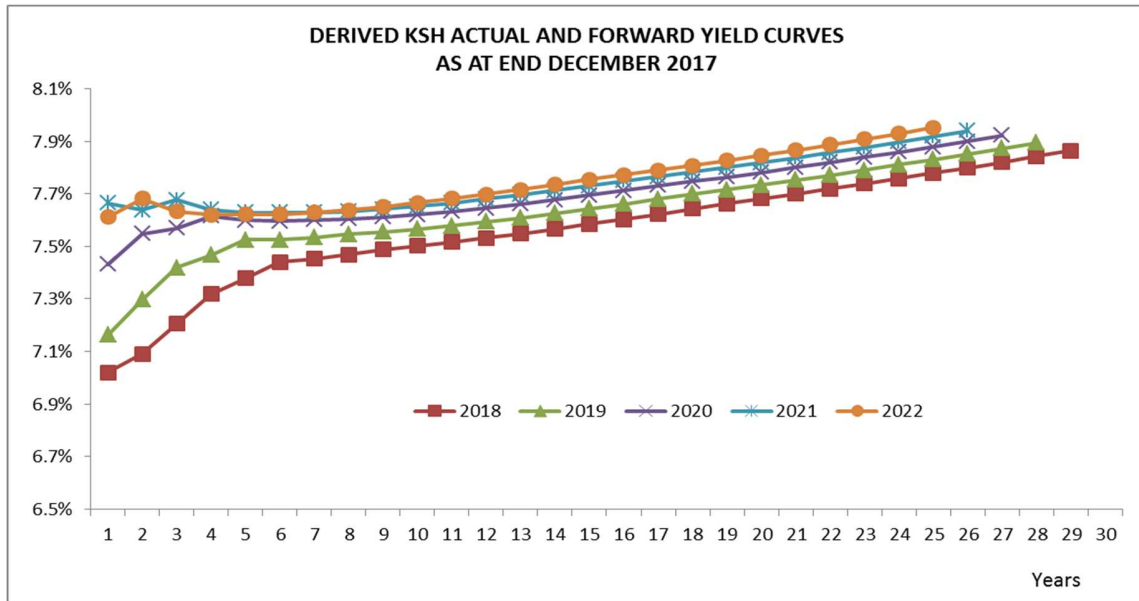
Source: US Treasury

59. The interest rates are expected to remain relatively stable to the baseline projections. Kenya’s credit risk premium is not likely to change and the Kenya’s inflation is expected to be within the target band of 5 ± 2.5 per cent.

60. The following interest rate and exchange rate shock scenarios for FY2018/19–FY2020/21 are considered against the baseline scenarios. Three risk scenarios are evaluated; 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:

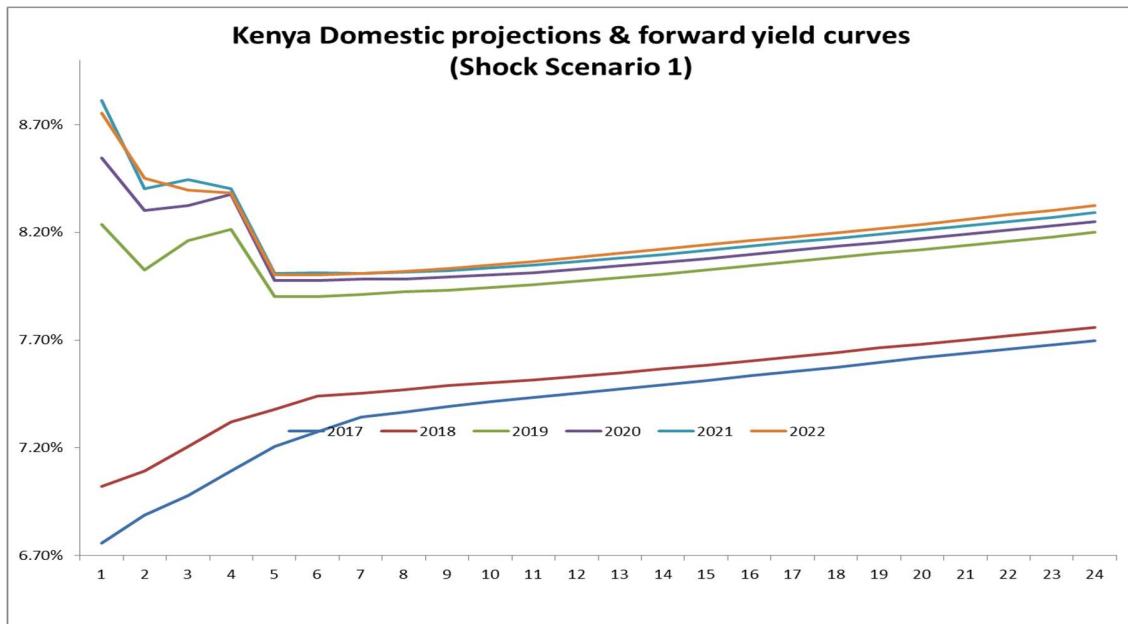
- The first risk scenario assume that U.S. Treasury rates increases faster than expected by 2019, it increases by a moderate shock of 2 percent and remains constant thereafter (Chart 3). Domestic interest rates receive a moderate shock of: (i) 7 percent for T-bills; (ii) 4 percent for 2-year; (iii) 2 percent for 5-year; and (iv) 1.7 per cent for 10-year and longer (Chart 4). The interest rate scenario is combined with the 15 percent exchange rate depreciation.

Chart 3: Kenya Domestic Projections & Forward Yield Curves



Source: National Treasury

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

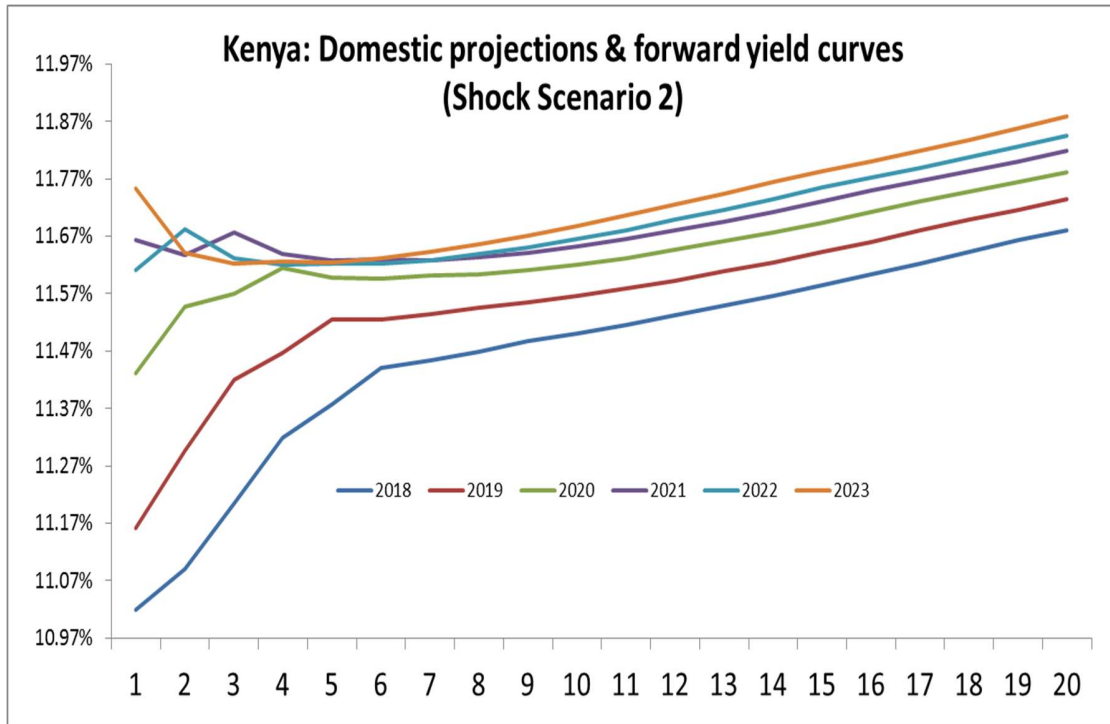


Source: National Treasury

- The second risk scenario assumes U.S. Treasury rates increases faster than expected by 2019, it increases by an extreme shock of 3 percent over the baseline projections and remains constant thereafter (Chart 5). Domestic

interest rate also increases in an extreme shock of: (i) 11.2 percent for T-bills; (ii) 7.5 percent for 2-year; and (iii) 3.7 percent for 5-year and longer bonds.

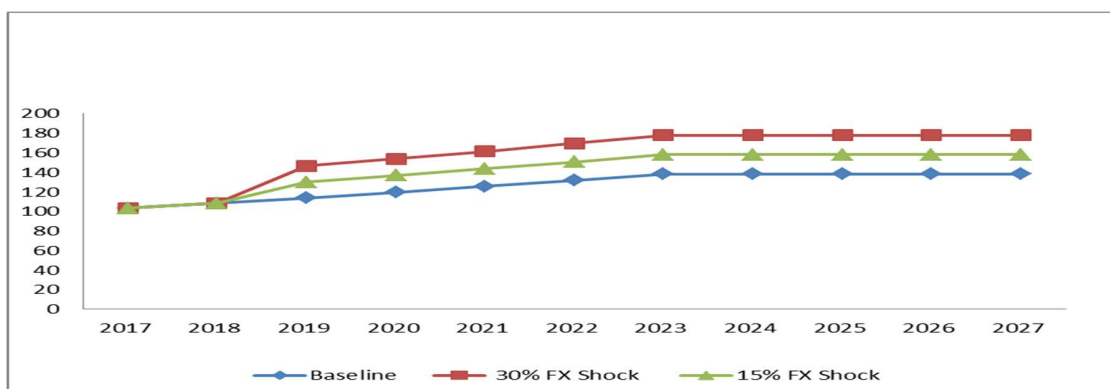
Chart 5: Kenya Domestic Spot & Forward Yield Curves (Shock Scenario 2)



Source: National Treasury

61. A stand-alone exchange rate risk shock scenario is applied where by the Ksh declines by an aggressive depreciation shock of 15 and 30 per cent against the US\$ in 2019 compared to the baseline exchange rate projections. (Chart 6)

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



Source: National Treasury

B. Description of Alternative Debt Management Strategies

62. The 2018 MTDS considered four strategies. These strategies reflect alternative ways to meet the borrowing requirement during FY2018/19–FY2020/21.

Table 11: Implied Net Borrowing (In percent of GDP)

External net borrowing	2018	2019	2020	2021
S1	3.4%	2.3%	2.0%	1.6%
S2	3.4%	1.3%	0.6%	0.5%
S3	3.4%	2.3%	0.7%	1.6%
S4	3.4%	4.2%	1.9%	1.3%
Domestic net borrowing				
S1	2.2%	2.1%	1.4%	1.3%
S2	2.2%	3.0%	3.0%	2.7%
S3	2.2%	2.1%	2.7%	1.5%
S4	2.2%	0.1%	1.6%	1.8%
Fiscal Deficit				
S1	5.6%	4.4%	3.4%	3.0%
S2	5.6%	4.4%	3.5%	3.2%
S3	5.6%	4.4%	3.4%	3.1%
S4	5.6%	4.4%	3.5%	3.2%

Source: National Treasury

63. The strategies combine different mix of stylized instruments that reflect the potential sources of financing outlined in Section VII. The strategies are built first on the split between net external and domestic financing (Table 11), and then on the share of T-Bills used for net domestic financing (Table 12).

- **Strategy 1 (S1):** This strategy represents current policy intent, and will be referred to as the baseline strategy. Under this strategy, the fiscal deficit will be met by net borrowing from external and domestic borrowing. This composition is to be achieved by external commercial borrowing of US\$ 2.79 billion in FY2018/19 and US\$ 0.97 billion in FY2019/20, in addition to the contracting of credit from concessional sources. On the domestic front, the objective is to lengthen the maturity profile for domestic debt by reducing the share of T-Bills in total net domestic financing from 2016/17 strategy ratio of 35:65 as at June 2017. The share of T-Bills in net domestic financing is to

decrease to a level around 13 percent from the 35 percent actual realized by end June 2017.

- **Strategy 2 (S2):** More domestic borrowing each year. This strategy increases the size of domestic borrowing by increasing the amounts to be issued in the domestic market as compared to S1. The increase in the amounts will improve liquidity in the market and help develop domestic debt market.
- **Strategy 3 (S3):** Increased issuance of domestic medium to long term debt. As opposed to S2, this strategy increases the quantum on external borrowing but the domestic issuances concentrates on the medium to long term tenors. This is aimed at reducing the refinancing risks associated with the short-term debt and also improve trading in the secondary market with increased volumes.
- **Strategy 4 (S4):** Commercial borrowing. This strategy assumes accelerated borrowing from international capital market or other commercial sources, while maintaining presence in the domestic market through issuance of T bills and T-Bonds.

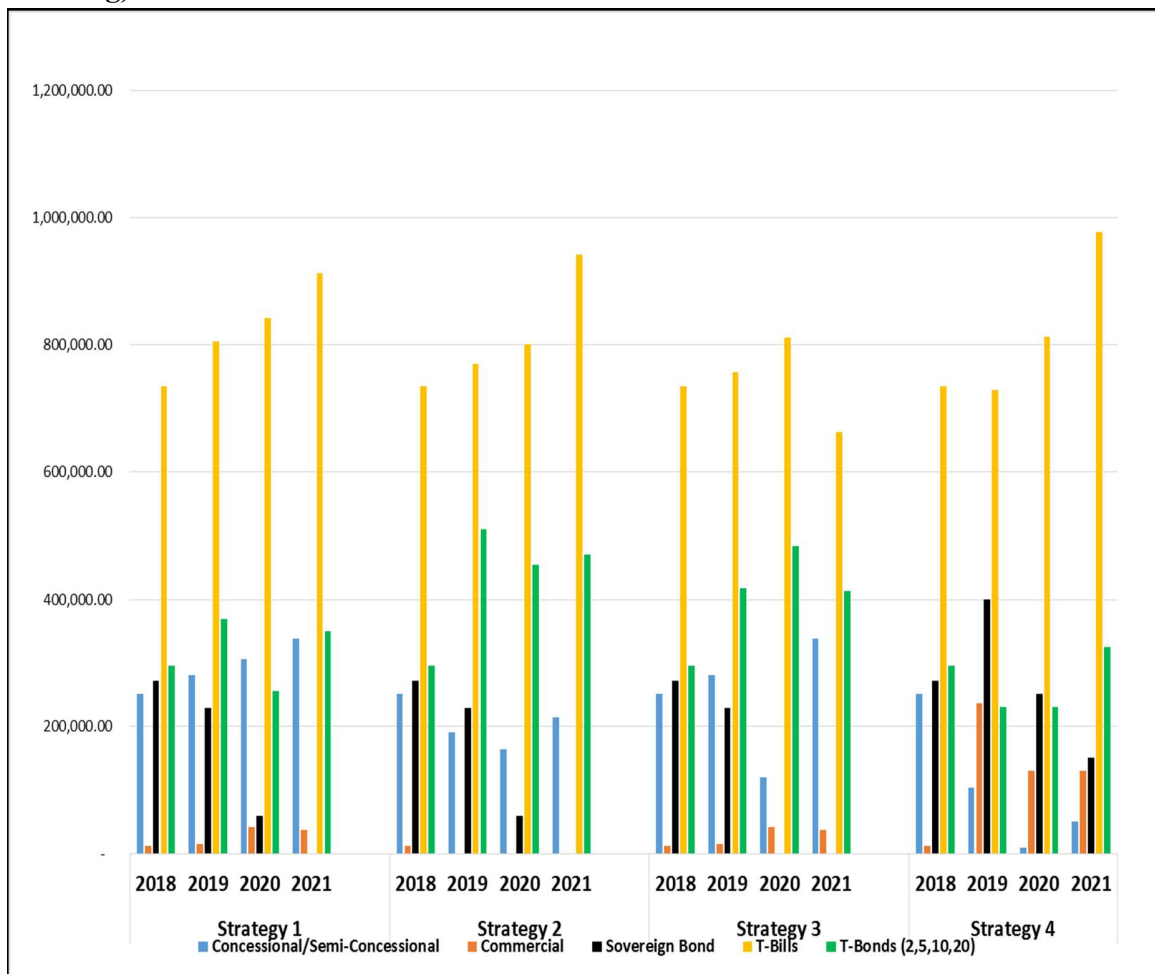
64. The gross issuance volumes of the instruments are derived by adding the actual and projected redemptions to the net financing. The share of instruments in gross financing for each year for each strategy is depicted in Table 13. While T-Bills dominate the gross financing profile (Figure 6), the concessional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

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

		Strategies	2018	2019	2020	2021
Share of Tbills		S1	13%	40%	21%	37%
		S2	13%	16%	11%	50%
		S3	13%	16%	17%	15%
		S4	13%	9%	69%	88%
Share of Tbonds		S1	87%	60%	79%	63%
		S2	87%	84%	89%	50%
		S3	87%	84%	83%	85%
		S4	87%	91%	31%	12%

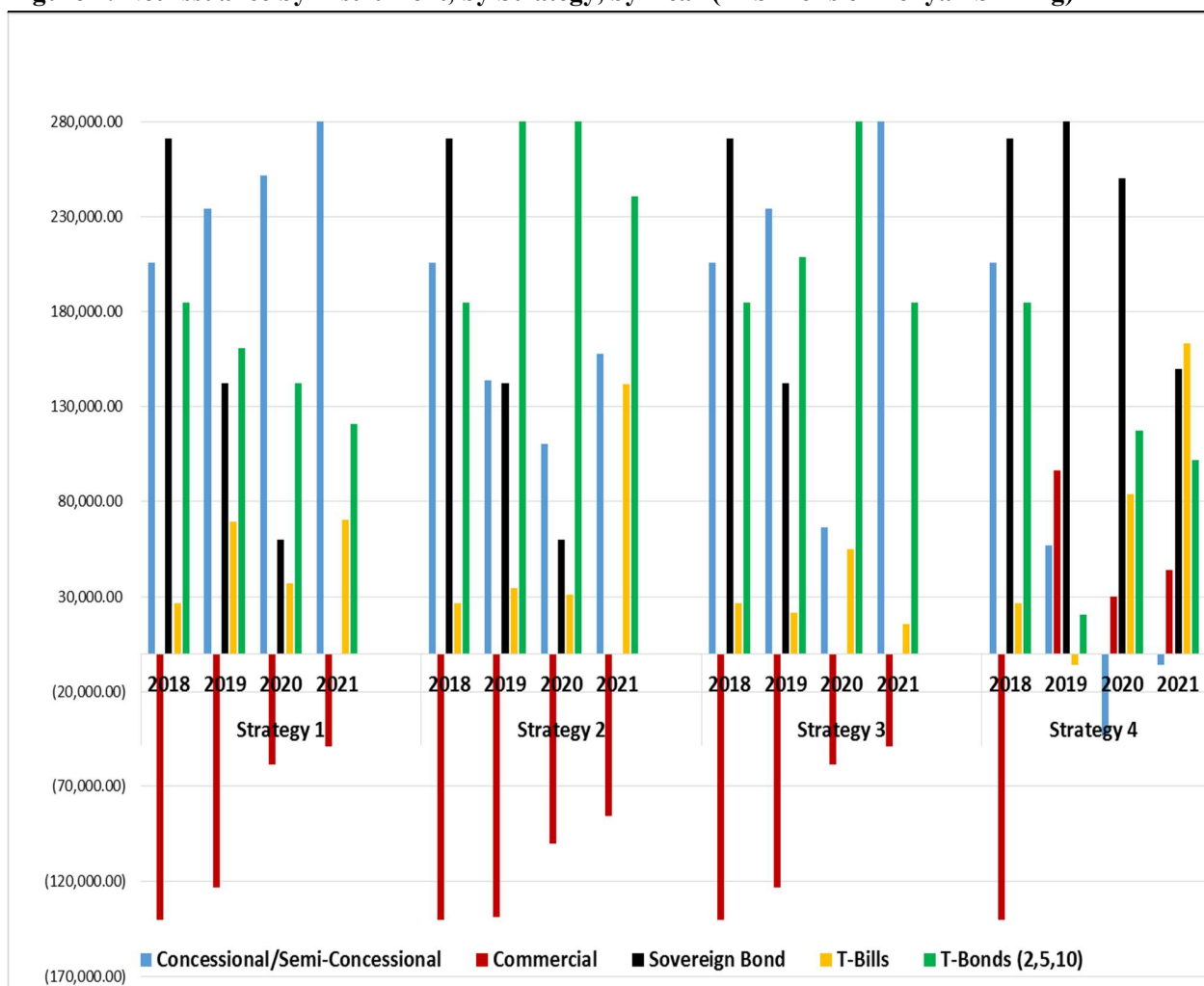
Source: National Treasury

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



Source: National Treasury

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



Source: National Treasury

C. Cost-Risk Analysis of Alternative Debt Management Strategies

65. The performance of the alternative 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. Under the 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 FY2018/19-FY2020/21.

i. Baseline results

66. The financing policies to be pursued during FY2018/19-FY2020/21 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 FY2018/19 and the medium term. The results of analysing the alternative debt management scenarios in terms of composition of the debt as at end-FY 2020/21 is presented in Table 13 which shows the impact of various borrowing policies.

Table 13: Composition of Debt by Instrument under Alternative Strategies, as at end-FY2020/21 (in percent of outstanding portfolio)

	FY2017/18	As at end FY2020/21			
	Existing Debt	S1	S2	S3	S4
Instrument					
Concessional	19	23	21	22	18
Semi-Concessional	6	12	8	12	5
Commercial	19	9	7	9	15
Eurobond	6	13	13	13	21
T-Bills	16	13	14	10	14
T-Bonds (2,5,10)	33	30	37	34	27
External	50	57	49	56	59
Domestic	50	43	51	44	41
Total	100	100	100	100	100

Source: National Treasury

67. The baseline strategy (S1) foresees an increase in the share of external debt. Although in terms of gross financing, the weight is greater on domestic borrowing, the trend is reversed in net financing. The long maturity profile of external debt, due to outstanding portfolio, means that the gross external borrowing will be much greater than maturing debt. Therefore, net external financing will be higher than net domestic financing.

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

the scope of decision making for the debt strategy. The baseline interest costs of alternative strategies are also comparable, reflecting Kenya's credit spread in the domestic and external markets, and the expected path of depreciation for the local currency.

Table 14: Cost and Risk Indicators under Alternative Strategies (End-FY2020/21)

Risk Indicators		FY2017/18	As at end FY2020/21			
		Current	S1	S2	S3	S4
Nominal debt as % of GDP		50.8	47.6	47.7	47.6	47.9
Present value debt as % of GDP		46.4	39.7	40.5	40.7	41.7
Interest payment as % of GDP		3.8	3.3	3.5	3.5	3.5
Implied interest rate (%)		7.5	7.7	8.1	8.0	8.1
Refinancing risk	Debt maturing in 1yr (% of total)	23.0	19.4	20.2	18.1	19.1
	Debt maturing in 1yr (% of GDP)	11.7	9.2	9.6	8.6	9.2
	ATM External Portfolio (years)	9.7	11.9	11.5	11.7	10.8
	ATM Domestic Portfolio (years)	4.4	3.5	4.7	5.0	4.3
	ATM Total Portfolio (years)	7.1	8.5	8.2	8.7	8.3
Interest rate risk	ATR (years)	6.2	8.0	7.9	8.3	7.5
	Debt refixing in 1yr (% of total)	37.1	26.3	26.1	25.0	28.4
	Fixed rate debt (% of total)	83.1	92.0	93.0	92.1	89.7
FX risk	FX debt as % of total	50.4	56.3	49.3	52.7	58.4

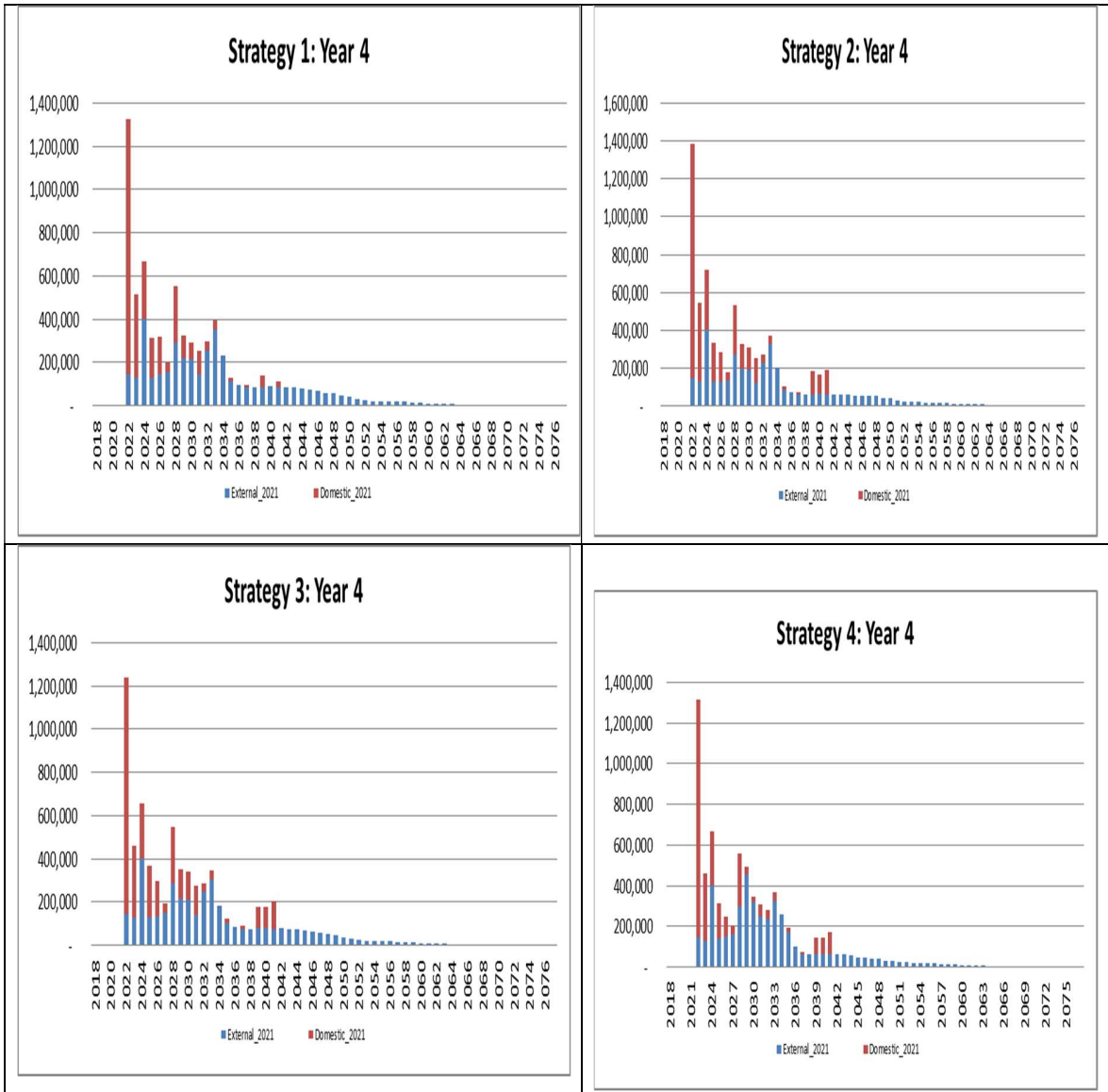
Source: National Treasury

69. If domestic interest rates increase, the cost of financing will be immediately reflected on the T-Bills and T-bonds. In such a case, Strategy 3 can be more resilient, as there will be less debt to be re-fixed in one year compared to other strategies though not comparable to the current portfolio.

70. Strategy 3, encompassing increased issuance of medium to long term domestic debt, has one of the longest average-time-to-maturity (ATtM), and the lowest ratio of debt maturing within the next year.

71. As depicted in Figure 8, the maturity profile provides information on exposure to refinancing risk. The share of T-Bills dominates the financing mix, however, near term redemption levels increase due to the share of external commercial debt maturing but the issuance of medium to long term T-Bonds smoothens the redemption profile.

Figure 8: Redemption Profiles for Alternative Strategies (End-FY2020/21)



Source: National Treasury

ii. Effect of market shocks

72. The performances of the four alternative debt management strategies were also evaluated under the shock scenarios. Among a number of cost and

risk indicators considered as part of the scenario analysis, three key indicators, Present Value of Debt/GDP, debt/GDP, 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.

73. The Present Value of debt/GDP ratio illustrates changes in the size of the outstanding debt under the baseline and market shock scenarios.

74. The Nominal debt/GDP ratio demonstrates the change in the size of the outstanding debt under the baseline and market shock scenarios. The deviations are primarily due to exchange rate fluctuations and the cumulative impact of higher interest payments, primary deficit, refinancing of maturing debt and refinancing of the fiscal deficit at higher interest rates. External debt can be issued at lower interest rates, and thus the real effect of an increase in the exchange rates is captured more effectively by analysing the changes in the level of outstanding debt, rather than interest payments. On the other hand, this measure does not account for the debt service costs as depicted in the government budget or in terms of National Treasury cash-flows.

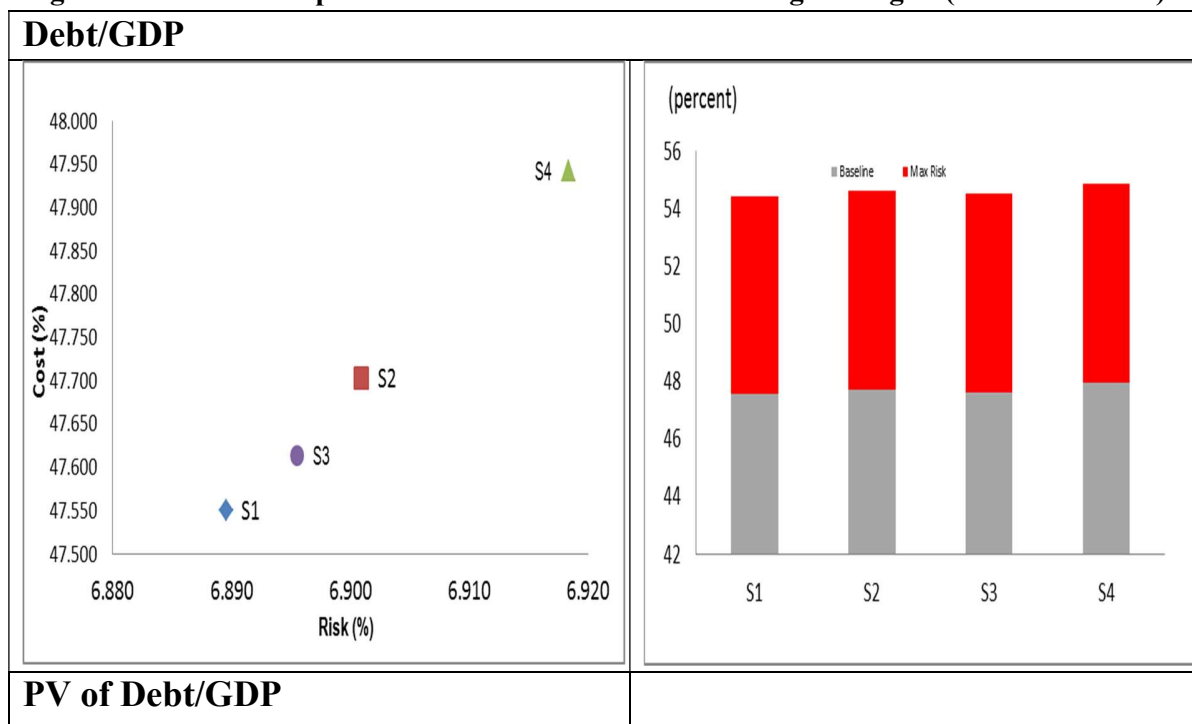
75. Interest payments/revenue and interest payments/GDP measures each strategy in terms of direct interest costs. These measures capture the outcome of rising interest rate levels, as reflected in the actual cash-flows. The burden of interest service on the budget is reflected by the ratio of interest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

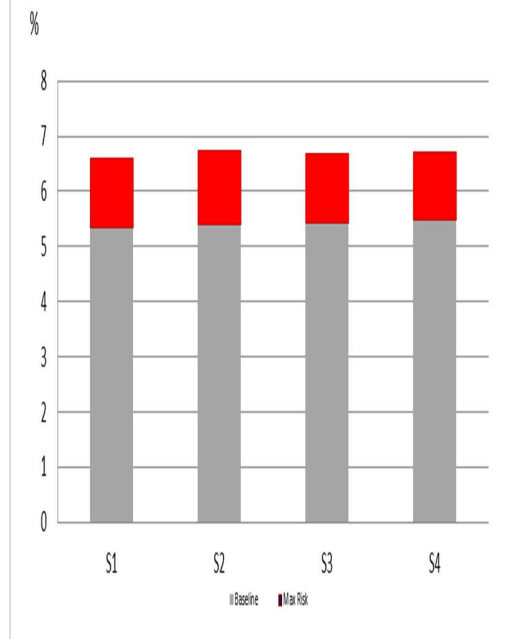
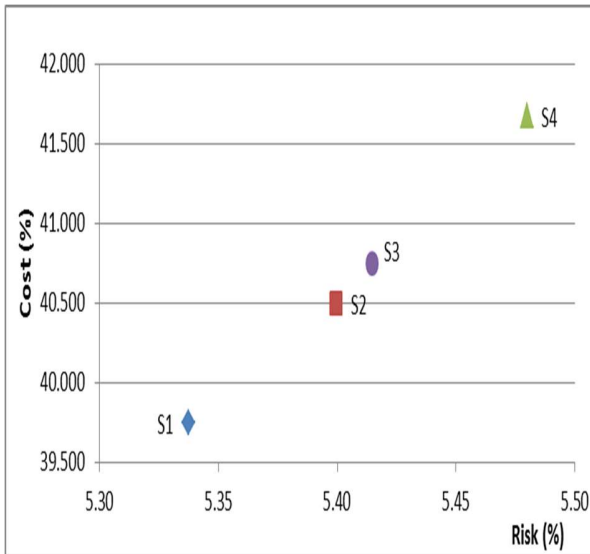
76. The outcome of the analysis identifies the trade-offs between costs and risk, even though the strategies can be more and less efficient. This means that a better result cannot be achieved in either cost or risk without losing on either. The results with respect to different indicators can also pose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

in Table 15 were used together to enable a more complete evaluation of costs and risks. The results are depicted in Figure 9.

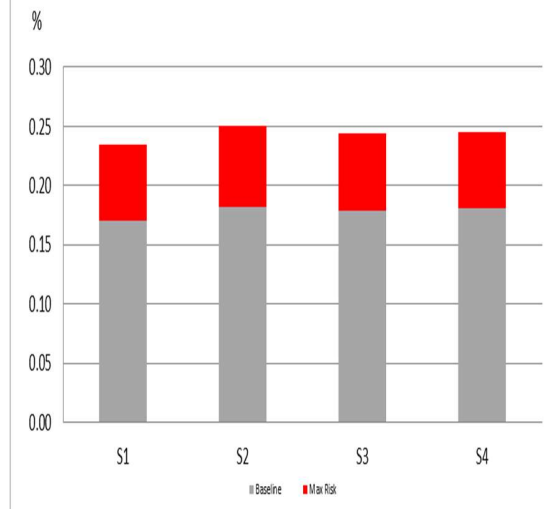
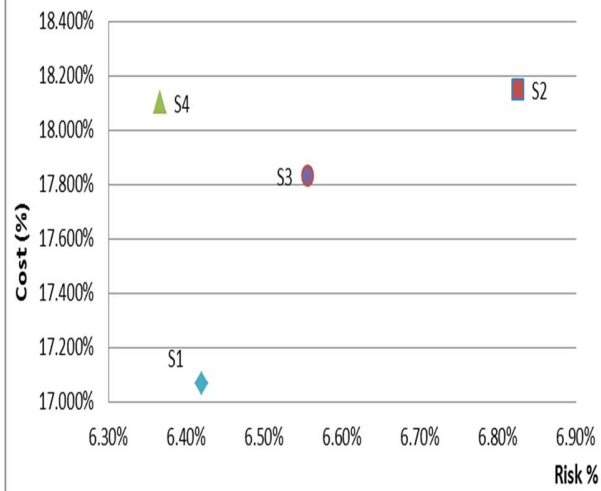
77. In ranking all the strategies, S1 dominates all other strategies based on the above indicators. S2 is more costly due to the high interest rates relating to domestic debt. In terms of refinancing risk, S3 dominates other strategies while strategy S4 is worst in terms of foreign exchange rate risk exposure, PV of Debt /GDP and Nominal Debt / GDP. Other considerations, like the redemption profile, market environment and the practicability of implementing the Strategy needs to be taken into account in making a decision.

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

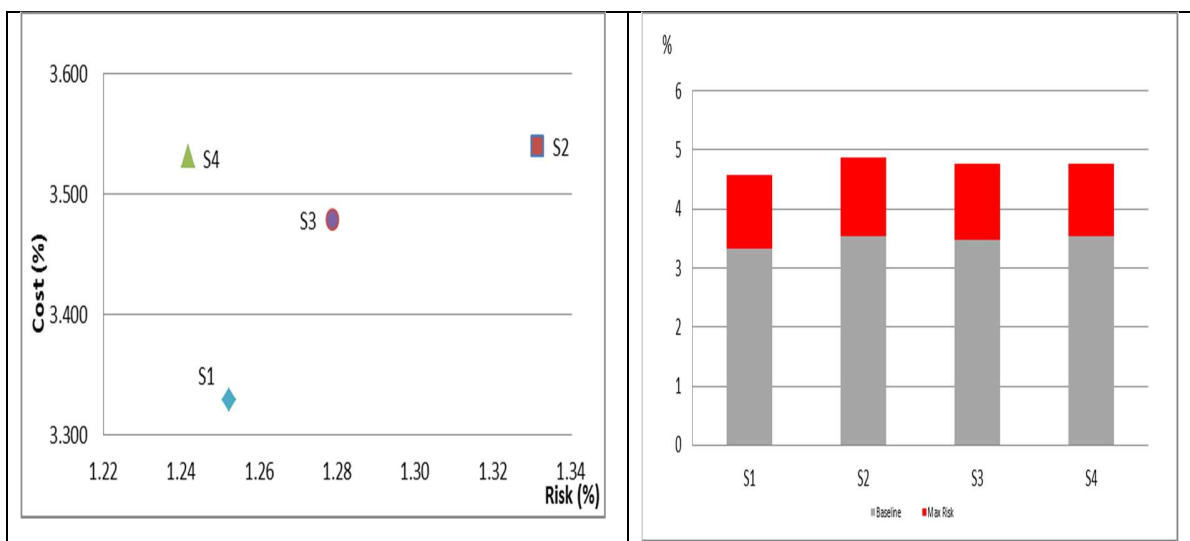




Interest/Revenue



Interest/GDP



Source: National Treasury

78. Given the limited size of the domestic debt market, the National Treasury will diversify its funding sources to mitigate the risks associated with over reliance on either domestic or external debt. In this regard, the emphasis is absorption of semi concessional and concessional financing already contracted from multilateral and bilateral sources.

79. Increasing the issuance of domestic borrowing mitigates against the exchange rate risk, but the high interest rates associated with it will be offset by increasing the size of borrowing through semi concessional loans (S1) leading to a lower interest cost overall.

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

81. Treasury Bills will be used for cash management purposes, while long term financing needs will be met by issuing Treasury Bonds, but achieving this

will depend on the demand side constraints and the need to maintain presence in the international capital markets.

82. In conclusion, taking into account both risk and cost trade-offs, the implied quantity of gross borrowing, the need to develop the domestic debt market, the need to diversify the funding sources and ability to implement the strategy, the 2018 MTDS proposes Strategy 1(S1) as the optimal strategy. The results of the cost and risk analysis (Tables 15, 16 and 17; Figures 10, 11 and 12) reveal that Strategy 1 of the 2018 MTDS is the most favorable going forward in terms of all indicators. This strategy is realistic in terms of managing the large repayments falling due for both domestic and external debt in the medium term. The strategy also provides an opportunity to extend the debt maturities for the overall debt which will improve the average time to maturity of the overall debt.

83. Strategy 1 involves increased borrowing of semi concessional loans. The external debt comprising 57 per cent of gross borrowing while 43 per cent comprise of the domestic borrowing. On the external debt, concessional is proposed at 23 per cent, semi-concessional 12 per cent and commercial 22 per cent. In this strategy, T-bonds will be the main source of net domestic financing, while T-bills will primarily be an instrument to manage government cash position. Considering the macroeconomic and domestic market environment issuance of medium term domestic debt through benchmark bonds is recommended.

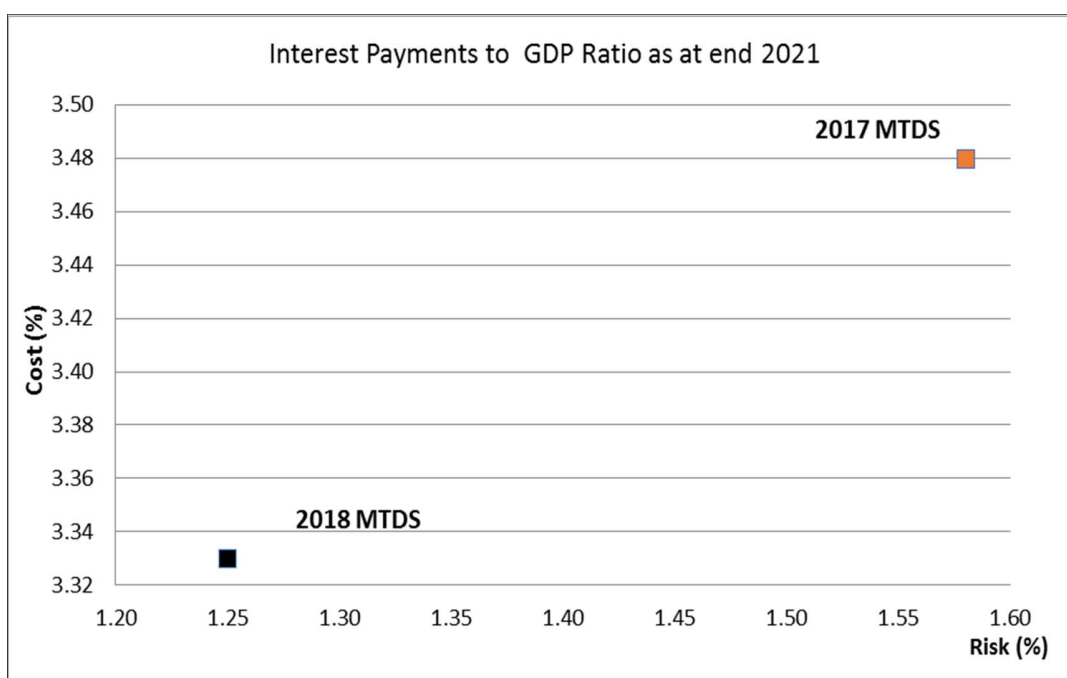
84. The analysis below gives the comparison on the recommended strategy in the FY 2017/18 (MTDS 2017): and the FY2018/19(MTDS 2018).

Table 15: Cost and Risk Analysis: MTDS 2017vis-à-vis MTDS 2018: Interest to GDP as at 2021

Scenarios	MTDS 2017	MTDS 2018
	%	%
Baseline	3.48	3.33
Exchange rate shock (30%)	3.77	3.65
Interest rate shock 1 (Moderate Shock)	4.50	4.08
Interest rate shock 2 (Extreme Shock)	5.06	4.58
Combined shock (15% depreciation and interest rate shock 1)	4.67	4.27
Max Risk	1.58	1.25

Source: National Treasury

Figure 10: Interest Payments to GDP Ratio as at end FY2020/21



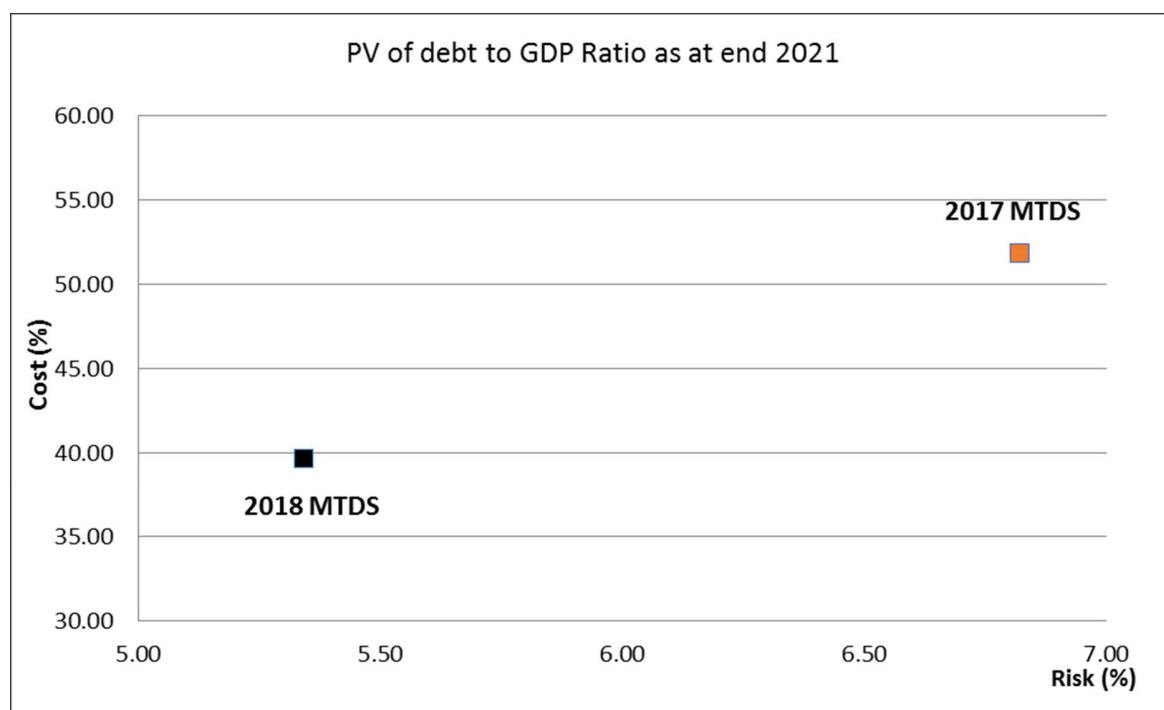
Source: National Treasury

Table 16: Cost and Risk Analysis: MTDS 2017 vis-à-vis MTDS 2018: PV of Debt to GDP as at 2021

Scenarios	MTDS 2017	MTDS 2018
	%	%
Baseline	51.92	39.75
Exchange rate shock (30%)	58.75	45.08
Interest rate shock 1 (Moderate Shock)	52.10	41.06
Interest rate shock 2 (Extreme Shock)	52.15	41.92
Combined shock (15% depreciation and interest rate shock 1)	55.52	43.81
Max Risk	6.82	5.34

Source: National Treasury

Figure 11: PV of Debt to GDP Ratio as at end FY2020/21



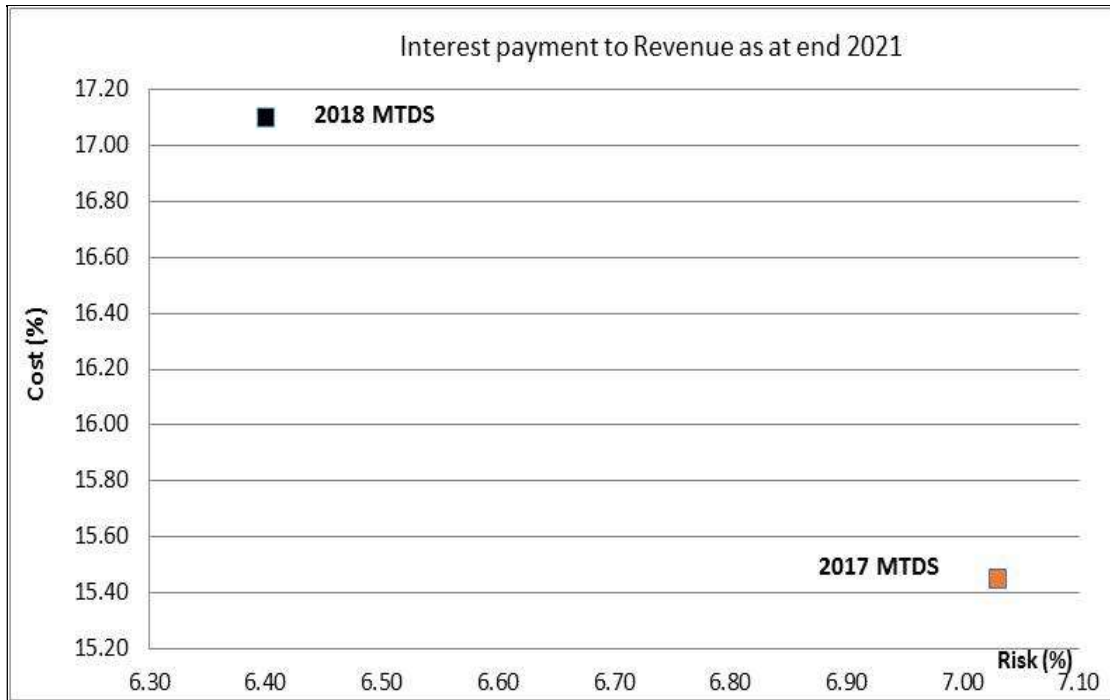
Source: National Treasury

Table 17: Cost and Risk Analysis: MTDS 2017 vis-à-vis MTDS 2018: Interest to Revenue Ratio as at 2021

Scenarios	MTDS 2017	MTDS 2018
	%	%
Baseline	15.45	17.1
Exchange rate shock (30%)	16.76	18.7
Interest rate shock 1 (Moderate Shock)	19.98	20.9
Interest rate shock 2 (Extreme Shock)	22.47	23.5
Combined shock (15% depreciation and interest rate shock 1)	20.74	21.9
Max Risk	7.03	6.4

Source: National Treasury

Figure 12: Interest to Revenue Ratio as at 2021



Source: National Treasury

IX. DEBT SUSTAINABILITY

85. The Kenya Government through the National Treasury endeavours to maintain public debt and obligations at sustainable levels in line with section 15 (2) (d) of the Public Finance Management (PFM) Act 2012. Public debt sustainability is the ability of a country to service its debt obligations as they fall due without disrupting its budget implementation.

86. In the Debt Sustainability Framework (DSF), 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 performer and being a lower middle-income country it is subject to public debt sustainability threshold of **74 percent**⁶ PV of Debt/GDP.

a. Kenya's External Debt

87. Under the baseline scenario, Kenya's debt ratios listed in Table 18 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 18: Kenya's External debt sustainability

Indicator s	Thresholds	2017	2018	2019	2026
PV of debt-to-GDP ratio	50	22.6	22.5	21.4	18.3
PV of debt-to-exports ratio	200	137.9	132.2	124.1	103.5
PV of debt-to-revenue ratio	300	108.7	104.7	98.9	82.8
PPG Debt service-to-exports ratio	25	15.2	9.2	13.8	12.2
PPG Debt service-to-revenue ratio	22	12.0	7.3	11.0	9.8

Source: IMF Country Report No. 17/25, February 2017

⁶ The EAC public debt convergence criterion for PV of Debt/GDP is 50 percent to be achieved by 2021.

b. Total Public Debt

Kenya's public debt sustainability threshold on PV of Debt/GDP as a strong performer and a low middle-income country is **74 percent**⁷.

88. Under the baseline scenario shown in Table 19, the PV of public debt-to-GDP, decreases from 49.0 percent in 2017 to 47.1 percent of GDP by 2019. In the long term, the PV of public debt-to-GDP is expected to decline to about 35.6 percent by 2026. Given Kenya's relatively strong revenue performance, the PV of public debt-to-revenue ratio would gradually decline from 235.7 percent in 2017 to about 217.4 percent in 2019. Going forward, the debt service-to-revenue ratio is expected to decline from 35.8 percent in 2017 to about 24.3 percent in 2026. Overall, the results from the DSA indicate that Kenya's public debt remain sustainable over the medium term.

Table 19: Public debt sustainability

Indicator	Threshold	2017	2018	2019	2026
PV of public sector debt to GDP ratio	74	49.0	48.6	47.1	35.6
PV of public sector debt-to-revenue ratio	300	235.7	226.6	217.4	161.4
Debt service-to-revenue ratio	30	35.8	30.5	33.4	24.3

Source: IMF Country Report No. 17/25, February 2017

89. In Table 20, a worst-case scenario, a "borrowing shock" scenario is presented which assumes Government borrowing 10 percent of GDP in FY2016/17. The results indicate that in the medium term, one of the debt burden indicators will lead to a temporary breach. However, this ratio is expected to remain within sustainability threshold given the Government commitment to implement ongoing fiscal consolidation.

⁷ The EAC public debt convergence criterion for PV of Debt/GDP is 50 percent.

Table 20: Sensitivity Analysis for Key Indicators of Public Debt

Indicator	Threshold	2017 ratios	Impact of 10% of GDP increase in borrowing in 2017 on debt indicators in 2018
PV of Debt as % of GDP	74	49.0	58
PV of Debt as % of Revenue	300	235.7	272
Debt Service as % of Revenue	30	35.8	35

Source: IMF Country Report No. 17/25, February 2017

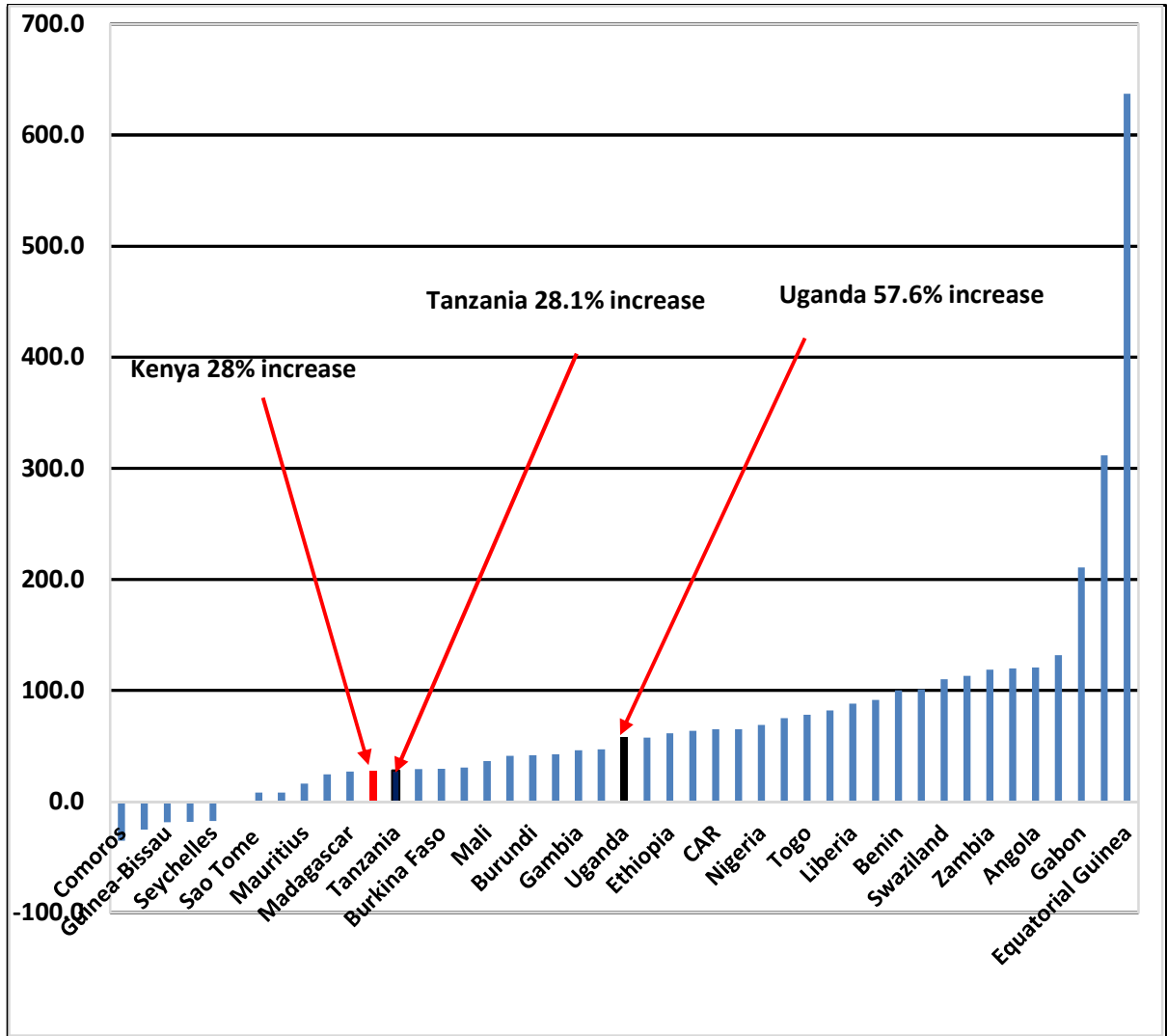
90. Kenya's rate of debt accumulation a percentage of GDP has been low compared to her peers in the African region as shown in Table 21 and Figure 13. Kenya's debt to GDP ratio increased by 28% over the last 5 years (2012-2017), while most of her peers' debt increased relatively by higher proportions.

Table 21: Government Debt as Percentage of GDP 2012-2017

	2012	2013	2014	2015	2016	2017	% change (2012-2017)
Comoros	42.6	17.8	23.3	25.6	32.1	27.6	-35.2
Democratic Republic of the Congo	22.7	20	17.5	16.1	16.8	17	-25.1
Guinea-Bissau	53.1	54.7	52.3	49	47.3	43.3	-18.5
Botswana	18.9	17.5	17.3	16.4	15.5	15.5	-18.0
Seychelles	80.1	68.2	72.7	67.7	69	66.2	-17.4
Eritrea	127.6	128.4	126.5	127.1	125.5	127.4	-0.2
Sao Tome and Principe	81	71.1	69.6	86	94	87.5	8.0
Cote d'Ivoire	45	43.4	44.8	47.8	47.8	48.7	8.2
Mauritius	51.5	53.9	57.5	62.3	61.5	59.9	16.3
Malawi	43.9	59.3	55.2	61.1	60.2	54.7	24.6
Madagascar	33	33.9	34.7	35.5	38.7	41.9	27.0
Kenya	43.9	44	48.5	51.6	52.6	56.2	28.0
Tanzania	29.2	30.9	33.8	36.7	37.2	37.4	28.1

	2012	2013	2014	2015	2016	2017	% change (2012- 2017)
South Africa	41	44.1	47	49.3	51.7	53	29.3
Burkina Faso	28.2	28.8	30.6	33.4	35.7	36.5	29.4
Lesotho	35.4	37.8	42.1	49.7	47.6	46.3	30.8
Mali	25.4	26.4	27.3	30.7	35.9	34.7	36.6
Cabo Verde	91.1	102.5	115.9	126	129.7	128.8	41.4
Burundi	41.4	36.1	35.8	46.1	48	58.8	42.0
Senegal	42.8	46.9	54.4	56.9	60.6	61.1	42.8
Gambia	77	83.3	104.9	105.3	120.2	112.7	46.4
Ghana	47.9	57.2	70.2	72.2	73.4	70.5	47.2
Uganda	24.5	27.6	30.7	33.3	37.3	38.6	57.6
Guinea	27.2	34	35.1	42.1	42.9	42.9	57.7
Ethiopia	36.9	42.4	46.3	60	57.9	59.7	61.8
Sierra Leone	36.8	30.5	35	45.3	55.9	60.3	63.9
Central African Republic (CAR)	23.5	38.5	54.8	51.1	44.3	38.8	65.1
Chad	28.8	30.5	39.4	43.3	51.2	47.6	65.3
Nigeria	12.6	12.4	12.5	13.2	17.6	21.3	69.0
Namibia	23.7	24.2	25.5	39.4	40	41.5	75.1
Togo	44.7	56.4	65.2	75.6	80.8	79.7	78.3
Zimbabwe	38.8	48.3	49.6	51.9	69.7	70.7	82.2
Liberia	27	27.5	33.2	39.5	45	50.8	88.1
Niger	26.9	26.3	32	41	43.6	51.5	91.4
Benin	26.7	25.3	30.5	42.4	50.3	53.4	100.0
Rwanda	20	26.7	29.1	33.4	37.6	40.2	101.0
Swaziland	14.8	15.3	14.3	18.5	25.2	31.1	110.1
South Sudan	8.9	17.6	34.8	65.7	33.1	19	113.5
Zambia	25.4	27.1	35.6	61.4	60.5	55.6	118.9
Mozambique	40.1	53.1	62.4	88.1	113.6	88.2	120.0
Angola	29.5	32.9	40.7	65.4	75.8	65.1	120.7
Cameroon	15.4	19	26.2	34.2	35.2	35.7	131.8
Gabon	21.4	31.1	34.1	44.7	64.2	66.5	210.7
Republic of the Congo	28.6	34.2	46.8	96.3	115	117.7	311.5
Equatorial Guinea	7.3	6.1	11	28.1	38.4	53.8	637.0
Sub Saharan Africa	28.4	29.9	32.3	38.3	43.2	45.1	58.8

Figure 13: Accumulation of Government Debt (Percent of GDP)



X. IMPLEMENTING THE 2018 MTDS

91. The *2018 MTDS* (Strategy 1) will be implemented through preparing a borrowing plan that meets the funding requirements of the Government for the fiscal year 2018/19. The cash flow plan will be prepared by the National Treasury to provide a basis for the projected annual borrowing plan. The borrowing plan will take into account the desired composition assumed in the MTDS analysis. The information of the Government's domestic borrowing plan is disseminated to the market through the *Consultative Forum for Domestic Debt Market (CDDDM)*.

92. The *2018 MTDS* provides a clear set of assumptions and some information on key risk parameters that are associated with the Strategy (S1) (Table 9). The implementation of the strategy will be monitored throughout the fiscal year. In case there are changes in the macro environment which lead to substantial discrepancies as assumed by the MTDS analysis, the strategy will be revised.

93. The institutional arrangement for public debt management as envisaged in the PFM Act, 2012 has been established and the government will continue to strengthen it and provide the necessary support to ensure there is capacity to manage the debt levels.

94. The Government will ensure there is transparency on debt management in accordance with best international practice through provision of accurate and timely information on public debt through various publications. This is important to the public for accountability purposes and to investors for sovereign risk assessment.

95. The Government will continue working with partners, such as the US Treasury, the IMF, the World Bank, IFC, MEFMI and the Commonwealth Secretariat to continue with its reforms in the financial sector in a bid to deepen the domestic market, corporate bond markets, capacity building and improve efficiency in the debt management.

XI. CONCLUSION

96. The 2018 MTDS strategy provides for a systematic approach to decision making on the desired mix of domestic and external borrowing to finance the budget in the financial year 2018/19, taking into account both cost and risk. The cost-risk trade-off has been evaluated within the medium term framework.

97. 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.

98. The 2018 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 to maximize the concessional debt already contracted, contract more semi concessional external debt with the issuance of medium to long term domestic debt.

99. This is the tenth time that the Government is formally presenting the Medium Term Debt Management Strategy and the fifth time as per the PFM Act, 2012 requirements. The Government is committed to transparency and accountability in public debt management.
