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Republic of Kenya

THE NATIONAL TREASURY

**Medium Term  
Debt Management Strategy  
2014**

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February 2014



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## FOREWORD

The importance of countries to pay serious attention to management of public debt is evident from the serious consequences on the global economy arising from the Eurozone debt crisis. Many African countries also went through a similar experience about ten years ago and they had to be rescued under the Highly Indebted Poor Countries (HIPC) initiative. Fortunately, for Kenya, Public debt has been managed prudently over the years and this trend should be maintained.

The Constitution and the Public Finance Management Act, 2012 provide the needed framework to ensure our country continues with prudent debt management. The PFM Act, 2012 has provision for the National Treasury to establish a Debt Management Office (DMO). Strict procedures, accountability and reporting requirements have been laid down for both National and County Government on public debt management.

The Medium Term Debt Management Strategy (MTDS) is one of the important deliverables of the National Treasury as provided under the PFM Act, 2012. It provides guidance to the National Government on the amount and type of borrowing to undertake over the medium term. It evaluates the costs and risks of various scenarios and recommends an optimal strategy for implementation. The *2014 MTDS* is aligned to the broad strategic priorities and policy goals set out in the Budget Policy Statement to be tabled in Parliament in February 2014.

As the County Governments become more established, caution is required before they consider borrowing. Many of them have inherited substantial liabilities. It should be underscored that even if the National Government takes over to write off the debts, this will require Kenyans to forego other critical



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services. It is therefore important to avoid this trend and contract loans for projects which are beneficial to the counties and which are able to generate income for servicing.

The National Treasury will develop guidelines for engagement between the Development Partners, Counties and the National Government to ensure proper co-ordination not only on the area of loans but also in grants and on other forms of Aid. The staff in the DMO will carry out workshops and visit the counties to assist in the preparation of the county MTDS as required by the law.

A handwritten signature in black ink, appearing to read 'Henry Rotich', is written over the typed name below.

**HENRY ROTICH  
CABINET SECRETARY  
THE NATIONAL TREASURY  
FEBRUARY 2014**

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## ACKNOWLEDGEMENT

This is the sixth Medium Term Debt Management Strategy (MTDS) to be tabled in Parliament. This is however, the second MTDS to be tabled under the requirement of Public Finance Management (PFM) Act, 2012.

The MTDS sets out the debt management strategy of the National Government over the medium term with respect to actual and potential liabilities for both loans and guarantees given by the National Government.

The preparation of MTDS is a fairly technical process involving use of a tool to analyze data inputs to produce scenarios from which an optimal borrowing strategy is determined. The preparation of MTDS in Kenya and indeed many other developing countries has benefited greatly from the World Bank and Commonwealth Secretariat. These institutions provide support for capacity building as well as constantly improving the tool to produce better results. I take this opportunity to express GoK appreciation for the continued assistance.

As required by the PFM Act 2012, the MTDS will be formally submitted to the Commission on Revenue Allocation (CRA) who will ensure sound borrowing principles are adopted in the counties.

To ensure wide circulation of the MTDS, it is available in the Treasury Website: [www.treasury.go.ke](http://www.treasury.go.ke). However, in view of the fact that the document is technical, a brief non-technical summary will also be distributed and posted on the website.

Let me take this opportunity to acknowledge the staff of the Debt Management Department, National Treasury who were involved in the preparation of the *2014 MTDS*. Specifically, the

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core team comprising of Mr. Charles Kairu, Ms Racheal Njoroge, Mr. Bernard Gibet and Mr. Robert Osudi under the guidance of Mrs. Felister Kivisi – Ag. Director, Debt Management Department.



**DR. KAMAU THUGGE, EBS  
PRINCIPAL SECRETARY  
THE NATIONAL TREASURY  
FEBRUARY 2014**

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## **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 15<sup>th</sup> 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 and publish and publicize the statement.

## LIST OF ABBREVIATIONS

ADB	African Development Bank
ADF	African Development Fund
ATM	Average Time to Maturity
BoP	Balance of Payments
BPS	Budget Policy Statement
CBK	Central Bank of Kenya
CBR	Central Bank Rate
CPI	Consumer Price Index
CPIA	Country Policy and Institutional Assessment
CS-DRMS	Commonwealth Secretariat Debt Recording and Management System
DGIPE	Department of Government Investment and Public Enterprises
DMD	Debt Management Department
DSA	Debt Sustainability Analysis
DX	Domestic currency denominated debt
EAC	East African Community
ECF	Extended Credit Facility
EEC	European Economic Community
EIB	European Investment Bank
EMBI	Emerging Markets Bond Index
ERD	External Resources Department
FX	Foreign currency denominated debt
FY	Financial Year
GDP	Gross Domestic Product
IDA	International Development Association
IFB	Infrastructure Bond
IFC	International Finance Corporation



IFMIS	Integrated Financial Management Information System
IMF	International Monetary Fund
ISB	International Sovereign Bond
Ksh	Kenya Shilling
LIC	Low Income Country
MEFMI	Macroeconomic and Financial Management Institute of Eastern and Southern Africa
MTDS	Medium Term Debt Strategy
NPV	Net Present Value
NSE	Nairobi Securities Exchange
NT	National Treasury
PFM	Public Financial Management
PPP	Public Private Partnerships
PV	Present Value
SDR	Special Drawing Rights
US	United States
USD	United States Dollars

## EXECUTIVE SUMMARY

The key drivers for the *2013 MTDS* were a desire to minimize overall cost by issuing medium term domestic debt to reduce cost associated with longer dated securities and to further develop and deepen the domestic debt market. In contrast, *2014 MTDS* envisages an increased uptake of domestic debt than in previous years to meet the Central Government budget-financing requirement.

In 2013, the Government also highlighted the need to minimize the degree of foreign exchange rate risk exposure associated with the external debt portfolio by borrowing more concessional debt, while maintaining a limited window for borrowing on commercial terms to minimize costs and refinancing risks. The *2014 MTDS* emphasizes that financing on non-concessional window will be limited to projects with high-expected risk-adjusted rates of return including critical infrastructure that would otherwise not be undertaken due to lack of concessional financing.

The *2013 MTDS* reaffirmed Government's commitment in realizing its objective of development of the domestic debt market. Arising from expenditure pressures, the original borrowing target of Ksh 106.7 billion was raised to Ksh 135.7 billion. The performance of the market has demonstrated the depth of the market with over-subscriptions for most of the government securities offered.

While the thrust of the *2013 MTDS* remained unchanged, the increased level of domestic borrowing led to increased refinancing risk. The average time to maturity remained constant at 4.9 years and the proportion of domestic debt to be refinanced within 12 months increased to 20 percent at end June 2014 from 18 percent the previous year.

Managing refinancing risk remains a priority for the *2014 MTDS*. Active debt management operations to smooth the refinancing profile, along with efforts to maintain a wider investor base have been instrumental in mitigating potential fiscal shocks, such as, impact of drought on food security, realization of contingent liabilities, or shortfall in revenues, the country continues to face.



The rapid growth of domestic debt and increase in interest expense rates on government securities poses major risk on debt sustainability. To mitigate these risks, there is need to explore the possibility of a switch from domestic to external debt. However, there is also concern that a sudden and aggressive shift from domestic debt could risk reversing some of the gains that previous debt strategies have achieved in terms of market deepening. In addition, while increasing the exposure to exchange rate risk would have a relatively limited budgetary impact in the short-term; it would aggravate the risk that the main fiscal anchor, the PV of Debt/GDP would exceed the ceiling of 74 percent in the event of shocks. This risk is real given the steep depreciation of the shilling witnessed in 2011 when the Shilling weakened to exchange at a historic low of Ksh 107 per USD in mid-October 2011.

With regard to external borrowing, the Government prefers concessional external financing while maintaining a limited window for borrowing on commercial terms to minimize costs and refinancing risks. Financing on non-concessional terms will be on exceptional basis and will be biased towards projects with high-expected risk-adjusted rates of return including critical infrastructure that would otherwise not be undertaken due to lack of concessional financing. A cautious approach will be adopted in the issuance of external Government loan guarantees to minimize the level of contingent liabilities.

Given aforementioned concerns related to both domestic and external borrowing, the performance of four alternative strategies relative to 2013 *MTDS* (“S2”) was evaluated. These included a strategy envisaging an aggressive switch to external official sector borrowing, accompanied by lengthening of maturities in the domestic market (“S2”). Apriori, this strategy was expected to have very attractive cost and risk characteristics. However, given the potential challenges in achieving the target level of external borrowing, three (3) alternative strategies were also considered - two envisaging relatively more domestic debt (“S3” with a bias to short-term debt to medium term debt) and “S4” with a continued bias toward medium-term debt) and a strategy that proposes contracting of a higher proportion of semi-concessional external financing. (“S5”).

In selecting the optimal strategy, two key indicators were considered – ratio of interest payments to GDP (*Interest/GDP*) and ratio of PV of Debt to GDP (*PV of Debt/GDP*). As anticipated, “S2” **outperforms all other strategies**. The refinancing risk was higher under “S4”. The strategy could not accommodate significant amounts of short to medium term domestic debt, thus the potential risk of losing the retail investor base. In terms of *Interest/GDP*, “S5” entails a higher cost and risk than “S3”. This reflects the relatively longer-tenor of domestic debt involved. However, once *PV of Debt/GDP* is considered, “S5” becomes less attractive, and aggravates the risk of breaching the 74 percent ceiling. This strategy exposes the portfolio to relatively high exchange rate and refinancing risks. Whereas these risks could be mitigated by use of a sinking fund, this approach has cost implications.

The 2014 MTDS presents “S2” as the **optimal strategy** after taking into account both cost and risk considerations, the need to develop the domestic debt markets and the feasibility of implementing the strategy over the medium term. The strategy comprises of the following actions:

- **60%** net domestic borrowing and **40%** net external borrowing to finance the central government budget;
- Considering macro-economic and domestic market environment **issuance of medium term domestic debt is recommended**
- External borrowing will comprise of **26%** on concessional terms and, **14%** on semi concessional terms.
- There will be no issuance of **an International Sovereign Bond during the year**.

**The Government is committed to maintain debt within sustainable levels.** Kenya has just concluded a three-year Extended Credit Facility (ECF) arrangement with the International Monetary Fund (IMF) in which the Government intended to raise real GDP to 7 percent, lower the nominal public debt to GDP ratio to below 45 percent and maintain inflation at 5 percent over the medium term. The Government is keen to maintain the economic indicators at the levels set while on the ECF programme.

Consistent with the principles of public finance in the Constitution of Kenya, 2010 (Section 201), the Government will seek to widen outreach of the *2014 MTDS*. A domestic borrowing plan anchored on government cash flow requirements will be developed for implementation, monitoring and evaluation. The Government will also actively monitor the key macroeconomic indicators and interest rates against those assumed in the analysis. Any significant and sustained change will trigger the need for revision of the strategy. The underlying cost-risk analysis also identifies a range of risk indicators consistent with the adopted strategy. These provide a set of strategic targets against which the portfolio will be assessed on a regular basis to ensure the strategy remains on track.

Availability of comprehensive and accurate information on a regular basis is critical in managing investors' sovereign risk assessment and the cost of debt. The Government will seek to publish public debt information on a regular basis to enhance transparency on debt management in accordance with best international practice.

The Government continues to strengthen capacity in public debt management. The debt recording system will be upgraded from CS-DRMS 2000+ version 1.3; additional skilled staff posted to DMD while training in debt management techniques will be scaled up.



## I. OUTLINE OF THE 2014 MTDS

### **Objective of Debt Management in Kenya**

1. The next section (II) outlines the basis on which the 2014 MTDS is prepared. It provides the intention of the Government for the FY 2014/15.

### **Recent Developments**

2. Section III provides an overview of the recent economic developments in both the domestic and external front.

### **Characteristics of Kenya's Public Debt**

3. Section IV describes the salient features of Kenyan's outstanding public and publicly guaranteed debt. It provides guidance on how to deal with the cost and risk considerations of the debt portfolio.

### **2014 MTDS: Key assumptions**

4. Section V outlines the fiscal framework that is supportive of growth over the medium-term, while continuing to provide adequate resources to facilitate development of the county governments while at the same time ensuring that the public debt is sustainable. It also highlights the future financing and pricing assumptions.

### **Outcomes of Analysis of Strategies**

5. Section VI gives the performance of the five alternative strategies in terms of their relative cost and risk..

### **Debt Sustainability**

6. Section VII provides the debt sustainability thresholds for Kenya which is currently ranked as a strong policy performer using the World Bank's *Country Policy and Institutional Assessment* (CPIA) index.

### **Implementing the 2014 MTDS**

7. Section VIII outlines the commitment of Government in implementing the 2014 MTDS. It also provides the engagements the Government intends to undertake.

## **Conclusion**

8. Section IX concludes.

## II. OBJECTIVE OF DEBT MANAGEMENT IN KENYA

9. The principal objective of Government debt management is to meet the Central Government financing requirements at the least cost with a prudent degree of risk. The secondary objective is to facilitate Government's access to financial markets and support development of a well-functioning vibrant domestic debt market.

10. In 2013, the National Treasury (NT) through the Debt Management Department (DMD) prepared a formal debt management strategy, the *2013 MTDS*, which outlined the Government Medium Term Debt Strategy for the period FY2013/14-FY2015/16. The *2013 MTDS* was the Government's fifth formal and explicit strategy and was an important step towards enhancing transparency of the Government's debt management decisions. The MTDS was presented to Parliament as part of the Budget Documents by the Cabinet Secretary for Finance. To institutionalize the production of the debt strategy, the publication of the MTDS has been provided for under the Public Finance Management Act, 2012.

11. The *2014 MTDS* will guide the Government debt management operations in the FY2014/15. The strategy seeks to balance cost and risk of public debt while taking into account Central Government financing needs. In addition, the strategy incorporates initiatives to develop the domestic debt market, seek new funding sources, support macroeconomic stability and achieve debt sustainability.

### **III. RECENT DEVELOPMENTS**

#### **a) Development in the Domestic Debt Market**

12. The government has continued to pursue the twin objectives of developing a deep and liquid domestic market since the development of the first MTDS in June 2009. The development of the *2013 MTDS*, reaffirmed the government's commitment in realizing its objective of deepening the domestic debt market.

13. The interbank interest rates rose to 12.19 percent in December 2013 from 6.01 percent in November 2012. The rise in short-term interest rate reflects increased inflationary expectation and tight liquidity in the financial system. The 91-day Treasury bill rates dropped marginally from 9.8 percent in November 2012 to 9.53 percent in December, 2013.

14. Recent downwards adjustment of the CBK policy rate (CBR) from 11 percent in December 2012 to 9.5 percent in January 2013 and to 8.5 percent in May 2013 and maintaining it at 8.5 percent as at January 2014 has led to reduction in short term interest rates, save for the commercial banks' lending rates which have remained stuck at about 20 percent, reflecting the high spread between the lending and deposit rates which has led to an increased investment in Government securities by retail investors. Meanwhile, the Government borrowing programme has progressed as planned with the cost declining as evidenced by the marginal decline in Treasury bill rates.

15. To confront the challenges of revenue shortfall and expenditure pressures, the Government will step up efforts on tax administration and mobilization of revenue to eliminate leakages and increase revenue collection as targeted in the FY 2013/14, as well as cut and rationalize expenditure so as to remain within the revised domestic borrowing ceiling of Ksh. 135.7 billion.

#### **b) External Financing**

16. The Government policy on external borrowing is to be analyzed in light of the ever-changing domestic and international macroeconomic conditions. In the 2013 MTDS, the Government's preference remained for concessional external financing and provision of a limited window for borrowing on commercial terms to minimize costs and refinancing



risks. Financing on non-concessional terms is restricted to projects with high-expected risk-adjusted rates of return including critical infrastructure such as energy. To support Government's economic and financial reforms, Kenya entered into a three-year Extended Credit Facility (ECF) arrangement with the International Monetary Fund (IMF) in January 2011 and the arrangement ended in January 2014. The program aimed at boosting the level of official foreign exchange reserves while supporting efforts for a gradual fiscal adjustment over a three-year horizon. The Government's intention under the ECF program is: i) to raise real GDP to 7 percent; ii) bring the public debt to GDP ratio to below 45 percent over the medium term; and iii) keep inflation at 5 percent while maintaining a floating rate regime. The Government intends to maintain the economic indicators at the levels set while on the ECF programme.

17. Performance of external financing, on a net basis, has been below target in recent years. In addition, the Government has seen new external commitments entered on relatively harder terms, that is, closer to the 35 percent grant element threshold for 'soft' loans. However, the overall concessionality has remained relatively unchanged given the high grant element of IDA loans, the leading source of multilateral loans.

18. The domestic debt market has proved an effective source for providing longer-dated funds for investment for the private sector through corporate Infrastructure Bonds (IFBs). One of the objectives of the Euro Bond to be issued in FY 2013/14 is to act as a benchmark for the corporates who may wish to access external funding.

19. In financial year 2011/12, a 2 year commercial banks syndicated loan facility of up to Ksh 52 billion (USD 600 million equivalent) was negotiated as an alternative source of financing the budget following the low uptake of Government securities by investors. The foreign currency inflows from the borrowing eased pressure on domestic interest rates added to the official foreign exchange reserves position and reduced pressure on the Kenya shilling exchange rate. It is envisaged that the syndicated loan will be repaid with proceeds of the Euro bond. However, the Government is exploring the possibility of rolling over the syndicated loan for three (3) years.



### **c) Guarantees**

20. The energy sector has been the primary driver for the rise in contingent liabilities in form of government guarantees. The government, in collaboration with its development partners has increased its efforts towards promotion of Public Private Partnership arrangements (PPP) in the energy sector and encouraged use of non-state guarantees from multilateral agencies like MIGA to minimize the level of explicit guarantees to maintain public debt within sustainable levels. Under the agreed framework, the World Bank and African Development Bank have been issuing Partial Risk Guarantees to provide payment security to the investors and lenders to be backstopped by Government Letter of Support. More than five Independent Power Producers have been provided with security under this framework. The key advantage under this framework is that the level of contingent liabilities reported for public debt statistics is reduced to 25% compared to 100% if the government were to issue a guarantee.

21. The demand for explicit guarantees is likely to increase in the medium term as the country implements a devolved system of governance under the Constitution of Kenya, 2010. It is required under the PFM Act that in order to borrow, County governments must be guaranteed by the National Government and hence the level of guarantees will rise. However, it is expected that county governments will exercise fiscal restraint in borrowing. Many of the counties have inherited debts, which may prove difficult to pay, and hence the PFM Act requires elaborate procedures before a guarantee can be issued to prevent contracting of debts that prove difficult to pay later.

22. A process to establish the level of contingent liabilities, as well as a World Bank funded management mechanism under the Public Private Partnership framework is ongoing under the Department of Government Investment and Public Enterprises and Public Private Partnership (PPP) Unit, respectively. The Transition Authority is also working to establish the debts held in the counties.

## IV. CHARACTERISTICS OF KENYA'S PUBLIC DEBT

### a) Stock of Debt

23. The stock of public and publicly guaranteed debt is projected at Ksh 2,221.3 billion or 53.3 percent of GDP in nominal terms as at end June 2014. In addition, the structure of the debt portfolio is projected to be 48 percent external debt and 52 percent domestic debt, respectively (Table 1(a)-1(c) and Figure 1, Chart 1).

24. The analysis done in the preparation of the 2014 MTDS excludes disputed external commercial debt, which is currently not being serviced.

**Table 1(a): External and Domestic Debt, End June 2013**

	USD Billion	Ksh Billion	Percent of GDP	Share of total debt (%)	Weighted average interest rate (%)
Domestic debt (gross)	12.2	1,050.6	28.7	55.5	4.0
External debt	9.8	843.6	23.0	45.5	1.1
o/w Guarantees	0.5	43.5	1.2	2.3	0.1
<b>Total debt</b>	<b>22.0</b>	<b>1,894.2</b>	<b>51.7</b>	<b>100</b>	<b>2.9</b>

*Source: National Treasury and IMF/WB estimates*  
*GDP: Ksh 3,662.6 billion*

**Table 1(b): External and Domestic Debt, End December 2013**

	USD Billion	Ksh Billion	Percent of GDP	Share of total debt (%)	Weighted average interest rate (%)
Domestic debt (gross)	13.8	1,189.2	29.2	56.3	4.6
External debt	10.7	922.4	22.6	43.7	1.3
o/w Guarantees	0.5	43.6	1.1	2.1	0.1
<b>Total debt</b>	<b>24.5</b>	<b>2,111.6</b>	<b>51.8</b>	<b>100.0</b>	<b>3.2</b>

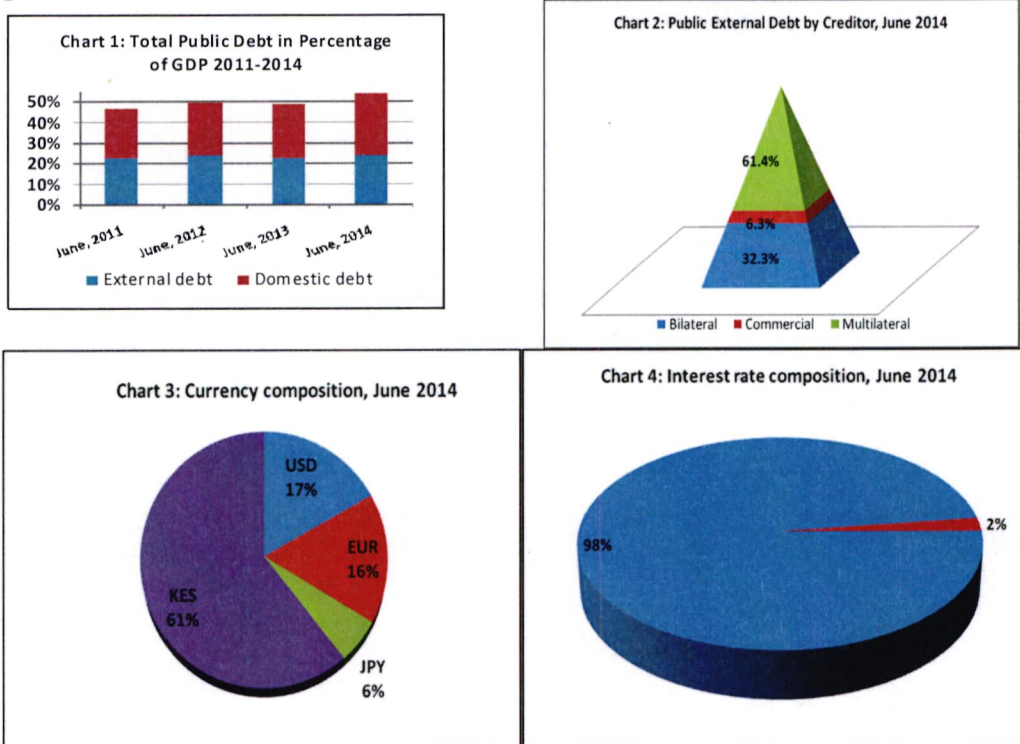
*Source: National Treasury and IMF/WB estimates*  
*GDP: Ksh 4,075.2 billion*

**Table 1(c): Projected External and Domestic Debt, June 2014**

	USD Billion	Ksh Billion	Percent of GDP	Share of total debt (%)	Weighted average interest rate (%)
Domestic debt (net)	14.2	1225.5	29.4	55.2	4.7
External debt	11.5	995.8	23.9	44.8	1.3
o/w Guarantees	0.6	51.8	1.3	2.4	0.1
<b>Total debt</b>	<b>25.7</b>	<b>2,221.3</b>	<b>53.3</b>	<b>100</b>	<b>3.0</b>

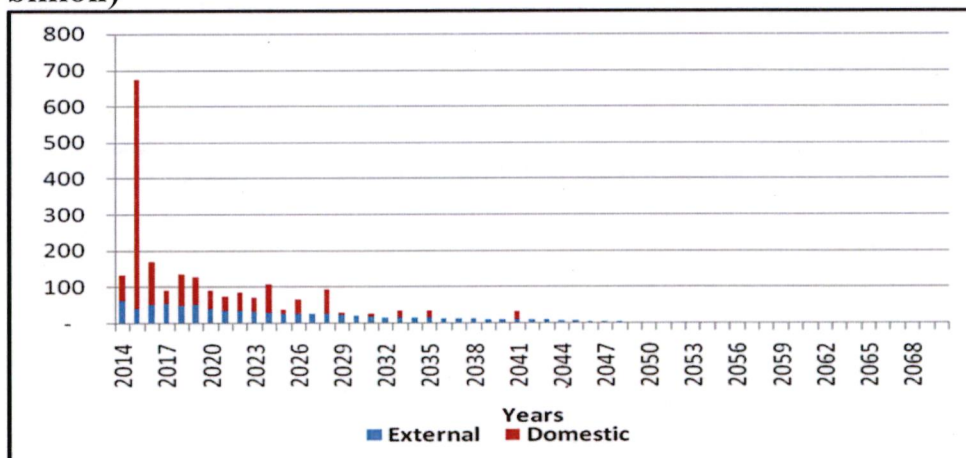
Source: National Treasury (BPS 2014) and IMF/WB estimates  
GDP: Ksh 4,164.6 billion

**Figure 1: Evolution and Composition of Public Debt**



Source: National Treasury and Central Bank of Kenya

**Figure 2: Total Debt Repayment Profile, End-June 2014 (Ksh billion)**



Source: National Treasury and Central Bank of Kenya



25. The huge spike noted in 2015 is attributable to the redemption of short term domestic debt contracted in FY 2012/13, mainly Treasury bills and 2 year Treasury Bonds.

## **b) Sources of Loans made to the National Government**

### **i. Domestic Sources of Loans**

26. Government domestic sources of loans consists of Government securities and Government Overdraft at Central Bank of Kenya. Government securities comprise of Treasury bills, Treasury bonds, Infrastructure bonds and the Pre-1997 Government Debt. The stock of outstanding Treasury Bonds increased from Ksh 744,174 million in June 2013 to Ksh 816,289 million in December 2013 while Treasury Bills increased from Ksh 267,211 million to Ksh 307,262 million over the same period as shown in Table 2 and Figure 3. The proportion of Treasury Bonds in total domestic debt decreased from 70.8 percent to 68.6 percent while Treasury Bills increased marginally from 25.4 percent to 25.8 percent during the period. The holding of domestic debt by commercial banks stood at 52.8 percent in December 2013 as shown in Table 3. They are the largest holders among all investor categories. The share of domestic debt held by non-bank investors is 47.2 percent at December 2013. As at end December 2013, the ratio of Treasury Bills to Bonds stood at 26:69 which is in accordance with the domestic debt borrowing strategy, with the Government seeking to achieve and maintain the ratio of Treasury Bills and Treasury Bonds at 30:70.

**Table 2: Domestic Debt Stock, Ksh Million**

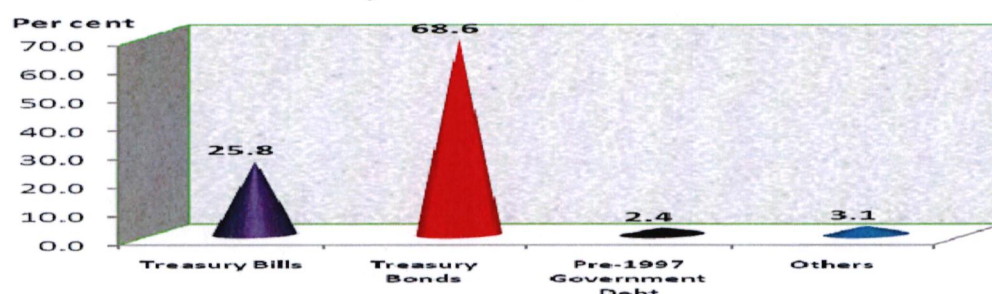
Instrument	June 2013		December 2013		Change
	Amount	%	Amount	%	
<b>Total Stock of Domestic Debt (A+B)</b>	<b>1,050,555</b>	<b>100</b>	<b>1,189,183</b>	<b>100</b>	<b>138,628</b>
<b>A. Government Securities(1-2)</b>	<b>1,040,274</b>	<b>99.0</b>	<b>1,152,440</b>	<b>96.9</b>	<b>112,166</b>
<b>1. Treasury Bills</b>	<b>267,211</b>	<b>25.4</b>	<b>307,262</b>	<b>25.8</b>	<b>40,051</b>
Banking Institutions	183,451	17.5	192,545	16.2	9,094
Others	83,760	8.0	114,717	9.6	30,957
<b>2. Treasury Bonds</b>	<b>744,174</b>	<b>70.8</b>	<b>816,289</b>	<b>68.6</b>	<b>72,115</b>
Banking Institutions	341,050	32.5	369,521	31.1	28,471
Others	403,124	38.4	446,768	37.6	43,644
<b>3. Pre-1997 Government Debt</b>	<b>28,889</b>	<b>2.7</b>	<b>28,889</b>	<b>2.4</b>	<b>-</b>
<b>B. Others<sup>1</sup></b>	<b>10,281</b>	<b>1.0</b>	<b>36,743</b>	<b>3.1</b>	<b>26,462</b>
Of which CBK Overdraft	6,999	0.7	34,187	2.9	27,188

Source: Central Bank of Kenya

**Table 3: Domestic Debt by Holder, Ksh Million, End December 2013**

Holder	June 2013		December 2013	
	Amount	%	Amount	%
<b>Banks</b>	<b>563,675</b>	<b>53.7</b>	<b>627,629</b>	<b>52.8</b>
Central Bank	39,170	3.7	64,620	5.4
Commercial Banks	524,505	49.9	563,009	47.3
<b>Non-Banks</b>	<b>486,880</b>	<b>46.3</b>	<b>561,554</b>	<b>47.2</b>
Non-Residents	13,083	1.2	10,277	0.9
Non-Bank Sources	473,797	45.1	551,277	46.4
<b>Total</b>	<b>1,050,555</b>	<b>100</b>	<b>1,189,183</b>	<b>100</b>

Source: Central Bank of Kenya

**Figure 3: Domestic Debt by Instrument, December 2013**

Source: Central Bank of Kenya

<sup>1</sup> Others consist of CBK Overdraft to GoK, cleared items awaiting transfer to PMG, commercial bank advances and Tax Reserve Certificates.



**ii. External Sources of Loans**

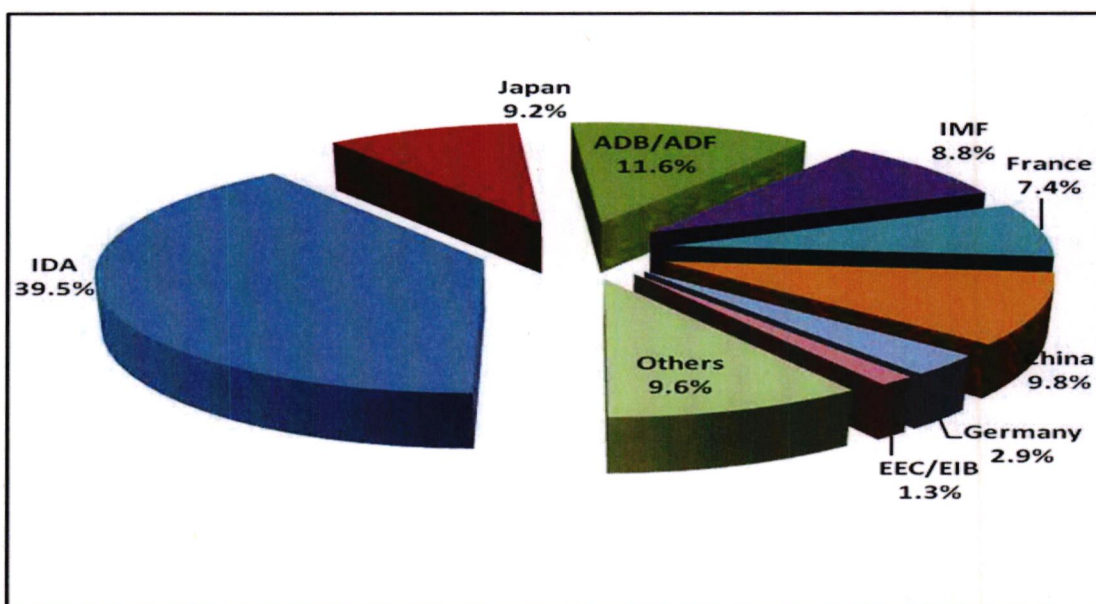
27. The main sources of financing are multilateral and bilateral creditors. As at end December 2013, multilateral concessional debts accounted for 61 percent of total external debt while bilateral creditors accounts for 31 percent. Commercial debt represents 8 percent of total external public debt.

28. The currency composition of external debt is relatively diverse. However, the largest share of foreign debt is denominated in USD and Euro (17 percent and 16 percent, respectively), with the Japanese Yen accounting for 6 percent (Figure 1, Chart 3). Kenya Shilling denominated debt accounts for 61 percent of total debt.

29. The interest rate composition of total debt stands at 98 percent fixed interest rates (Figure 1, Chart 4).

30. IDA, ADB/ADF and EEC/EIB are the main multilateral creditors as shown in Figure 4, accounting for 82 percent of outstanding multilateral debt as at end December 2013. IDA is the single biggest source of external resources, accounting for 62 percent of outstanding multilateral debt. In terms of bilateral creditors, Japan, France, China and Germany are the main creditors accounting for 87 percent of bilateral debt. China is the largest bilateral donor, accounting for 31 percent of bilateral debt.

**Figure 4: External Debt by Major Creditors, End June 2014**



Source: National Treasury

31. To facilitate financing of the expenditures that ordinarily would not be funded through multilateral and bilateral sources, the Government may resort to alternative financing sources including official Export Credit Agencies (ECAs). These agencies, which are state-owned assist their countries' exporters by providing them with financial and insurance services. The services offered by ECAs can be categorized as either buyer's or supplier's credits and their lending terms are mostly semi-concessional. Recent examples of ECA lending to Kenya include the financing of Biometric Voter Registration (BVR) kits for the March 2013 general elections by Standard Chartered Bank, London. The BVR kits were sourced from Canadian Commercial Corporation and the semi-concessional financing facility of USD 85 million was guaranteed and insured by the Canadian Export Credit agency, Export Development Canada (EDC). In the 2014 MTDS, this type of financing, principally for the SGR partial financing is catered for under the semi-concessional and commercial categories and will be considered within the non-concessional window.

### c) Cost/Risk Characteristics of Public Debt

32. Arising from the Government external debt strategy of contracting external loans on highly concessional terms to minimize interest rate cost, the average interest rate and grace period on new external loans contracted in financial year 2013/14 as at December 2013 was 0.7 per cent and 8.3 years, respectively. This profile, together with the long maturity of 34.4 years yields an average grant element of 79.8 per cent for new external loans (Table 4).

**Table 4: Average Terms for New External Loans**

<b>Terms</b>	<b>June 2013</b>	<b>December 2013*</b>
Interest rate (%)	1.2	0.7
Maturity (Years)	33.7	34.4
Grace period (Years)	8.0	8.3
Grant Element (%)	68.6	79.8

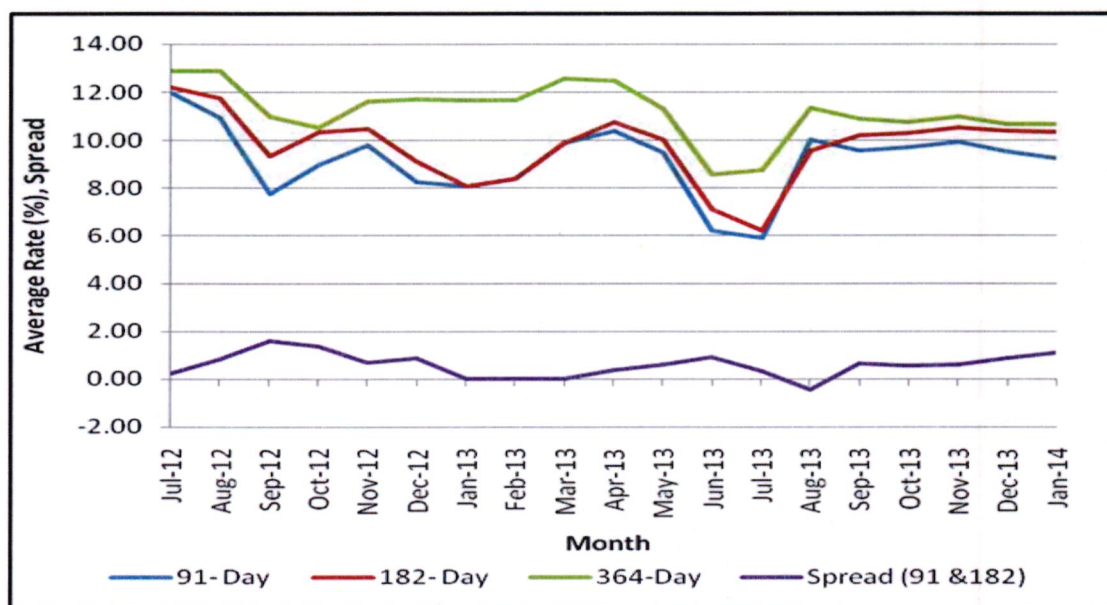
*\*Provisional*

*Source: National Treasury*



33. On the other hand, the average maturity profile of outstanding Government domestic debt has decreased from 5.2 years in June 2013 to 4.9 years in December 2013. The decline in years is attributed to increased issuance of Treasury Bills as opposed to Treasury Bonds. During the first half of the financial year 2013/14, average interest rates for Treasury Bills were on an upward trend in August 2013 but steadied between September to November 2013 before starting to dip in December 2013. As shown in Figure 5, the 91-day Treasury bill rate rose by 305 basis points from 6.21 percent in June 2013 to 9.26 percent in January 2014. Likewise, average interest rate for the 182-day Treasury bill went up by 323 basis points from 7.12 percent to 10.35 percent during the period while the average for the 364-day Treasury bill increased by 208 basis points from 8.57 percent in June 2013 to 10.65 percent in January 2014. The 91-day and 182-day Treasury Bills average rates act as reference interest rates for pricing other financial products, making adjustments to commercial banks' deposit and lending rates as well as structuring of investment portfolios.

**Figure 5: Trend in Domestic Interest Rates in 2013/14: Interest Rates on Treasury Bills, July 2012 – January 2014**



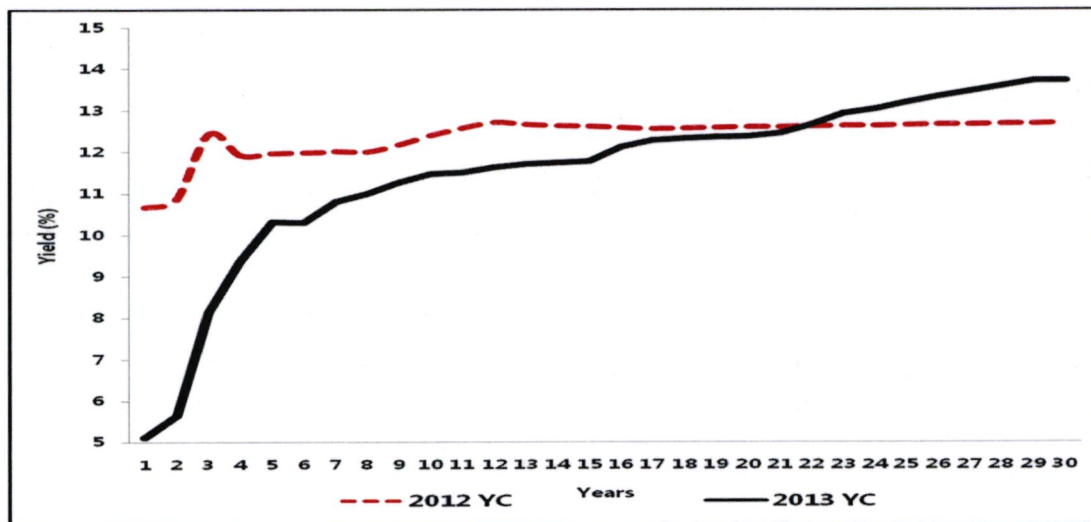
Source: Central Bank of Kenya

34. The Government securities trading yield curve depicts more or less a parallel and steady downward shift during the financial year indicating stability of pricing along the maturity profile. This movement is also in



line with trends in inflation during the year, which reflected on the confidence and certainty of the market. The yield curve reflects the risk premium associated with the uncertainty about the future rate of inflation and the risk this poses to the future value of cash flows.

**Figure 6: Government of Kenya Securities Yield Curve**



*Source: Central Bank of Kenya*

35. Refinancing risk in the debt portfolio remains significant but within tolerable limits. The Average Time to Maturity (ATM) of the total debt portfolio is projected at 8.6 years in June 2014 up from 7.8 years at end June 2013, with that of the domestic debt portfolio at 4.9 years (Table 5). The average maturity profile for external debt will decline marginally to 11.2 years in June 2014 from 11.3 years in June 2013, consistent with the hardening of terms on new external commitments. A close examination of the repayment profile indicate significant level of both refinancing and rollover risk with 26 percent of the domestic debt stock maturing in the next 12 months.

**Table 5: Cost and Risk Considerations of Debt Portfolio, End June 2014**

Characteristics of Existing Portfolio	Ex ante Risks	Ex ante Cost
<b>Currency composition</b> (FX = 39%; DX=61%)		
External, mostly concessional	Exchange rate risk	Low
Domestic	No exchange rate risk	High
<b>Maturity profile (ATM = 8.6 years)</b>		
External, mostly concessional (ATM =11.2 years)	Low refinancing risk	Low
Domestic (ATM = 4.9 years)	Medium refinancing risk	High
<b>Interest rate composition</b> (Fix=98%; Float=2%)		
	Low interest rate risk	

*Source: National Treasury and Central Bank of Kenya*

**d) Strategies to Deal with the Existing Public Debt**

36. **Going forward, the composition of the debt portfolio suggests that reducing refinancing risk should remain a priority for the 2014 MTDS.** In addition, although the extent of exchange rate risk is partially mitigated by the currency composition of external debt, given the sensitivity of the PV of Debt/GDP to exchange rate shocks, this suggests that the overall proportion of external debt should be carefully monitored. In particular, the assessment of the likely impact, and consequently, the relative importance of reducing exchange rate exposure, would change if the nature of external borrowing were to change (for example, if new debt was contracted on a bullet basis with shorter maturities, as is the case with the USD 600 million, 2-year bullet payment syndicated external commercial loan and the planned 10-year bullet USD 1,500 million Euro Bond).

37. Possible materialization of potentially large and unreported contingent liabilities has been identified as posing additional risk to the sustainability of public debt. Borrowing by state-owned entities with or without Government guarantees constitutes potential contingent liability to the Government. In the event of default on on-lent loans and guaranteed or non-guaranteed loans, Central Government will bear the cost of the debt. With the implementation of a devolved system of Government, the extent of contingent liabilities is expected to increase as liabilities of County Governments are taken into account. To mitigate this potential risk, the government will continue monitoring both explicit

and implicit liabilities to ensure they are maintained within sustainable levels.



**V. 2014 MTDS: KEY ASSUMPTIONS**

**a) Objectives and Scope**

38. In the *2014 MTDS*, the Government will continue pursuing the same broad objectives of funding the Central Government Budget while maintaining a prudent level of risk taking account of costs. This will be achieved through the diversification of external sources of financing and further lengthening the average time to maturity of the domestic debt portfolio.

39. The scope of the analysis of *2014 MTDS* is based on the combined Central Government debt and publicly guaranteed debt serviced by the Government. Guaranteed debt currently serviced by the Government amounts to USD 70.1 million or 0.7 percent of total public and publicly guaranteed (PPG) external debt.<sup>2</sup>

**b) Macroeconomic Environment and Risks**

40. The macroeconomic framework underpinning the MTDS is consistent with projections included in the *2014/15 Budget Policy Statement (2014 BPS)*. Fiscal policy will continue to support economic activity while allowing implementation of the new Constitution within a context of sustainable public financing. Over the recent years, the government has reoriented expenditure towards priority programmes in education, health, agriculture and infrastructure under the Medium-Term Expenditure Framework (MTEF). This process will be strengthened with a revamped legislative framework to enable accommodation of critical programmes that will accelerate socio-economic development.

41. The medium term outlook for FY2012/13-FY2014/15 assumes a real GDP growth to increase from 4.9 percent in FY2012/13 to 6.9 percent in FY2016/17 in Table 6. The overall fiscal balance (including grants) is projected to decline from 6.8 percent of GDP in 2012/13 to a sustainable level of about 4.6 percent of GDP over the medium term. This will have the effect of allowing public debt to decline from about 53.3 percent of GDP in June 2014 to about 49.3 percent of GDP by 2016/17 and decline thereafter to 47.8 percent in FY2017/18. Inflation is

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<sup>2</sup> Total guaranteed debt amounts to USD 505 million (at end December 2013).

expected to decline from 6.6 percent in FY2012/13 to 6.3 percent in FY2016/17, and the exchange rates to remain stable. The current account deficit is expected to decline gradually from about 10.5 percent of GDP in 2012/13 to 5.8 percent of GDP in 2017/18. The relatively higher interest rates and investor confidence with successful General Elections will support both the capital and financial accounts. Gross international reserves are assumed to reach 3.9 months of imports by FY2016/17. The risk to the medium-term outlook include further weakening in global economic growth, unfavorable weather conditions and rise in international oil prices.

**Table 6: Baseline Macroeconomic Assumptions**

Baseline macroeconomic assumptions	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
Real GDP growth (%)	4.9	5.5	6.1	6.6	6.9	7.2
Inflation (average, %)	6.6	6.5	7.2	6.8	6.3	5.4
<b>External Sector</b>						
Current account (% of GDP)	-10.5	-9.6	-8.5	-7.1	6.1	-5.8
Exports value, goods and services	25.6	24.9	25.4	26.2	26.9	27.5
Imports value, goods and services	42.0	40.2	39.0	38.0	37.5	37.5
Gross official reserves (months of next year's imports)	3.5	3.5	3.6	3.7	3.9	4.0
<b>Central government budget</b>						
Overall balance (in billions of Ksh)	-249.1	-368.8	-291.4	-278.4	-276.7	-285.0
Overall balance (% of GDP) including grants	-6.8	-8.9	-6.3	-5.3	-4.6	-4.2
Total revenue and grants (in billions of Ksh)	868.1	1,098.3	1,244.6	1,413.0	1,600.9	1,812.5
Total revenue and grants (% of GDP)	23.7	26.4	26.8	26.8	26.7	26.8
Total expenditure and net lending (in billions of Ksh)	1,117.0	1,467.0	1,536.0	1,691.4	1,877.6	2,097.5
Total expenditure and net lending (% of GDP)	30.5	35.2	33.1	32.1	31.3	31.0
Primary deficit (in billions of Ksh)	-111.2	-228.2	-151.9	-123.7	-102.9	-95.7
Primary deficit (% of GDP)	-3.0	-5.5	-3.3	-2.3	-1.7	-1.4
Nominal GDP (Market prices, in billions of Ksh)	3,662.6	4,164.6	4,636.6	5,276.7	5,991.2	6,765.8
Total public debt (% of GDP)	45.9	53.3	52.0	50.6	49.3	47.8

*Source: National Treasury, BPS 2014*



42. Debt financing needs are determined by the primary deficit, interest costs and principal payments/redemptions. Under the baseline macroeconomic assumptions, the primary deficit is expected to increase from Ksh 111.2 billion in FY2012/13 to Ksh 228.2 billion in FY2013/14 and decrease to Ksh 102.9 billion by FY2016/17. The *2014 MTDS* guides on the optimal borrowing mix to close the resource gap in the budget.

43. The macroeconomic outlook carries substantial uncertainty. In particular, the April 2013 *Joint World Bank-IMF LIC Debt Sustainability Analysis (DSA)* highlights the sensitivity of Kenya's debt sustainability to shocks in economic growth. Lower growth will negatively affect the primary deficit through both lower revenue collection and increased outlays to protect the most vulnerable. Overall, growth will depend on the pace of global economic growth, weather patterns and international fuel prices that impact negatively on revenues and hike expenditure demands.

44. Increased investment in infrastructure might require an increase in the level of guarantees while the implementation of the new Constitution (including County administrative units) may need the Government to take in more debt and take over liabilities of counties. The increase in contingent liabilities would represent a significant increase in risk to the current debt burden.<sup>3</sup> The Act to regulate PPPs as well as the envisaged implementation of a superannuation pension scheme for the civil service from July 2013 will also have implications for Government's contingent liabilities in the future.

45. Overall, the risk profile on the existing debt portfolio has not changed since June 2013. Thus, the thrust of the *2014 MTDS* is similar to *2013 MTDS*: - to maintain a diversified source of financiers, prudently manage the debt amortization profile to absorb fiscal shocks (for example, the impact of drought on the budget), and manage the external exposure of the portfolio taking into account the vulnerability to balance of payments shocks.

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<sup>3</sup> A Taskforce is expected to be set up to establish the extent of contingent liabilities under a devolved government system, while payments under the Public Service Superannuation Scheme (PSSS) are treated as contingent liabilities. GOK indemnity (USD 45 million or Ksh 3.9 billion) to IDA for guarantee to Kenya Railways has also been recorded as a contingent liability.



46. The principal risks to the baseline are summarised below in Table 7.

**Table 7: Macro-Risks and Implications for Debt Management Strategy**

Implications for Debt Strategy Preferences				
Macroeconomic Factors	Impact	Target source	Currency	Other comments
<b>Balance of Payment Risks</b>				
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
<b>Fiscal Risks</b>				
Potential volatility (revenues)	Expenditure volatility	Market	DX/FX	Create fiscal space, prioritize expenditure and improve efficiency Improve relationship with donors, improve absorptive capacity and implementation efficiency
Capital spending aid dependent	Growth volatility		DX/FX	
Contingent liabilities	Debt level increase	Market	DX/FX	Create fiscal space and strengthen overall PFM framework
<b>Monetary Risks</b>				
High inflation	Impede market development, higher interest costs			Increase credibility of monetary policy, improve monetary operational framework and monetary transmission mechanism to reduce inflation premium
Negative real interest rate	Impact real money investors and deposit growth			
<b>Natural Disasters</b>				
Natural Disasters	Growth volatility	Market	DX/FX	Diversify economy and explore the possibility of commodity hedge
Political Stability	Growth volatility Exchange rate		DX/FX	Ensure political stability

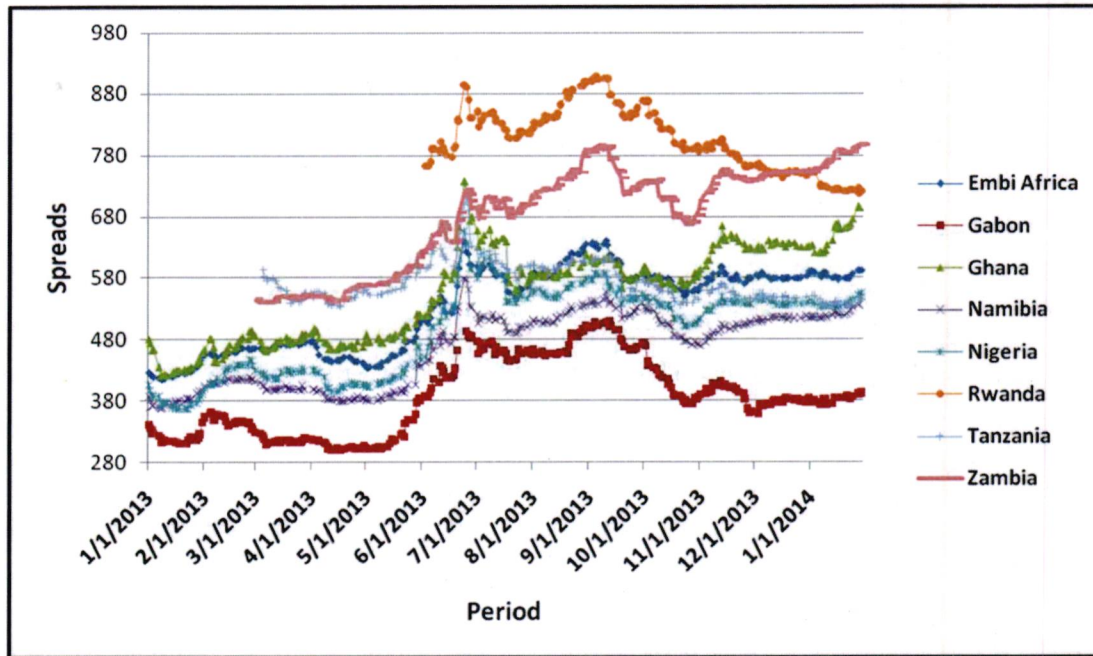
### c) Potential Financing Sources

47. Official external sources remain the preferred option for the Government to source financing on concessional terms. However, it has been observed that borrowing terms have increasingly hardened, with new loans often contracted on terms very close to the 35 percent grant element threshold for 'soft' loans.

48. The Government has made considerable progress in its plans to issue a Euro Bond in FY2013/14 with the timing of Sovereign Bond

placement preferable in the third quarter of FY 2013/14<sup>4</sup>. Figure 7 shows the performance of Kenyan peers debut sovereign bond issues. The size of non-concessional borrowing including the International Sovereign Bond and guarantees is set at a maximum USD 1,750 million for the year 2013/14. This amount was consistent with the ceiling set under the IMF supported ECF economic and financial program to safeguard debt sustainability levels.

**Figure 7: Performance of Peer Debut Sovereign Bond Issues**



*Source: National Treasury and IMF/WB estimates*

49. On domestic borrowing, the Government will seek to issue medium to long term debt securities to lengthen the maturity structure of debt, and thus reducing the underlying refinancing risk. The issuance program will be biased towards Benchmark Bonds. The effort to shift towards longer dated instruments supports development of the yield curve for government debt securities and the overall growth of domestic debt market.

50. The uptake of domestic debt will be reduced to cut-back on rises in interest costs and the rapid growth of the debt stock. This action is consistent with the strategy to shift the portfolio towards external debt

<sup>4</sup> The recent tapering of quantitative easing in the USA suggests Kenya's sovereign bond may be priced between 7.625 percent p.a. and 8.125 percent p.a.

dominance and also to safeguard debt sustainability over the medium term.

#### **d) Future Financing and Pricing Assumptions**

##### ***External sources***

51. The following pricing assumptions underlie the *2014 MTDS*.

- Concessional external loans are priced at a fixed rate of 0.75 percent, with a 40-year tenor and a 10-year grace period. These loans are assumed to be denominated in SDR.
- Semi-concessional loans are assumed to be contracted from official creditors. These loans have a fixed interest rate of 2.5 percent, a maturity of 20 years including a 5-year grace period.<sup>5</sup> These loans are denominated in Euros and USD.<sup>6</sup>
- In the absence of concessional financing, the Government will maintain non-concessional financing including guarantees at about USD 1,750 million for the year 2014/15 for investment projects that demonstrate revenue streams and high social returns. These loans have market-based terms and are denominated in Euros and USD.<sup>7</sup>
- Accessing the international capital market is priced-off the assumed effective yield curve, which is based on the underlying forward US Treasury curves plus an assumed credit spread. The analysis assumes that international capital markets could be accessed to finance infrastructure development, or if concessional resources fall below target. Alternatively, domestic borrowing could increase. The International Sovereign Bond will have a maturity of 10 years, with a bullet repayment. The

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<sup>5</sup> These terms are consistent with loans that have been contracted in the last two years from bilateral sources.

<sup>6</sup> A review of instruments indicated that it would be useful to include a semi-concessional fixed rate loan - with terms consistent with those secured on recent bilateral external debt - to the choices available in the analysis. There have been two new floating rate loans contracted in 2012 and overall, these instruments represent a marginal share of the portfolio. Consequently, losing this instrument should not significantly affect the analysis.

<sup>7</sup> These terms are consistent with loans contracted for the energy sector in the last two years.



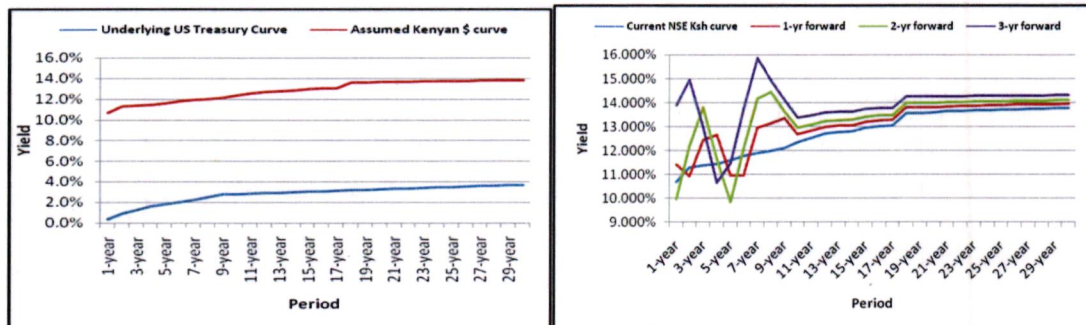
credit spread is set at between 475 and 525 basis points. A 5-year bond is expected to have a spread of between 450 and 500 basis points<sup>8</sup>.

52. The **net external borrowing** for financial year 2014/15 is **2.2 percent of GDP** and is projected to decline to 1.8 percent of GDP in the financial year 2016/17.

***Domestic market sources***

53. The pricing of new domestic borrowing is based on the underlying forward US Treasury curves. The assumed credit premium is taken into account, and the anticipated inflation differential is used to adjust for exchange rate differentials. This is then adjusted for an additional risk premium, which can be assumed to capture liquidity, inflation risk, and other risk effects. This premium is identified by determining the necessary premium required to fit today's observed yield curve.<sup>9</sup> The applicable Ksh curves are shown in Figure 8.

**Figure 8: Assumed USD and Ksh Yield Curves**



*Source: National Treasury and IMF/WB estimates*

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

55. In addition, Treasury Bonds will be issued around Benchmark Bonds of 2, 5, 10, 15 and 20-year tenors to build liquidity.

<sup>8</sup> These spreads compare with the current peer issuers' secondary market trading spreads and spreads on recent first issuance for bonds of 10- and 5-years maturity.

<sup>9</sup> The NSE yield curve is taken as the basis for the current Ksh curve.

56. **Net domestic borrowing** for financial year 2014/15 is **4.1 percent of GDP** and is expected to fall to 2.8 percent of GDP in the financial year 2016/17.

#### e) Description of Stress Scenarios

57. The robustness of each alternative strategy is assessed on the basis of the baseline scenario for interest and exchange rates. While a number of standard shocks are generally applied in the context of the DSA, it is important to also consider what might constitute a typical shock in the Kenya-specific context. To determine the appropriate size of these shocks, the historical performance of the relevant exchange and short-term interest rates in the relevant markets was considered. In particular, the size of the interest rate shock to be applied to the Kenya shilling interest rates was determined on the basis of the past 10 years, which includes periods when interest rates declined (and increased) sharply. Consequently, the implied annual deviation of interest rates is quite large at over 2 percent<sup>10</sup>. For the purposes of the analysis, it is assumed that shocks materialize in FY2014/15, and are sustained through the remainder of the simulation horizon<sup>11</sup>:

- Scenario 1: *Upward shift of the Ksh yield curve*. The cost of borrowing at all tenors increases by two standard deviations (equivalent to a 4.5 percent interest rate increase) calculated on the basis of the historical change in the interest rates on Treasury Bills.
- Scenario 2: *Flattening of the Ksh yield curve*. This scenario corresponds to the impact of a switch in the monetary policy stance, which would increase short-term rates, but where the market's longer-term expectations remain unchanged (that is, inflation expectations remains anchored to the 5 percent target). In this scenario, the interest rate of the 364-day

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<sup>10</sup> However, it appears that there were no particular structural factors that would argue for excluding that particular period from the analysis.

<sup>11</sup> Basically, this presumes that the baseline macroeconomic outlook and financing assumptions are highly uncertain. A more specific risk scenario could be considered on the basis of known future events, such as an election. The quantification of the shocks reflects the historical standard deviation over the last 10 years, except for Scenario 3 where an extreme shock to the nominal exchange rate is simulated.

Treasury Bill increases by two standard deviations, as in Scenario 1, but interest rates on long-term bonds increase proportionally less, with the interest rate of the bond with the longest maturity (30 years) unchanged from the baseline scenario.

- Scenario 3: *Extreme depreciation of the Ksh.* The Ksh depreciates by 30 percent vis-à-vis the other currencies in FY 2014/15.
- Scenario 4: *Country-specific depreciation of the Ksh.* The Ksh depreciates by two standard deviations of the percentage change of the historical nominal exchange rate vis-à-vis other currencies.<sup>12</sup>
- Scenario 5: *A combination of previous Scenarios 1 and 4.* In this scenario, the Ksh depreciates by one standard deviation vis-à-vis the other three currencies, while all interest rates increase by one standard deviation at all maturities. This reflects the likelihood that interest rates would likely react to an external shock that affects the exchange rate.

## **f) Description of Alternative Financing Strategies**

58. The analysis compares a number of alternative strategies with 2013 *MTDS*. In particular, this analysis assesses the relative performance of a strategy aiming to maximize external concessional financing (corresponding to Strategy 2 below). However, in light of the possibility of significant shortfall in external disbursements, as experienced in the recent past, and the contracting of commercial financing, the analysis also evaluates the costs and risks associated with alternative strategies that assume relatively higher domestic borrowing (Strategy 3 and 4) and the contracting of higher external borrowing on semi-concessional terms (Strategy 5) to meet the expected Government gross financing needs.

59. The candidate strategies are described below and in Table 8.

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<sup>12</sup> This shock corresponds to a 10 percent depreciation vis-à-vis the Euro and the USD and a 15 percent depreciation vis-à-vis the Yen.



a) *Strategy 1 (S1. 2013 MTDS)*. This is the preferred strategy in 2013 MTDS, which has been implemented in the past year. It assumes that 40 percent of the gross financing needs would be met by external borrowing, mainly from concessional creditors, and 60 percent from the domestic market, mainly through medium tenor Treasury Bonds. The concentration of issuance with 5- and 10-year maturities assumes a significant initiative to reduce cost of domestic debt associated with longer dated securities.

b) *Strategy 2 (S2. Concessional external borrowing)*. External and domestic borrowing would amount to 40 percent and 60 percent of gross financing needs respectively. There is concentration of more concessional debt to reduce cost.

c) *Strategy 3 (S3. More domestic debt)*. This strategy maximizes domestic borrowing, assuming 65 percent of gross financing needs are met through these sources. External financing would decrease to 35 percent of Government gross financing needs.

d) *Strategy 4 (S4. Medium term domestic borrowing)*. It assumes domestic borrowing would amount to 70 percent while 30 percent of the gross financing needs would be met by external borrowing, from concessional and semi-concessional creditors. The concentration of issuance with 5- and 10-year maturities assumes the initiative to reduce cost of domestic debt associated with longer dated securities is maintained.

e) *Strategy 5 (S5. Semi-concessional external debt)*. Under this strategy, domestic debt is 75 percent while external debt is 25 percent, mainly from semi-concessional sources.

Under all strategies, it is assumed that over 50 percent of all official sector external borrowing is on less concessional terms, in line with recent experiences.

**Table 8: Alternative Debt Management Strategies**

	<i>2013</i> MTDS	Concessional External debt	More domestic debt	Medium term domestic debt	Semi- concessional external debt
New debt	S1	S2	S3	S4	S5
<b>Domestic</b>	<b>60%</b>	<b>60%</b>	<b>65%</b>	<b>70%</b>	<b>75%</b>
Treasury bills (change in stock)	9%	9%	10%	10%	14%
2-year	11%	10%	12%	11%	11%
5-year	12%	14%	13%	20%	14%
10-year	10%	11%	11%	16%	14%
15-year	9%	8%	10%	7%	11%
20-year	9%	7%	10%	7%	11%
<b>External</b>	<b>40%</b>	<b>40%</b>	<b>35%</b>	<b>30%</b>	<b>25%</b>
Semi-concessional	3%	8%	6%	4%	4%
Concessional	17%	26%	23%	20%	15%
2-year syndicate	0%	0%	0%	0%	0%
10-year ISB	21%	6%	6%	6%	6%

## VI. OUTCOMES OF ANALYSIS OF STRATEGIES

60. The performance of the five alternative strategies was assessed under the five identified market stress scenarios in terms of their relative cost and risk. Consideration focuses on performance in terms of the cost-risk tradeoff reflected in two key indicators, that is, Interest/GDP and PV of Debt/GDP. The former is relevant as it indicates the amount of resources required to service the debt and which is, consequently, not available for other uses; the latter is relevant as the government has set an overall ceiling of 50 percent of GDP for the PV of Debt. The results of this cost-risk tradeoff are shown in Table 9 and Figure 9.

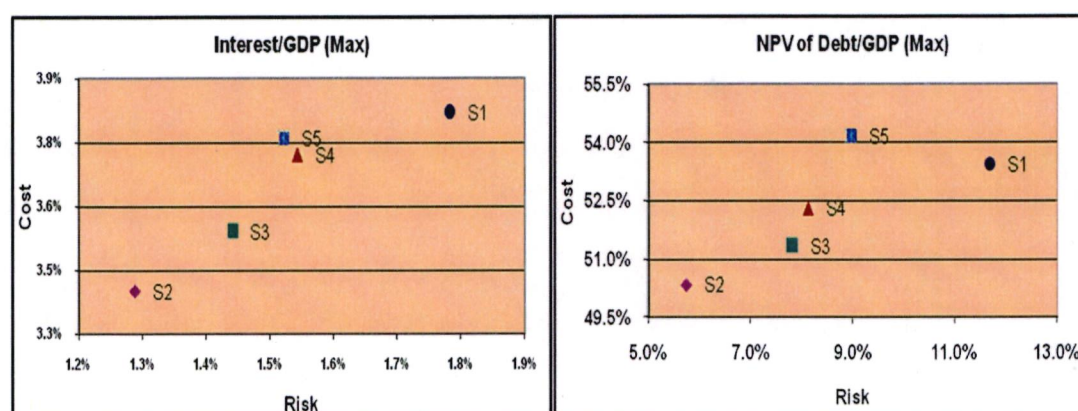
**Table 9: Cost-Risk Tradeoffs**

<b>Interest/GDP (%)</b>	<b>S1</b>	<b>S2</b>	<b>S3</b>	<b>S4</b>	<b>S5</b>
Baseline scenario	3.8%	3.4%	3.5%	3.7%	3.8%
Parallel shift in yield curve (2 std. deviations)	1.8%	1.3%	1.4%	1.5%	1.5%
Flattening of yield curve	0.4%	0.3%	0.3%	0.4%	0.4%
Extreme devaluation of exchange rate (30%)	0.2%	0.2%	0.2%	0.2%	0.2%
Devaluation of exchange rate by 2 std. deviations	0.1%	0.1%	0.1%	0.1%	0.1%
Combination shock (1 std deviation)	0.4%	0.3%	0.4%	0.4%	0.4%

<b>PV of Debt/GDP (%)</b>	<b>S1</b>	<b>S2</b>	<b>S3</b>	<b>S4</b>	<b>S5</b>
Baseline scenario	53.5%	50.3%	51.3%	52.3%	54.2%
Parallel shift in yield curve (2 std. deviations)	11.7%	5.7%	7.8%	8.1%	9.0%
Flattening of yield curve	1.7%	1.2%	1.3%	1.7%	1.3%
Extreme devaluation of exchange rate (30%)	5.4%	5.2%	5.3%	5.3%	5.4%
Devaluation of exchange rate by 2 std. deviations	2.0%	1.9%	1.9%	1.9%	2.0%
Combination shock (1 std deviation)	4.3%	3.3%	3.7%	3.8%	4.1%

**Figure 9: Cost-Risk Tradeoffs**





61. As expounded in the description of strategies (paragraph 51), all the strategies provide for commercial financing. The financing will be disbursed over 4 years unlike the single disbursement of the International Sovereign Bond in FY2013/14. This explains the poor performance of S1 (2013 MTDS) vis-à-vis all other strategies (Figure 9).

62. As anticipated, the strategy assuming the largest amount of official sector external borrowing (S2) has the most beneficial cost and risk attributes. This suggests that the government should target a slight increase in the amount of external official sector borrowing to 26 percent relative to S1 (2013 MTDS). However, given the potential challenges in achieving this strategy in practice, it is prudent to consider what the appropriate contingency should be in the event that there is a shortfall in disbursements. In that context, the choice is between relatively more domestic borrowing (as represented by S3 and S4) or the contracting of higher external borrowing on semi-concessional terms (S5).

63. However, there is a clear trade-off between S3, S4 and S5 in terms of Interest/GDP. Given the relatively greater weight of more domestic debt in S3, this strategy is less costly and less risky. On the other hand, S4 is costly and risky due to the increased uptake of medium to long-term domestic debt. However, when PV of Debt/GDP is considered, S3 is also less risky given that a lower proportion of external borrowing is now exposed to interest rate risk. S4 is more risky and costly on account of a higher proportion of domestic debt.

64. The relative ranking of strategies was also considered in the context of one alternative macroeconomic scenario. The scenario reflected the potential scale of direct government financing needed to support the development of county infrastructure. It is assumed that USD 1.15 billion (Ksh 100 billion)<sup>13</sup> will be required to finance additional expenditures over the next three years. Consequently, an adjustment was made for this presumed pipeline of debt (that is, the strategies described in Table 8 were applied to the total financing requirement net of this expenditure). Overall, this increases the proportion of external financing in each strategy by around 2 percent, but does not change the relative performance of the strategies (Appendix

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<sup>13</sup> This is derived by maintaining the level of Debt to GDP at 45 percent of GDP over the medium term as envisaged in the Budget Policy Statement, 2014.

I). Consequently, S2 would remain the preferred strategy, with the tradeoff between S3, S4 and S5 as above.

65. Overall, there is relatively little difference between how each strategy performs. This is due to the fact that net new borrowing over this period is quite limited relative to the size of the existing debt portfolio. As a result, the characteristics of the existing portfolio continue to dominate. *This suggests that other factors should have a more significant bearing on the ultimate decision.*

66. A range of other key indicators (Table 10) were also closely analyzed. The results consider S2 as the most optimal strategy that effectively mitigates refinancing risk. This risk has become increasingly relevant for debt managers in light of the continued turmoil in the recent global debt crisis. In addition, S2 will likely have a higher success rate of execution given the bias towards more concessional financing (Table 10, S1).

**Table 10: Other Key Indicators**

	Simulation Horizon (2014/2015-2016/2017)				
	S1	S2	S3	S4	S5
<b>Cost indicators (average over simulation)</b>					
Average interest rate	6.8%	6.3%	6.5%	6.7%	6.7%
Interest / revenues	12.9%	12.1%	12.4%	12.7%	12.8%
<b>Risk indicators (end simulation horizon)</b>					
% DX in debt portfolio	59%	50%	53%	56%	54%
ATM (years)	9.9	10.9	10.7	9.9	9.9
% of debt refixing within 12 months	5.8%	5.6%	6.0%	5.9%	6.5%
% of DX debt refinancing within 12 months	6.7%	7.4%	7.9%	7.2%	9.1%
Short-term external debt / reserves	7.6%	7.6%	7.6%	7.6%	7.6%
<b>Implied net borrowing (% of GDP) (average over simulation)</b>					
Net domestic borrowing	4.93%	2.91%	3.52%	4.23%	3.88%
Net external borrowing	0.98%	2.78%	2.24%	1.63%	2.07%

67. Other factors may also be relevant if the government were to consider tapping the international capital markets. In Kenya's case, the investors' risk appetite may be affected by any residual political uncertainty, which suggests that the optimal time for a future issue might be periods of relative political calm and not during general elections. In addition, investors' continued focus on issues relating to fiscal



transparency, quality of statistics and effectiveness of public financial management and expenditure controls requires the Kenyan Government to strengthen public financial management and expenditure frameworks coupled with continued improvements in data quality and transparency if the country is to secure best pricing on any issue.

68. Finally, it is prudent to consider the implied quantities to be borrowed in each instrument type to assess the feasibility of any of the strategies. As designed, S2 requires the greatest amount of net official sector borrowing at an average of around USD1,362 million a year.

**Table 11: Borrowing Quantities by Instrument**

Implied gross borrowing (annual average)	S1	S2	S3	S4	S5
<b>Foreign borrowing (US\$ mn)</b>	<b>1,143</b>	<b>2,027</b>	<b>1,762</b>	<b>1,462</b>	<b>1,680</b>
Official sector borrowing (US\$ mn)	1,143	2,027	1,762	1,462	1,169
International capital market securities (US\$ mn)	-	-	-	-	511
<b>Domestic borrowing (Ksh mn)</b>	<b>514,774</b>	<b>407,168</b>	<b>446,496</b>	<b>480,957</b>	<b>482,307</b>
Money market instruments	57,197	55,861	61,662	62,264	89,133
Short-term bonds (2-year)	68,637	63,310	73,994	66,711	74,277
Medium-term bonds (5 - 10 years)	274,546	194,894	187,515	263,034	170,343
Long-term bonds	114,394	93,102	123,324	88,949	148,555
<b>Implied net borrowing (annual average)</b>					
<b>Foreign borrowing (US\$ mn)</b>	<b>479</b>	<b>1,362</b>	<b>1,097</b>	<b>798</b>	<b>1,015</b>
Official sector borrowing (US\$ mn)	479	1,362	1,097	798	504
International capital market securities (US\$ mn)	-	-	-	-	511
<b>Domestic borrowing (Ksh mn)</b>	<b>206,089</b>	<b>154,405</b>	<b>186,360</b>	<b>223,428</b>	<b>205,051</b>
Money market instruments	(100,460)	(101,386)	(99,176)	(98,993)	(189,961)
Short-term bonds (2-year)	14,041	10,227	17,129	12,872	18,547
Medium-term bonds (5 - 10 years)	231,144	152,462	145,083	220,601	127,910
Long-term bonds	114,394	93,102	123,324	88,949	148,555

69. **In conclusion, taking into account both risk and cost trade-offs, the implied quantity of gross borrowing, the need to develop the domestic debt market and ability to implement the strategy, the 2014 MTDS proposes Strategy 2 (S2) as the most optimal strategy.** Indeed, the results of the cost and risk analysis (Tables 12 and 13; Figures 10 and 11) reveal that the 2013 MTDS is less favorable going forward compared to the 2014 MTDS.

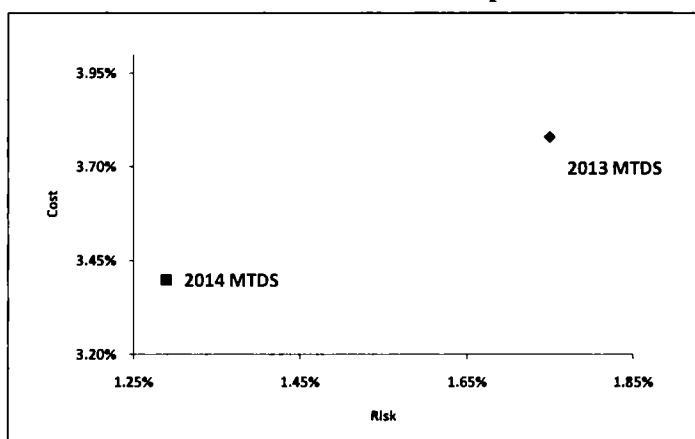


**Table 12: Cost and Risk Analysis: 2013 MTDS vis-à-vis 2014 MTDS: Interest/GDP ratio**

Scenarios	Strategies	
	2013 MTDS	2014 MTDS
	(Interest in percent of GDP at end-2017)	
Baseline	3.78%	3.40%
Stress test 1: Parallel shift in yield curve	5.53%	4.69%
Stress test 2: Flatter yield curve	4.16%	3.73%
Stress test 3: 30% exchange rate devaluation	3.95%	3.55%
Stress test 4: 2 std deviation devaluation	3.84%	3.46%
Stress test 5: Combination shock	4.20%	3.74%
Change under parallel shift in yield curve	1.75%	1.29%
Change under flatter yield curve	0.38%	.33%
Change under 30% exchange rate devaluation	0.17%	.15%
Change under 2 std deviation devaluation	0.06%	.06%
Change under combination shock	0.42%	.34%
Maximum under stress	1.75%	1.29%

**Figure 10: Cost and Risk Analysis: 2013 MTDS vis-à-vis 2014 MTDS**

**Cost-Risk Measure: Interest in percent of GDP, at end 2017**

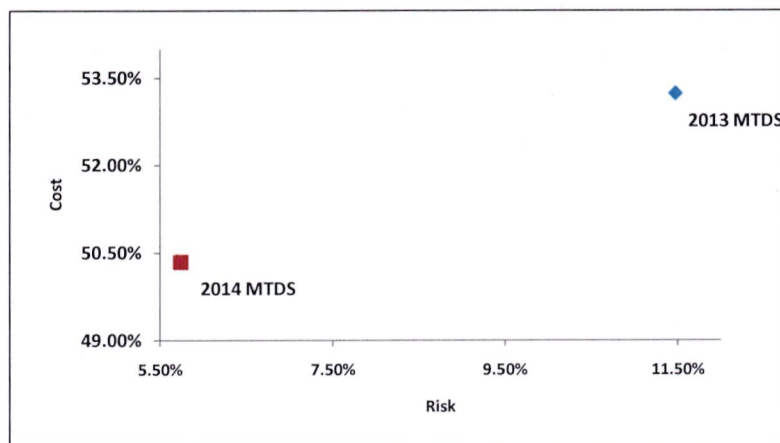


**Table 13: Cost and Risk Analysis: 2013 MTDS vis-à-vis 2014 MTDS: PV Debt/GDP ratio**

Scenarios	Strategies	
	2013 MTDS	2014 MTDS
	(PV of Debt in percent of GDP at end-2016)	
Baseline	53.24%	50.35%
Stress test 1: Parallel shift in yield curve	64.71%	56.09%
Stress test 2: Flatter yield curve	54.86%	51.59%
Stress test 3: 30% exchange rate devaluation	58.61%	55.56%
Stress test 4: 2 std deviation devaluation	55.20%	52.26%
Stress test 5: Combination shock	57.51%	53.67%
Change under parallel shift in yield curve	11.47%	5.74%
Change under flatter yield curve	1.62%	1.24%
Change under 30% exchange rate devaluation	5.37%	5.22%
Change under 2 std deviation devaluation	1.96%	1.91%
Change under combination shock	4.27%	3.32%
Maximum under stress	11.47%	5.74%

**Figure 11: Cost and Risk Analysis: 2013 MTDS vis-à-vis 2014 MTDS**

**Cost Measure: PV Debt in percent of GDP, at end 2017**



## VII. DEBT SUSTAINABILITY

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

71. The Debt Management Department (DMD) at the National Treasury is responsible for formulating debt strategy and ensures prudent debt management. The Public Financial Management Act, 2012 provides for a new institutional and legal framework (Public Debt Management Office) of managing public debt in a devolved system of government.

72. The latest (April 2013) debt sustainability analysis (DSA) for Kenya indicates that Kenya's debt is sustainable. The DSA compares debt burden indicators to indicative thresholds over a 20-year projection period. A debt-burden indicator that exceeds its indicative threshold suggests a risk of experiencing some form of debt distress. There are four ratings for the risk of external debt distress:

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

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



**Table 14: External Debt sustainability thresholds**

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

**a) External debt sustainability**

74. Given the above thresholds, under the baseline scenario, Kenya's debt ratios listed in Table 15 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 15: External debt sustainability**

Indicator	2012	2013	2014	2015	2016	2017	2018
PV of debt-to-GDP ratio (50)	19.0	20.1	27.0	25.7	24.4	23.4	22.5
PV of debt-to-exports ratio (200)	72.1	83.6	110.9	105.7	99.3	94.3	91.2
PV of debt-to-revenue ratio (300)	79.7	82.9	78.5	77.3	76.4	75.7	75.0
Debt service-to-exports ratio (25)	4.1	6.3	9.8	4.9	5.3	5.6	5.5
Debt service-to-revenue ratio (22)	4.6	6.3	11.1	4.9	5.1	5.2	5.0

*Source: World Bank-IMF Debt Sustainability Analysis- Kenya (April 2013) and IMF Staff Guidance Note*

**b) Public debt sustainability**

75. Kenya's public debt sustainability thresholds as a strong performer are as follows:

**Table 16: Public Debt sustainability thresholds**

	PV of Debt in percent of		Debt Service in percent of
	GDP	Revenue	Revenue
Strong Policy Performer	74	300	22

76. Under the baseline scenario shown in Table 17, the PV of public debt-to-GDP, increases from 39.4 percent in 2012 to 40.3 percent in 2013 and to 45.3 percent of GDP by 2015. In the long term, the PV of public debt-to-GDP is expected to decline to about 42.2 percent by 2018. Given Kenya's relatively strong revenue performance, the PV of public debt-to-revenue remains well below the threshold of 300 percent throughout the period of analysis. The debt service-to-revenue ratio consistently remains below the 30 percent threshold. Overall, the results from the DSA indicate that Kenya's public debt remain sustainable over the medium term.

**Table 17: Public debt sustainability**

<b>Indicator (Threshold)</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>
<b>PV of public sector debt to GDP ratio (74)</b>	39.4	40.3	47.7	45.3	44.1	43.3	42.2
<b>PV of public sector debt-to-revenue ratio (300)</b>	165.1	165.7	195.7	186.7	179.6	174.6	171.4
<b>Debt service-to-revenue ratio (30)</b>	26.6	27.3	31.9	24.7	24.0	23.4	22.7

*Source: World Bank-IMF Debt Sustainability Analysis- Kenya (April 2013) and IMF Staff Guidance Note*

77. In Table 18, a worst-case scenario, a "borrowing shock" scenario is presented which assumes Government borrowing 10 percent of GDP in FY2014/15. The results indicate that in the medium term, the debt burden indicators will remain within the debt sustainability thresholds.

**Table 18: Sensitivity Analysis for Key Indicators of Public Debt**

<b>Indicator</b>	<b>Threshold</b>	<b>2014 ratios</b>	<b><i>Impact of 10% of GDP increase in borrowing in 2014 on debt indicators in 2016</i></b>
PV of Debt as % of GDP	74	39	48
PV of Debt as % of Revenue	300	151	189
Debt Service as % of Revenue	30	28	27

78. However, in the FY2014/15, the Government plans to borrow, on a net basis amount equivalent to **6.3 percent of GDP** to finance the budget. The net borrowing is expected to decline to 4.6 percent of GDP in FY2016/17.

79. The sustainability of Kenya's debt depends on macroeconomic performance and a prudent borrowing policy. Recourse to significant uptake of domestic debt financing could further increase the domestic interest rates, and put pressure on the debt sustainability position. In addition, non-concessional external financing carries an inherent foreign exchange risk, worsens the PV of debt and therefore increases the risk of debt distress. The borrowing envisaged under the *2014 MTDS* will be undertaken with caution taking these factors into account.



## VIII. IMPLEMENTING THE 2014 MTDS

80. The Government will prepare a borrowing plan to accompany the 2014 MTDS (Strategy 2) and meet the financing requirement for the financial year 2014/15. The borrowing composition assumed in the MTDS analysis together with the Government cash flow plan provides the basis for the projected annual borrowing plan. The Government will communicate the domestic borrowing plan to the market participants through the *Market Leaders Forum*.

81. The 2014 MTDS provides a clear set of assumptions and some information on key risk parameters that are associated with the Strategy (S2) (Table 10). These provide the basis on which the implementation of the strategy will be monitored and reported. If there is a significant and sustained deviation in the outturn relative to that assumed in the MTDS analysis, the strategy will be reviewed and revised.

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

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

84. Continued collaboration with partners, such as the US Treasury, the IMF, the World Bank, IFC, MEFMI and the Commonwealth Secretariat will be encouraged in developing the Government and corporate bond markets and capacity building in debt management. Recent experience in issuance of a Euro bond will enhance capacity in future issuances. The debt recording system will be upgraded and

**SECRET**

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

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## IX. CONCLUSION

85. The *2014 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 2014/15, taking into account both cost and risk. The cost-risk trade-off of the *2014 MTDS* has been evaluated within the medium term context.

86. 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.

87. The *2014 MTDS* has considered the current macro-economic environment both at the local and international scene and the related vulnerabilities. The recommended strategy is one that seeks the issuance of medium term domestic debt, and contracting of external concessional debt.

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



**APPENDIX I****ANALYSIS OF THE COST/RISK TRADE OFF UNDER AN ALTERNATIVE SCENARIO-FINANCING COUNTY GOVERNMENT INFRASTRUCTURE THROUGH DEBT FINANCING**

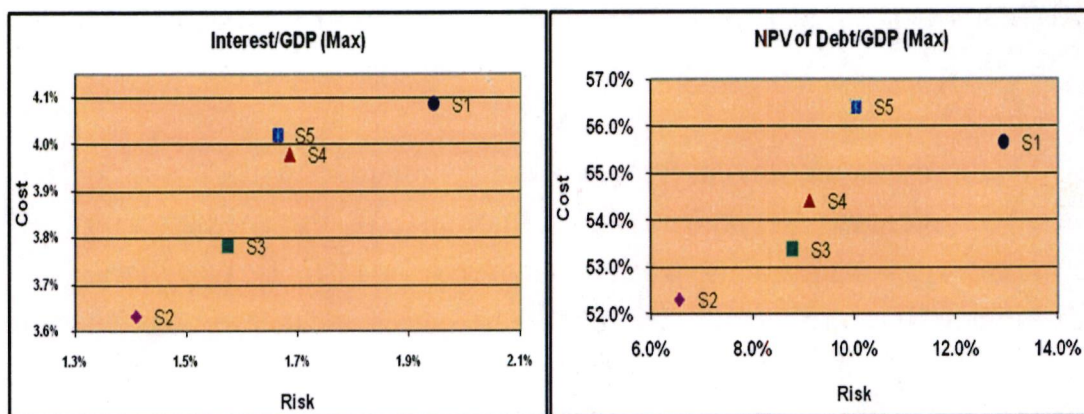
1. Debt management strategies were evaluated on the basis of an alternative scenario which envisages financing of the infrastructure at the county government level through borrowing. In this scenario, an additional USD 1.15 billion (Ksh. 100 billion)<sup>14</sup> in spending is spread over the three years of the simulation horizon with debt financing adjusted accordingly. However, given the onerous task of mobilizing these resources through the domestic market without crowding out the private sector, it is assumed that this expenditure is partly financed by a committed pipeline of a syndicated loan under commercial terms. In this case, the strategies described in Table 8 are applied to the financing requirement net of this committed debt. Consequently, the final strategy implemented would incorporate a relatively higher proportion of external debt of around 2 percent. In particular, the proportion of external debt increases from 40 to 42 percent under S2, 35 to 37 percent under S3, 30 to 32 percent under S4, and from 25 to 27 percent under S5.

2. The impact of this change on the key cost and indicators is shown in Figure 12. Again, while all cost indicators shift upward, the relative ranking does not change. In addition, given the increase in the size of external debt stock, the indicators outlined in Table 10 would change as indicated in Table 19 below.

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<sup>14</sup> This is derived by maintaining the level of Debt to GDP at below 45 percent of GDP over the medium term as envisaged in the Budget Policy Statement, 2014.

**Figure 12: Cost and Risk under County Government Infrastructure Funding**



**Table 19: Other Key Indicators under County Government Infrastructure Funding**

	Simulation Horizon (2014/2015-2016/2017)				
	S1	S2	S3	S4	S5
<b>Cost indicators (average over simulation)</b>					
Average interest rate	6.9%	6.4%	6.6%	6.8%	6.8%
Interest / Revenues	13.3%	12.4%	12.7%	13.1%	13.2%
<b>Risk indicators (end simulation horizon)</b>					
% DX in debt portfolio	60%	51%	53%	56%	54%
ATM (years)	9.9	11.0	10.8	10.0	10.0
% of debt refinancing within 12 months	5.9%	5.6%	6.1%	5.9%	6.5%
% of DX debt refinancing within 12 months	6.8%	7.6%	8.0%	7.3%	9.3%
Short-term external debt / Reserves	7.6%	7.6%	7.6%	7.6%	7.6%
<b>Implied net borrowing (% of GDP) (average over simulation)</b>					
Net domestic borrowing	5.55%	3.38%	4.04%	4.51%	4.42%
Net external borrowing	1.14%	3.07%	2.49%	1.84%	2.31%