**And Then, Floods** [1/]

A critical macroeconomic assessment of IMF Conditionality on Kenya, 2021-present

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Abstract

By April 2021, in the context of long-standing deep growth shortfalls, a heavily overvalued exchange rate, an excessively loose fiscal stance, and an elevated public debt stock, Kenya's prospects were threatened by rising global interest rates, a large bullet payment due, and droughts.

What was needed was an IMF program to deliver an immediate change in the policy mix, with a sharp front-loaded fiscal consolidation to allow a monetary loosening sufficient to correct the exchange rate and inward orientation while keeping inflation on target. But the total fiscal correction should not have been at the expense of medium-term growth, even if that required debt write-offs to reconcile it debt sustainability. And the entire package should also have been resilience to further shocks.

But that was not the program that Kenya got. The program misdiagnosed misalignment, thus back-loaded fiscal adjustment, and required medium-term primary fiscal balances well above global best practice at the expense of growth potential, all reflected in relentless tax increases. And when its conditionality on the Central Bank of Kenya turned out to be misspecified—including that in practice it treated a large non-permanent relative food price shock as a matter only of inflation—that was not corrected. So the program also delivered a monetary stance which was too tight, impeding the necessary correction in the exchange rate, all at the expense of short-run growth as well.

These basic failures of quality control at the IMF meant that the program achieved neither its stated goals nor the fundamental correction that was required—hence major nationwide social unrest.

A reset of the program for 2024/25 should be led by an immediate big relaxation in monetary policy, an unchanged underlying primary balance outturn of a deficit of 1 percent of GDP remaining there thereafter, leaving revenue ratio targets to the authorities, and activating a targeted program of income support given food price shocks. If that requires debt write offs to secure sustainability, those should be calibrated against a medium-term primary deficit of 1 percent of GDP. Alongside a major retrenchment in the number of conditions and an increase in IMF transparency are necessary.

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Since April 2021, the boundaries of Kenyan macroeconomic policy—within which policymakers have discretion with IMF support—have been set by the IMF Extended Extended Fund Facility and Extended Credit Facilities, supplemented since 2023 by its Resilience and Sustainability Facility.

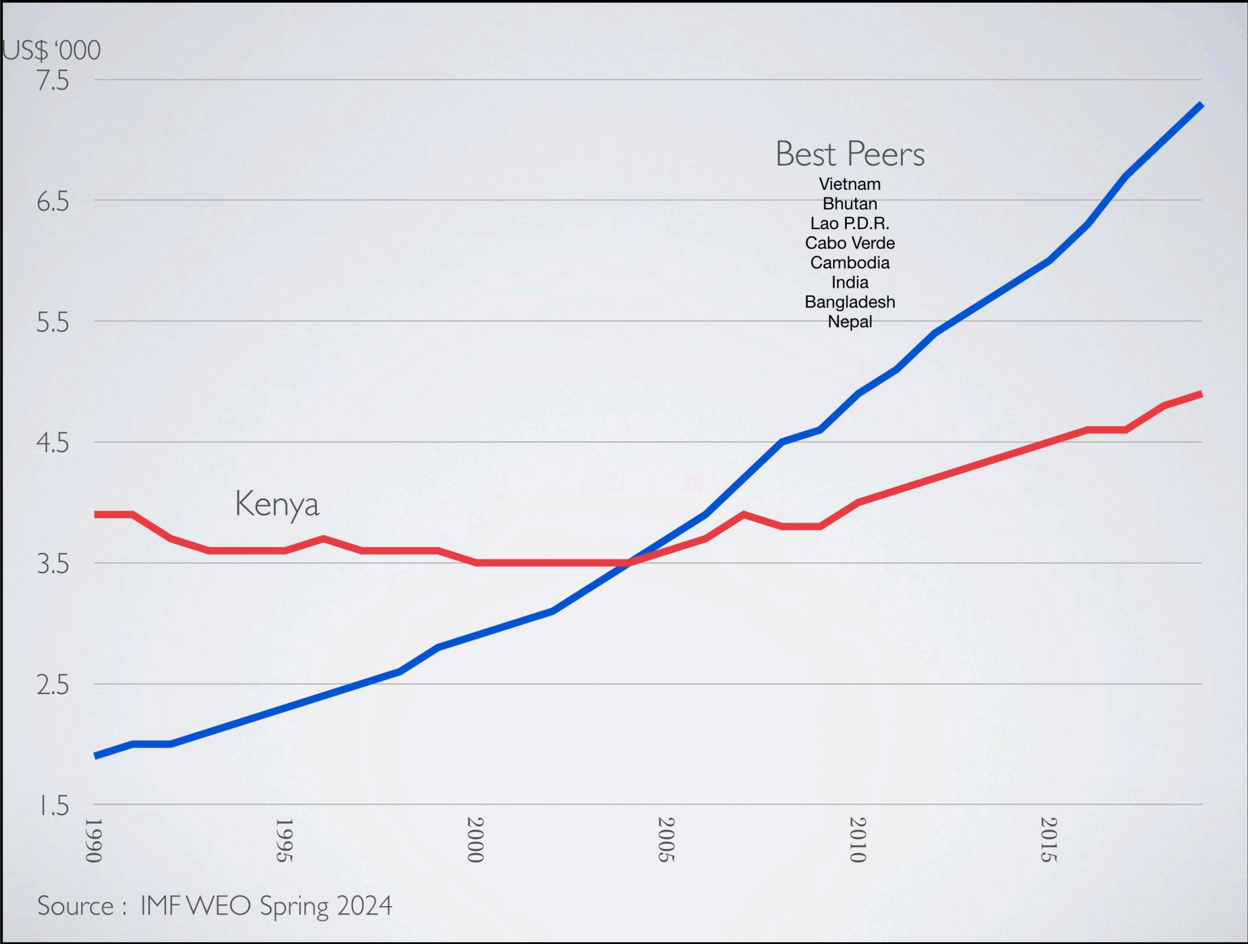
Have those boundaries been well set?

## I. Ten Antecedents

### 1. Low Growth

From 1990-2019, Kenya per capita real GDP, measured in 2017 International US$, grew by just a quarter. That compares with the average of the eight highest real per capita GDP growth countries in Kenya's GDP per capita neighborhood which nearly quadrupled (Figure 1).

Figure 1. Real GDP Per Capita, 2017 US International Dollars, 1990-2019




Had per capita GDP in Kenya over that period grown at the same rate throughout as that of its best performing peers, Kenyan real GDP per capita in 2019 would have been three times what it actually was. That enormous per capita growth shortfall is apparent in all three of the sub-decades, so that most of Kenya's total growth over that period came from that of its population, not from its productivity.

So in the per capita marathon, Kenya, exceptionally for any marathon and even after a head start, has long been well off the leaders' pace.

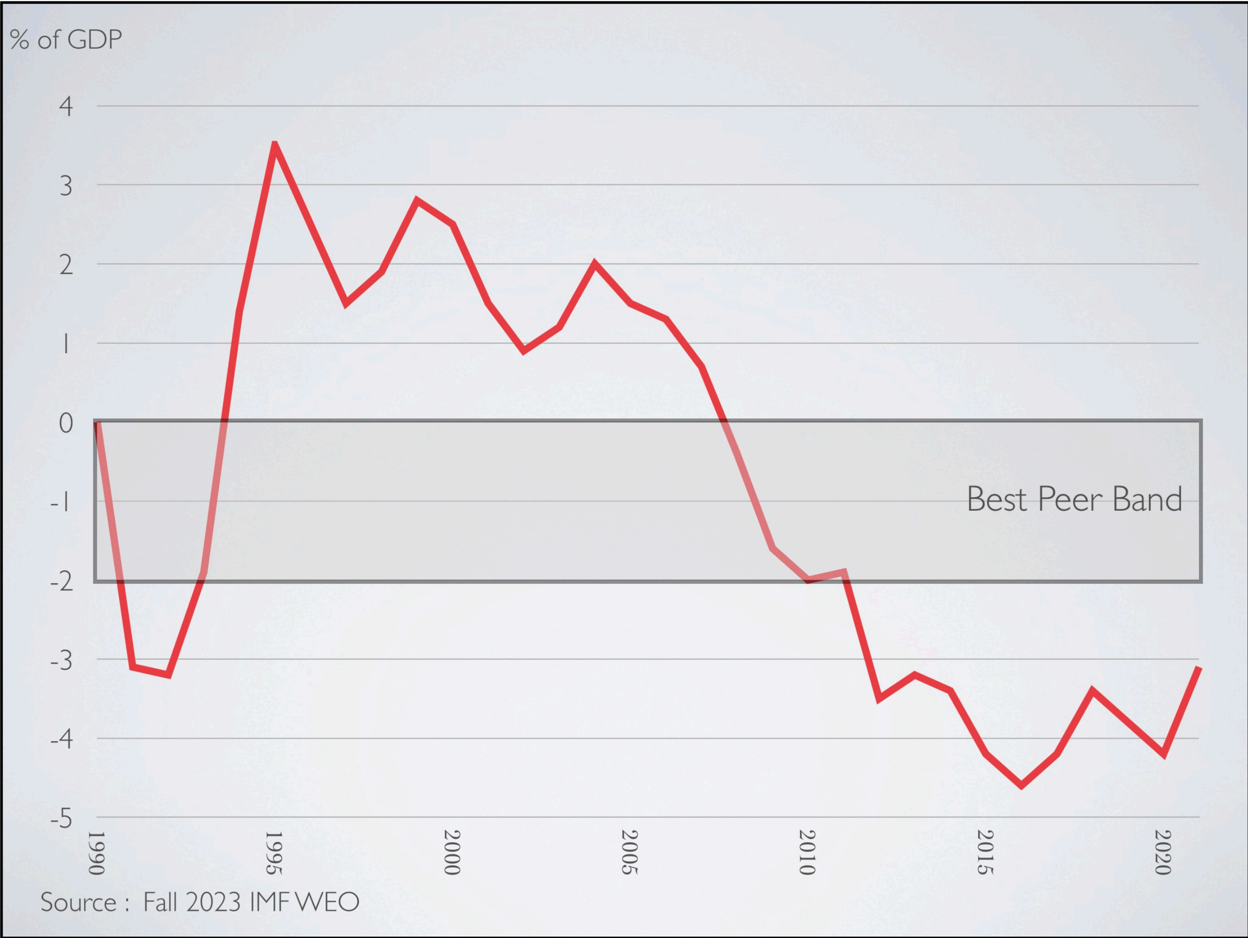
## 2. Misspecified Fiscal Policy

A misspecified fiscal stance is core to Kenya's long-run per capita growth shortcomings—far too tight from 1993-2010, then far too loose in the 2010s, with growth damaged by both errors.

Thus, the countries globally in Kenya's GDP per capita neighborhood which achieved the fastest growth of real GDP per capita 1990-2019 recorded average primary deficits (revenue less non-interest spending) of some 1 percent of GDP. The interquartile range of the top eight of them was from balance to minus 2 percent of GDP. And these countries maintained their primary balances inside this interquartile range—the best peer band—for the bulk of this period.

Kenya's record, measured against this best peer band, is shown in Figure 2.

Figure 2. Primary Fiscal Balance, 1990-2021 [2/]

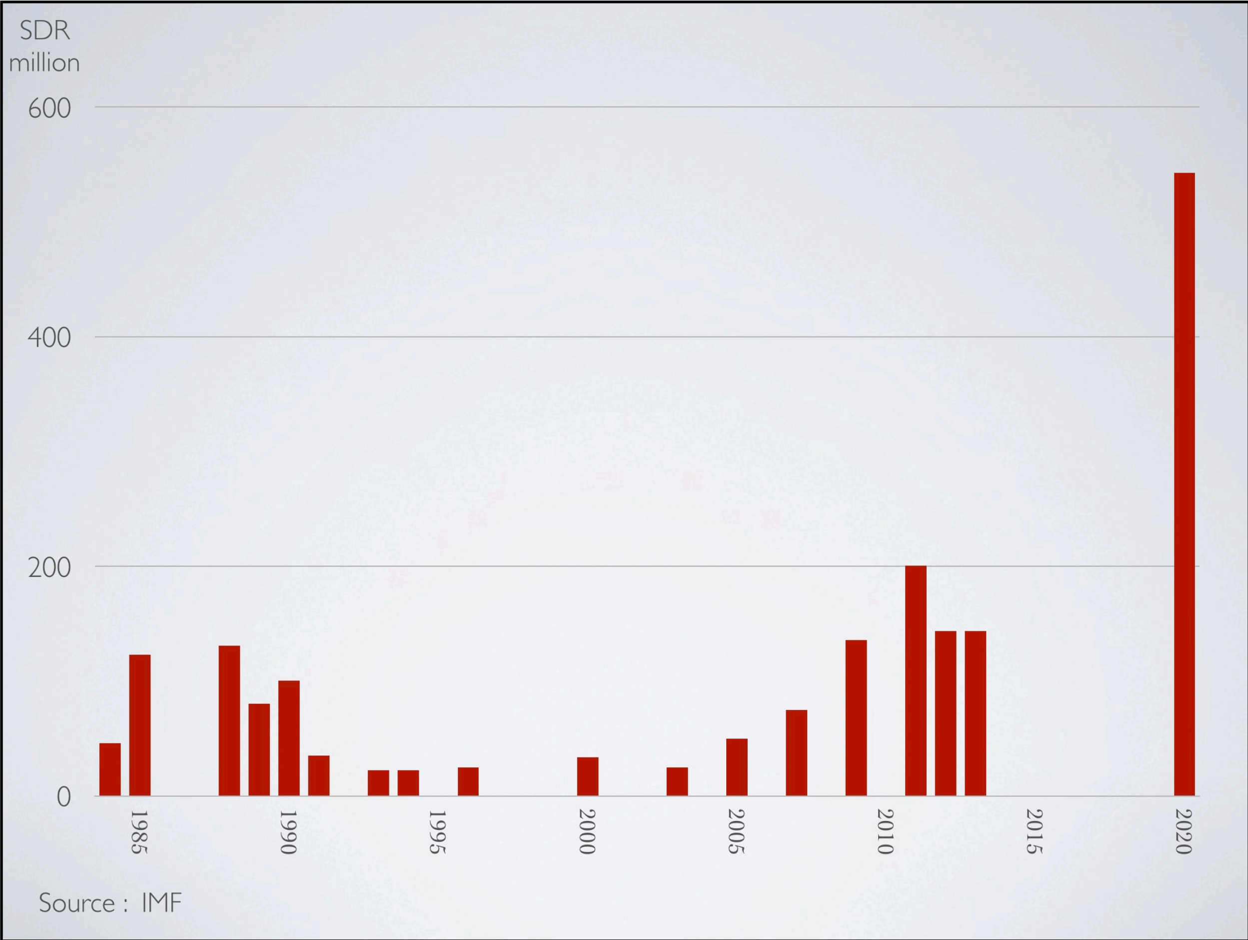



[2/] Kenyan fiscal data to calendar year 2024 are all on a cash basis.

Thus, rather than the prevailing narrative of official corruption and low quality spending—*madharau*—from the mid-1990s to 2010, Kenya constrained the supply of public goods necessary for development and incurred the X-inefficiencies from excess taxation so as to run primary balances far in excess of optima for growth. It did so for the decade and a half to 2010, especially in the mid-1990s.

Those over-tight fiscal and associated lower-than-best-peer-growth outturns reflected quasi-continuous IMF program conditionality which also addressed key matters in the composition of revenue and spending, as well as structural policy matters (Figure 3).

Figure 3. IMF Program Disbursements, 1984-2020




As top marathon runners affirm, dietary discipline is essential. But no matter how well-specified the rest of the exercise regime, starvation goes too far.

That privation reversed in the 2010s. Liberated from earlier IMF stringency by access to private capital markets in an era the IMF applauded as “Africa rising”, Kenya then loosened its fiscal stance considerably beyond the optima indicated by its best-performing peers.

The evidence from those best peers (and top marathoners) is that starvation is not corrected by subsequent gluttony—but rather that long run growth is harmed by both errors, which compound.

In that light, several Kenyan economists in the 2010s correctly warned of the dangers of fiscal excess. But these were “one-handed” economists as none of those condemned the earlier excess stringency.

The IMF, by contrast, was “two-handed” but in the wrong way—insisting on the earlier excess stringency, then also welcoming the excess indulgence, wrongly on both counts.

Best-peer-matching fiscal policy throughout may not have sufficed for Kenya to match its best peers’ growth performance from 1990-2019. But the international evidence is that it was necessary for Kenya to match their fiscal stance in order to have had any hope of matching their growth.

## 3. Real Effective Exchange Rate

A—if not the—key way in which the fiscal excesses of the 2010s transmitted into much lower-than-best-peer growth outturns was by compromising Kenyan competitiveness.

The Kenya shilling appreciated some 40 percent between 2010 and 2019 (Figure 4).

Figure 4. CPI Real Effective Exchange Rate of the Kenya Shilling, 2000-2023

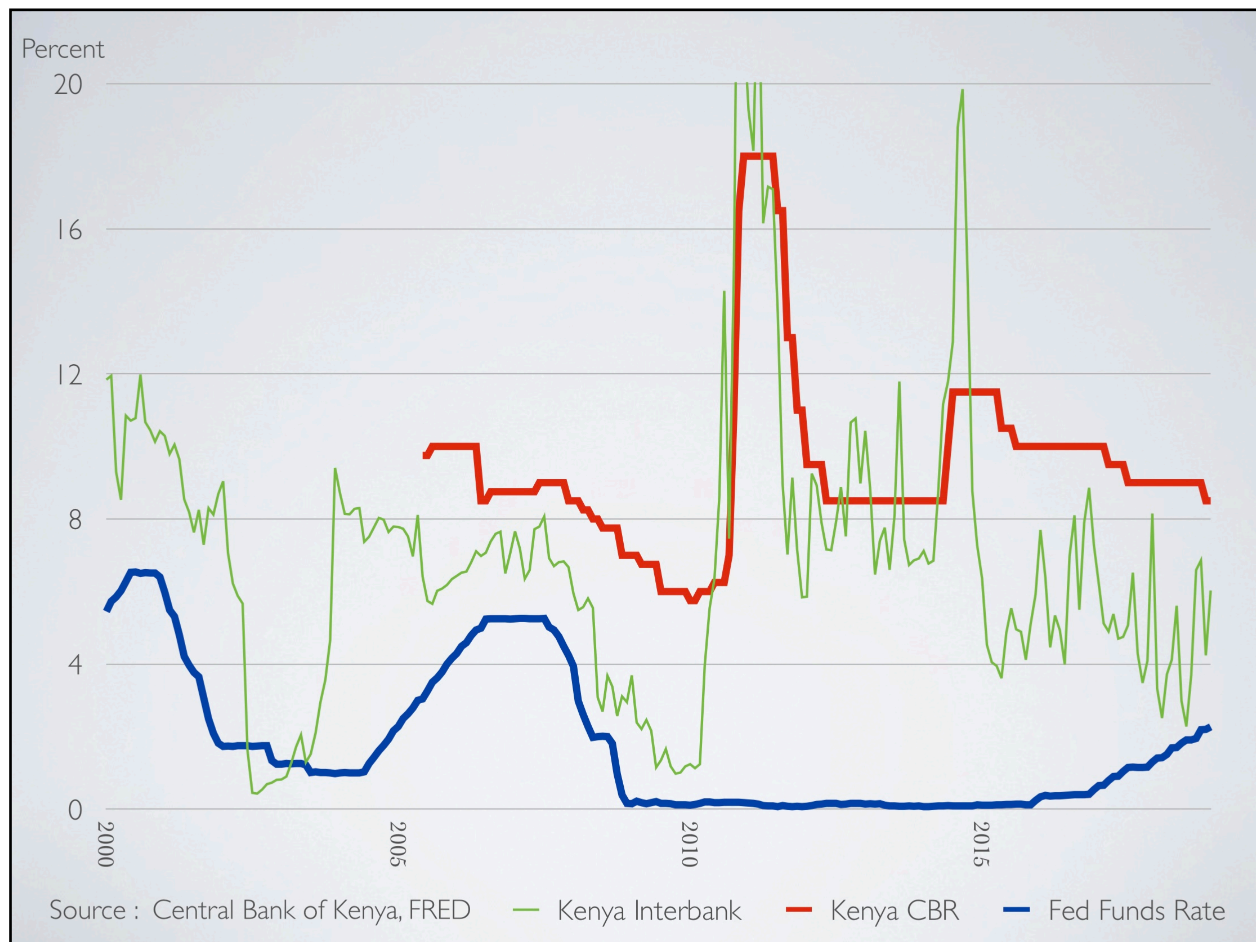
The misspecified fiscal stance during the 2010s is the apparent cause of this appreciation.

Following Dornbusch, in an open and small foreign exchange market with a floating exchange rate, the fiscal expansions from 2010 onwards required the Central Bank of Kenya to raise its policy interest rates to keep inflation within its target band of 5 percent plus a band of 2½ percentage points on either side. That successfully kept average inflation at around 7½ percent annually both in the 2000s excluding the Great Financial Crisis in 2008-09 and in the 2010s thereafter.

So in contrast to the early 1990s, when a brief destabilizing fiscal loosening in the context of a central bank lacking independence manifested in a burst of inflation up to some 50 percent (Figure 2), the strong policy response by the Central Bank of Kenya to fiscal loosening in the 2010s raised yield differentials in Kenya's favor to contain inflation, thus drawing capital into Kenya's small forex market to fund the deficit in a "risk on" phase in global capital markets, manifesting in Shilling overshooting.

Reforms in the monetary policy architecture complicate portrayal of these developments. Nevertheless, it is clear that the differential between the Central Bank of Kenya policy rate and the Effective Federal Funds Rate of some 3-5 percentage points in the 2000s widened in the 2010s to some 7-9 percentage points (Figure 5).

Figure 5. Central Bank Policy Rates, 2000-2019



Furthermore, the process of yield differential widening was serial. As "news" repeatedly came in during the 2010s that the global "risk on" period was extending and that Kenya's primary fiscal deficit continued to deteriorate, so the corresponding serial unanticipated increases in the yield differential elicited further capital inflows, and hence repeated episodes of Dornbusch overshooting, eventually yielding a cumulative appreciation of a remarkable 40 percent in the CPI Real Effective Exchange Rate over the decade.

This sequential/repeated Dornbusch overshooting account of the Kenyan shilling in the 2010s, rooted in the analysis of global risk on and of Kenya's primary balance relative to best-performing-peers, offers a more compelling account of the appreciation than a "Balassa-Samuelson" account of it. According to the latter, positive productivity shocks in the tradable sector drive up CPI real effective exchange rates. But Kenya's real GDP growth performance was lackluster in the relevant period indicating absence of a particularly marked productivity shock (Figure 1). And if Balassa-Samuelson was the driver, the external current account balance would not have deteriorated, let alone as sharply and deeply as Kenya's did (Figure 6).

Figure 6. External Current Account Balance, in percent of GDP, 2000-2019

And the Dornbusch-type explanation is also more compelling than a pure "capital inflows" account. Exogenous surging capital inflows might explain an appreciating exchange rate and a rising current

account deficit but would do so alongside declines in yield spreads. But as noted above, those rose markedly in the 2010s. And whereas capital surges usually exhibit for groups of countries, Tanzania and Uganda did not exhibit similar exchange rate appreciations, but did avoid fiscal excess.

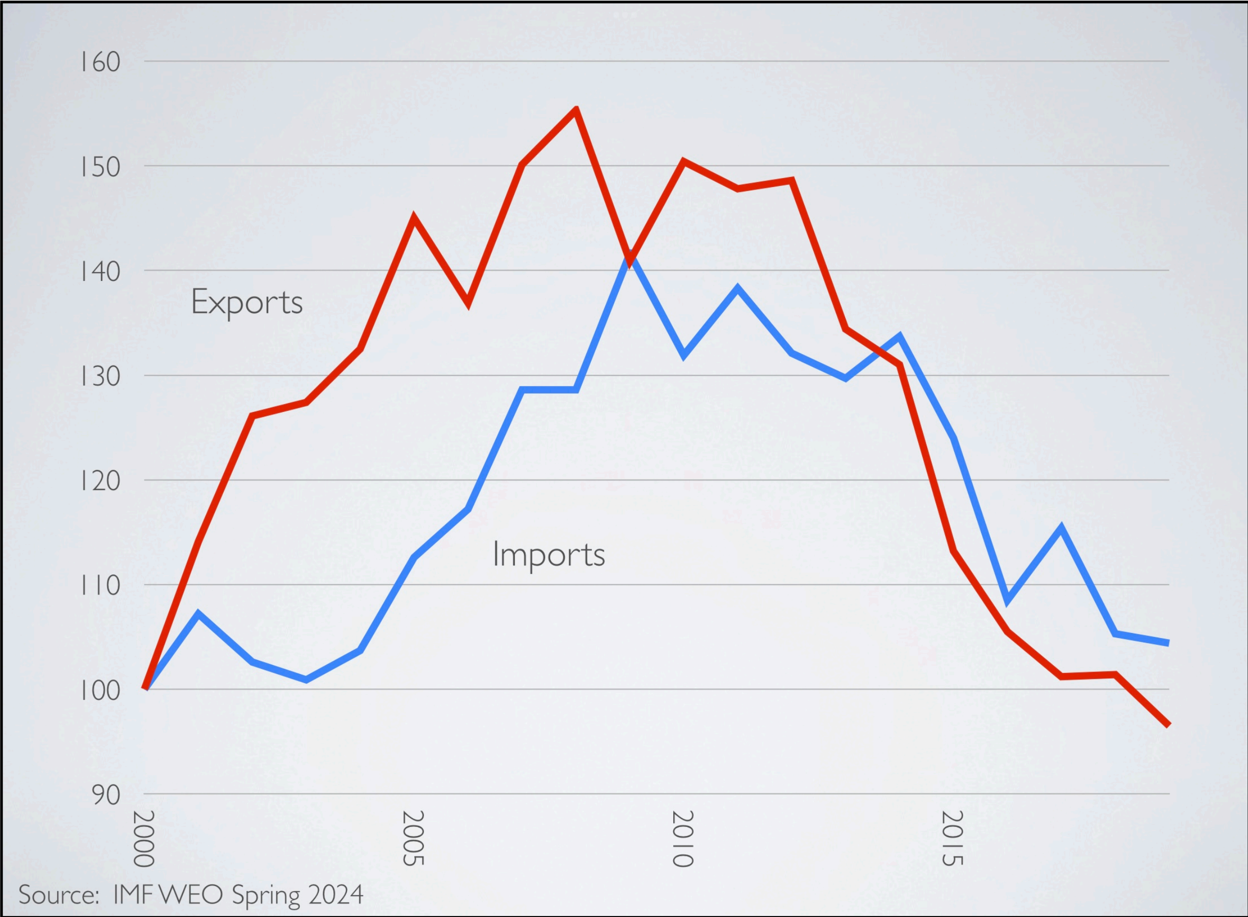
An examination of the political economy roots of the Dornbusch overshooting episode in Kenya after 2010—on both creditor and debtor sides—is beyond the scope of this paper. But its upshot was macroeconomic. And congruent with that account of the exchange rate, the CPI-REER began to depreciate in 2021 as fiscal retrenchment began (Figures 2 & 4).

## 4. Economic Orientation

The post 2010 marked appreciation of the Shilling was at the expense of Kenya's outward orientation.

From 2000 to 2010, the volume of Kenyan exports rose by 40 percent relative to real GDP, a period of export-led-growth (Figure 7). However, from 2011-19, alongside the marked appreciation of the Kenyan Shilling, that totally reversed, so that by 2019, export volumes had grown only as much as real GDP since 2000.

Figure 7. Export and Import Volumes of Goods and Services, Relative to Real GDP. 2000-2019

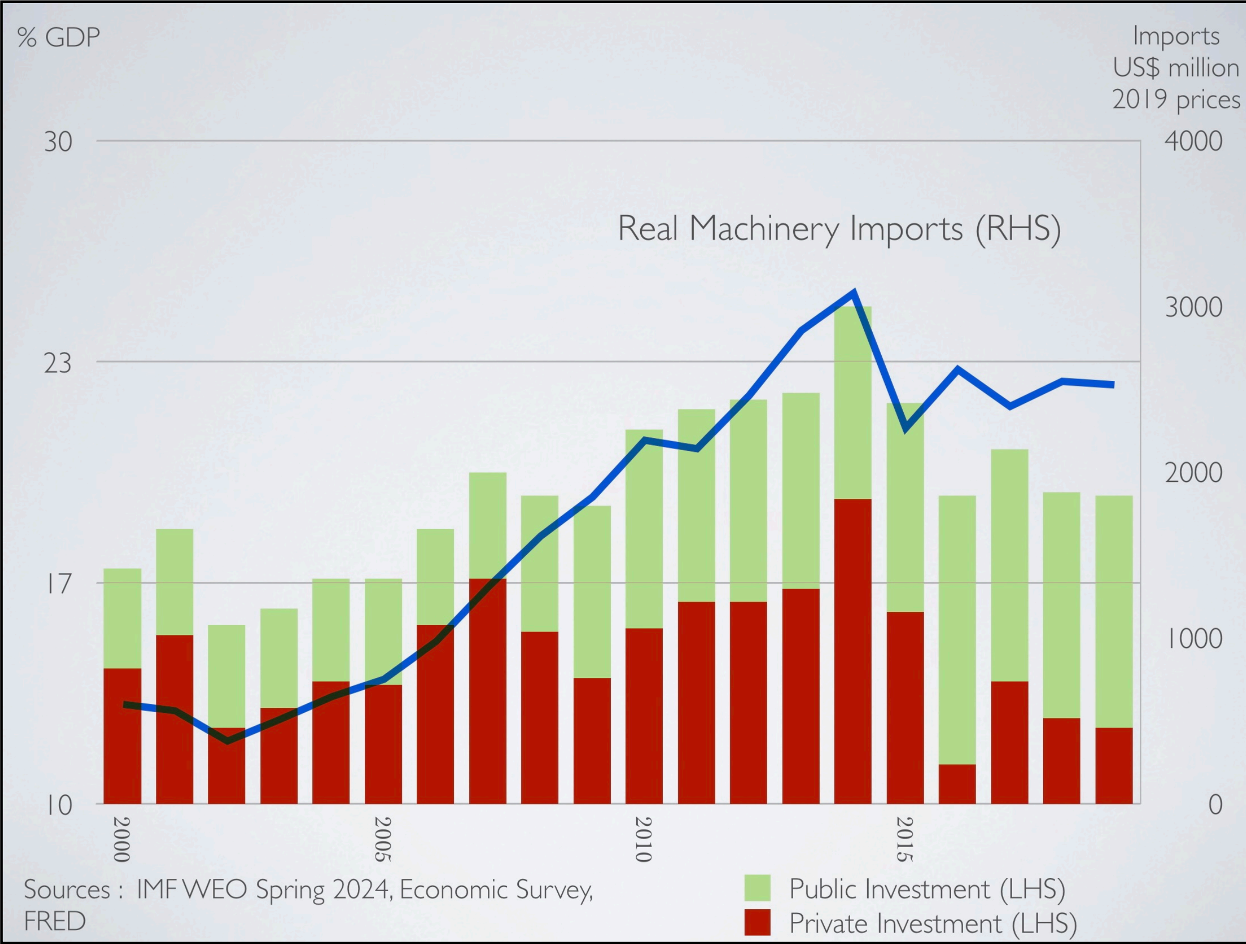


However, accompanying that remarkable gyration in the degree of export orientation of the economy, import volumes broadly followed the same pattern, albeit from a lower peak and at a slower pace of decline from 2010 than exports—even though the marked deterioration in competitiveness would conventionally be expected to cause import intensity to rise rather than fall relative to GDP.

The explanation lies in the structure of Kenya's imports. In 2010, over ⅓ of Kenya's imports consisted of industrial machinery—closely tied to total domestic, including public, fixed investment.

In the absence of official data on volumes specifically of industrial machinery imports, total industrial machinery imports in US$, deflated by the US index for prices of machinery and equipment, after rising strongly from the early 2000s fell sharply from its 2014 peak and then plateaued (blue line, Figure 8). That broadly followed the share of total investment in GDP (red and green bars, Figure 8).

Figure 8. Private and Public Investment in GDP, and Real Machinery Imports, 2000-2019




Note that this estimation of the volumes of industrial machinery imports by Kenya using the US index for prices of such goods invokes the law of one price for tradable goods. But it is qualified to the extent that the specific product composition of such Kenyan imports may not fully match that of US producers.

The key insight here is that the elasticity of the largest single subset of Kenya's imports—machinery and equipment—with respect to the real effective exchange rate is negative. So in contrast to the conventional sign which other import categories exhibit, overvaluation causes a large part of Kenya's imports, machinery, to fall, other things equal, because appreciation impairs Kenya's standing as a global production base, especially but not only for manufacturing.

That factor has to be taken into account when applying the standard techniques to assess currency misalignment in Kenya. For Industrial Countries, for which those techniques and parameters were developed and estimated, machinery looms large in *both* their exports and imports, so this particular characteristic of machinery with respect to such means of measuring misalignment broadly cancel out.

But for Kenya—and others with highly structurally imbalanced shares of machinery between exports and imports—a fundamental symptom of misalignment, low investment, *reduces* the large external deficits which conventionally signal misalignment. This feature also distorts the trade elasticities and trend exchange rate misalignment metrics of misalignment because it renders fundamental overvaluation more sustainable in capital markets but at the expense of medium-term growth—which is the ultimate metric of competitiveness.

Thus, all three conventional techniques used to measure misalignment estimated for and on industrial countries systematically overstate competitiveness when applied to cases, like Kenya, where imports of investment goods loom large in total imports and do not feature in exports. To date, the necessary corrections to such metrics have not been made, including by the Central Bank of Kenya (2019).

Accordingly, the total export and import volume data (Figure 7) both confirm the deterioration in Kenya's outward orientation as the Shilling appreciated in the 2010s—with exports decelerating markedly relative to GDP, and imports, dominated by machinery for investment, behaving likewise.

The negative impact on imports of machinery from the mid 2010s would have been even more evident absent the strength public investment (green bars, Figure 8). Thus, the underlying demand for such goods is indicated by private investment—which fell sharply from its 2007-13 norm in 2015-19 (red bars, Figure 8), a decline that is even more precipitous for business (non-housing) investment.

That indication of business investment aversion reflected in the sharp decline in private investment ratios after the 2007-13 norm suggests that the real effective exchange rate was broadly appropriate at around the last time private investment was sustainably close to those norms, in 2011-13. This was also the time at which export volumes began declining relative to GDP (Figure 7).

Given these indicators of private investment, machinery imports, and exports and their interpretation —and with due regard to the error band of some 10 percentage points around any central point estimate—the inference is that the Kenyan real effective exchange rate became overvalued from at least 2013-2014—with the implication that by end 2019, it was overvalued by some 20 percent.

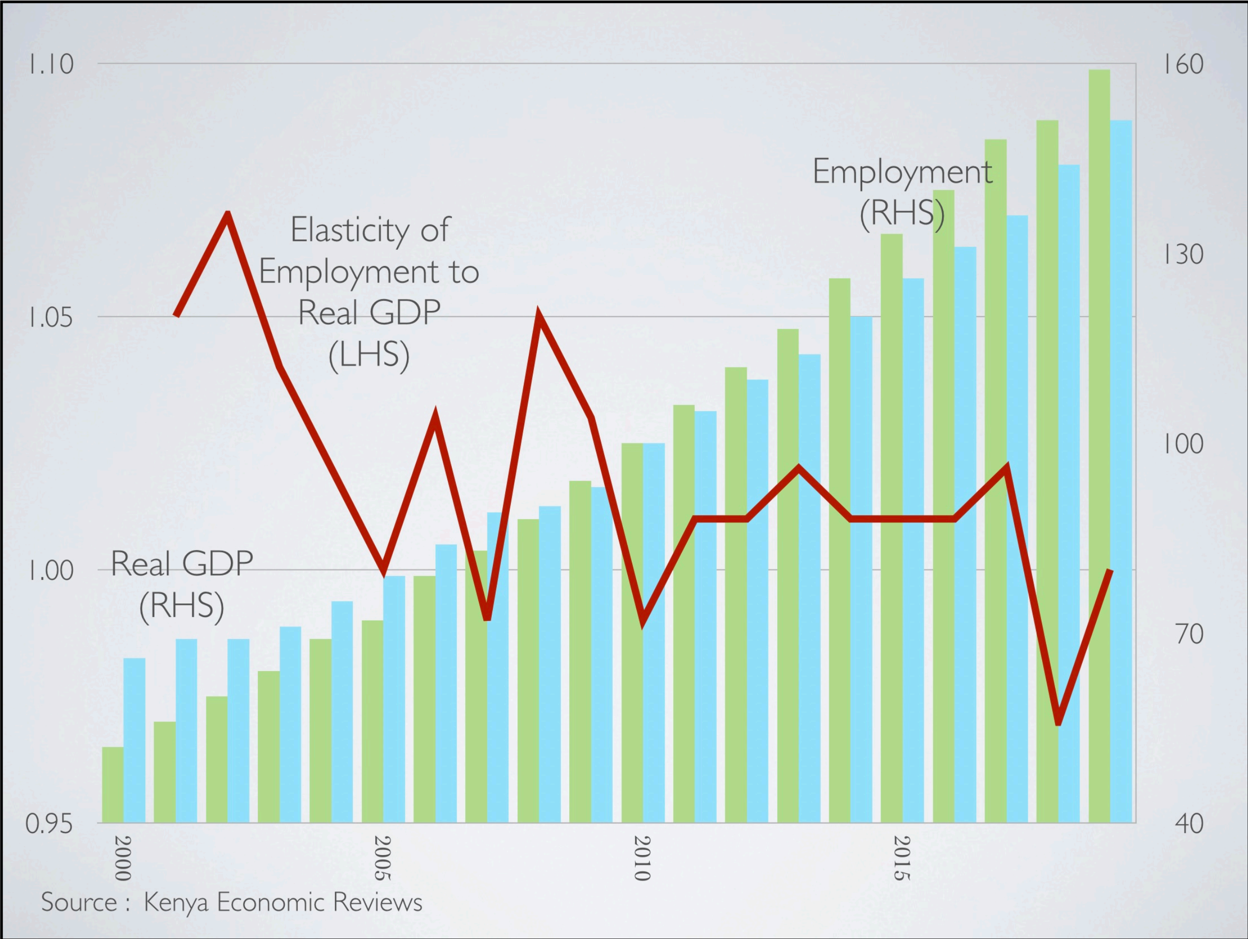
That estimate of misalignment for 2019 is far higher than others have suggested. But it is the outcome fundamentally of a sustained weak fiscal stance in context of a small forex market, a risk-on global environment, and an effective inflation-fighting Central Bank.

And it's indication is rooted in private investors actual behavior from the mid 2010s, expressing stress in declining private investment ratios and stagnant real machinery imports. That foundation of the estimate of the degree of overvaluation is buttressed by declining export volumes relative to GDP, by

sustained below best-peer per capita growth, as well as by the standard metrics of misalignment when corrected for Kenya's particular import structure. And it is reflected in disappointing growth of manufacturing, in a frequent preference for protectionist trade measures, including for foods, and in the extent of the fall in private investment ratios, especially non-housing, in a global risk-on phase.

And its pattern is even commensurate with aggregate employment data over 2000-2019. The elasticity of total employment to real GDP was highest and greater than unity—so employment grew faster than GDP—in the 2000s when the real effective exchange rate was most competitive and the economy strongly outward-oriented. But it declined in the 2010s when those conditions changed—falling to its lowest level below unity at the end of the period when competitiveness was compromised (Figure 9).

Figure 9. Elasticity of Employment to GDP, 2000-2019




## 5. Public Debt

The overvaluation of the Shilling from the mid 20-teens attenuated the reported growth of public debt by reducing the domestic valuation of foreign currency denominated debt.

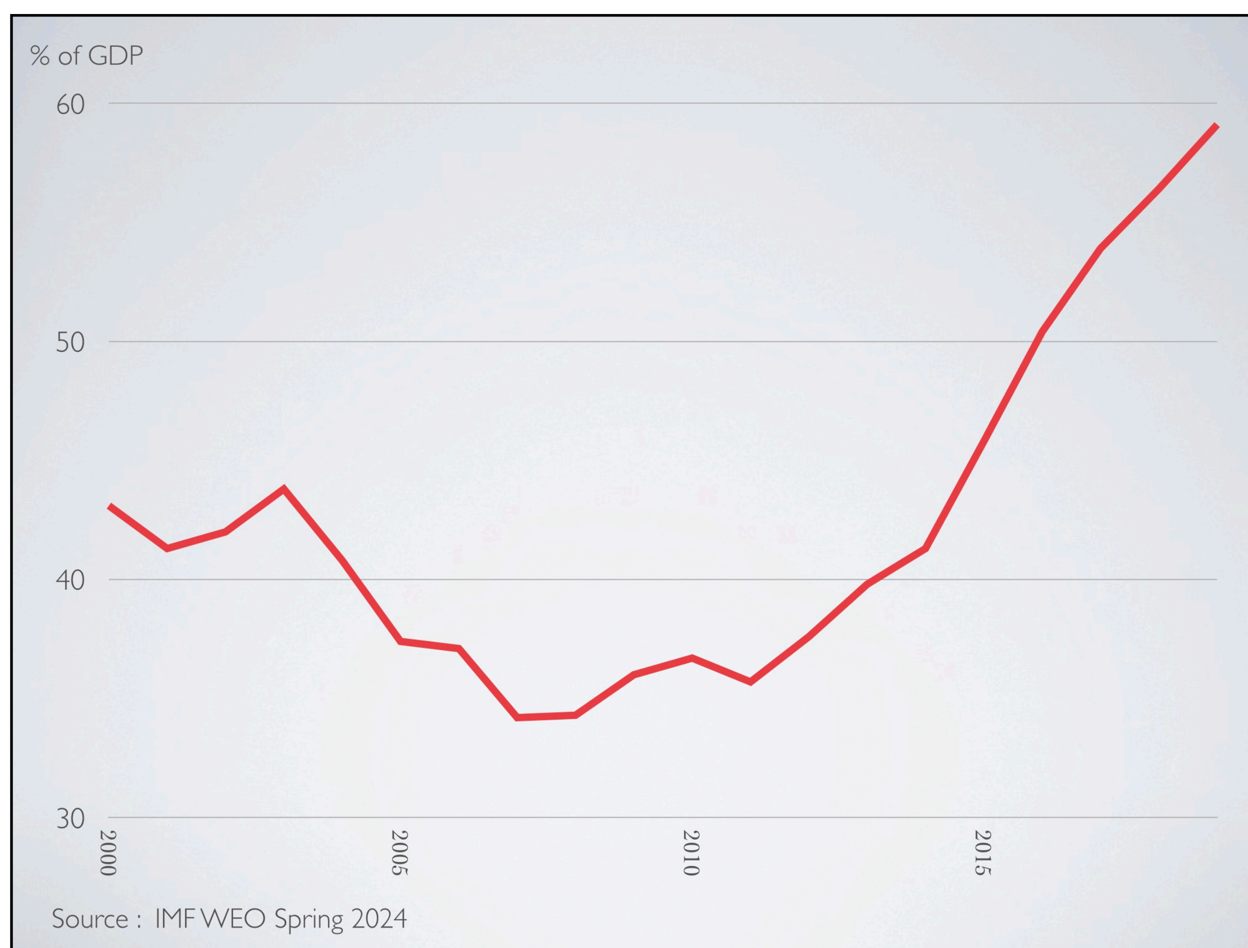
Remarkably, none of the IMF program Debt Sustainability Analyses (DSAs) nor their stress tests nor any of the Staff Report Risk Matrices consider the implications for the debt stock and IMF fiscal

policy counsel of the "contingency" that the comforting staff assessment of Shilling misalignment might be wrong. This elementary professional lapse—to use an unduly generous term—includes that none of those DSAs so much as report the foreign currency denominated share of the debt stock, let alone draw any attention to it or run any illustrative simulations to assess its potential implications.

As ready reckoner, if all external debt at program eve is assumed foreign currency denominated and no domestic debt is, the foreign currency share of public and publicly guaranteed debt was 2/3. If the Shilling was 20 percent overvalued at that point, the headline debt stock to GDP ratio was understated by some 8 percentage points of GDP. At the least, this shifts assessment of the strategic options of adjusting to pay the debt versus write-offs in the direction of the latter.

Even absent this exchange rate correction, a key consequence of the radical shift in the fiscal stance from 2010 (Figure 2) alongside weak growth was a significant rise in public debt ratios (Figure 10).

Figure 10. Public Debt, in Percent of GDP, 2000-2019 [3/]

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[3/] For the composition of Kenya's public debt, at prevailing market exchange rates, by creditor, see IMF Debt Sustainability Analysis p7, text table 2, here. Find the IMF presentation of the IMF/World Bank Low Income Country Debt Sustainability Framework here.

And when Kenya issued its US$ 2 billion bullet Eurobond in 2014, the settlement of which recently proved so challenging, the IMF issued a full-throated endorsement of the credit, unsighted both to the deterioration in competitiveness and associated harm to the economy's outward orientation already ongoing which the bond would aggravate, and to the impact on underlying public debt ratios.

So by end-2019, if debt is valued at the implied "correct" exchange rate—removing the estimated overvaluation at that point—the public debt stock at end-2019 was close to 70 percent of GDP.

## 6. Land

That ratio is fruit not only of a half-decade of misalignment and three decades of second-best-primary balances but also of six decades of misallocated land. That last is legacy of the colonialists who, by Independence, had seized half the agricultural land, locking in that concentrated ownership thereafter by insisting on full "willing-buyer-willing-seller" property rights as their last affliction bestowed on Kenya before finally conceding democracy.

With less than 20 percent of Kenya comprising high-potential land where three-quarters of its people live, that yielded extensive landlessness, squatting, congestion, and land clashes with half of the three quarters of Kenyans who own land owning less than a hectare. And as, after full price sales, half of arable land is now owned by just 20 percent of Kenyans, it has spawned a "big man" oligarchy, not least as women comprise just 5 percent of registered land owners and the bulk of agricultural labor.

So, for most, the customary artery from land—via nourishment, employment, insurance, collateral, livestock, marriage, and inheritance—to prosperity was severed, leaving many living short Malthusian lives.

## 7. And then, Covid

So Kenya was highly vulnerable going into the Covid shock, even before that shock was amplified by the Vaccine Apartheid practiced by the IMF's dominant shareholders.

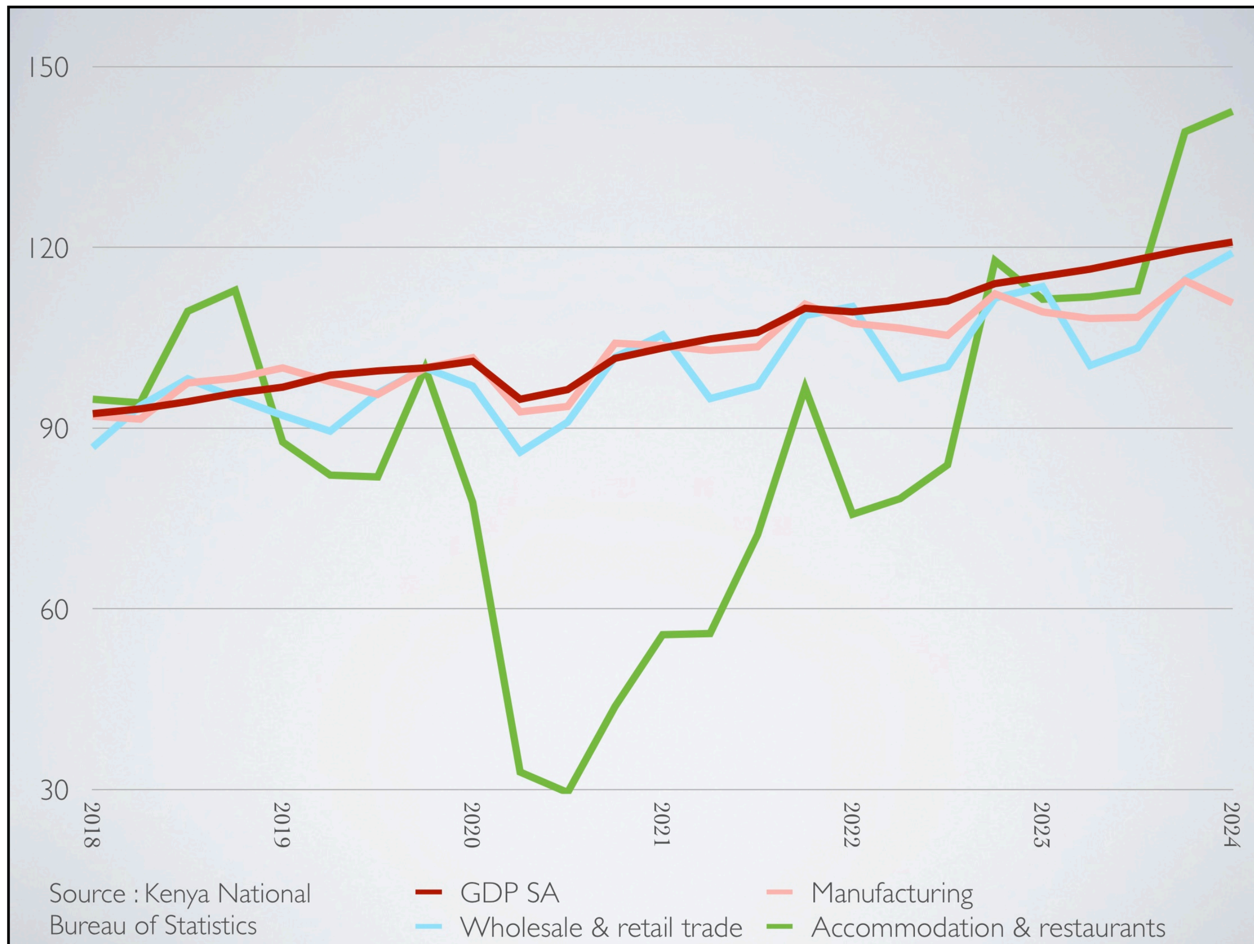
And so it was hit hard. But its limited fiscal resources meant that where Covid fiscal packages yielded a change in the G7 primary fiscal balance in 2021 some 8 percentage points of GDP weaker than anticipated in the Fall 2019 WEO, that difference was only 2½ percentage points in Kenya, due to the relative modesty of its Covid fiscal package.

Underlying that package, with additional health spending, Kenyan Covid tax measures included full income tax relief for monthly individual earnings below US$225; and cuts in the top pay-as-you-earn rate from 30 to 25 percent, in the corporate income tax rate from 30 to 25 percent, in the turnover tax rate on small businesses from 3 to 1 percent, and in the standard VAT rate from 16 to 14 percent, partly offset by elimination of many exemptions in the VAT and corporate taxes. The consequent revenue ratio fall was modest—less than ½ a percent of GDP—and temporary.

The Central Bank of Kenya did, however, follow other central banks cutting its policy rate, thus avoiding what would otherwise have been yet further overvaluation of the already overvalued shilling.

And so the overall consequences for Kenyan real output were severe, with the accommodation and restaurant sector particularly hard hit as tourism collapsed and the wholesale and retail sectors also suffering as customers avoided stores (Figure 11).

Figure 11.  Real Output Across Covid




But as it turned out, the global pandemic proved short-lived and by the time of the IMF program design in Spring 2021, Kenya was already well on the way to full recovery to pre-Covid trend, even though recovery for accommodation and restaurants took considerably longer.

**8. And then, Global Interest Rates**

Though the Covid hit to output turned out to be short-lived, so was the reprieve to Kenya's vulnerabilities from the sharp drop in global interest rates it occasioned.

By time of the IMF program design, long rates as indicated by the US 10 year treasury, were already rising as markets began anticipating decisive in policy rate rises which then transpired (Figure 12).

Figure 12. 10 Year US Treasury Bond Rate

For Kenya, the timing could hardly have been worse. After the full-some praise the IMF had given to Kenya's 10-year Eurobond on issue in 2014 and after the considerable deterioration in Kenya's competitiveness which it accommodated thereafter, its bullet 10-year maturity swung into view at the precise moment that financial markets began to close to emerging market borrowers.

### 9. And then, Droughts

Poor rainfall in five seasons beginning in 2020 gave rise to the most severe drought in Kenyan records. The challenges were amplified by Covid and by migratory desert locust infestations, greatly damaging households as critical water shortages devastated food security and livelihoods, and conditions for raising livestock, whether commercial or subsistence. When relief eventually came from these and Covid, many (most?) households' balance sheets—already fragile—had been significantly impaired.

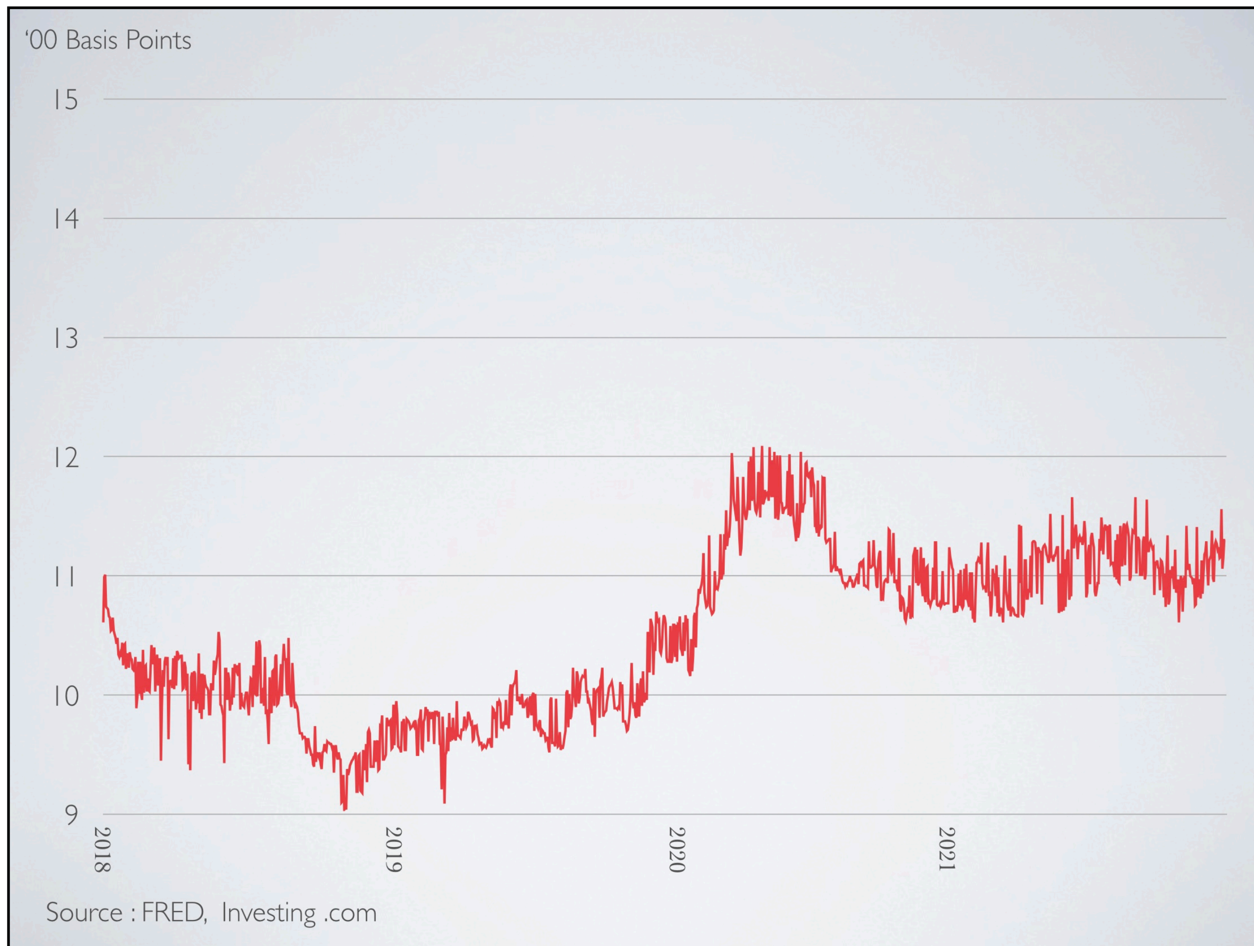
### 10. Stunting

The shortcomings in macroeconomic policy over the past three decades in Kenya, often at IMF insistence or indulgence, aggravated by recent shocks, are no intellectual abstraction. In 2021, as the latest IMF program was being designed, one in five of Kenya's children were stunted, reflecting

severe, widespread, and enduring deprivation, even outside drought areas. Given widespread concern with gender disparities, it is notable that this was concentrated disproportionately amongst boys.

On IMF program's eve in 2021 therefore, all these ten antecedents were reflected in high yield spreads between Kenya and global benchmarks, albeit off the recent mid-Covid highs, indicative of the substantial and increased non-credibility of the prevailing policy framework (Figure 13).

Figure 13. Yield differentials, 10 year Government Bonds, Kenya less US$ Treasuries 2018-2021



## II. IMF Program Framing and Priorities

By April 2021, Kenya needed an IMF program.

By then, already emerging from Covid, it had a long-standing deep growth shortfall, a heavily overvalued exchange rate primarily reflecting an excessively loose fiscal stance, consequently a difficult—and understated—challenge to manage its public debt stock, an adverse context of rising global interest rates for commercial refinance for that stock, a large bullet payment on it looming, and ongoing droughts.

Absent an IMF program, all of that was set to make prospects for Kenya's shockingly high proportion of stunted children even worse.

What was needed was an IMF program to address those matters decisively, notably an immediate change in the policy mix with a sharp front-loaded fiscal consolidation to allow a monetary loosening sufficient to correct the exchange rate and inward orientation while keeping inflation on target.

But that total fiscal correction should not be excessive, at the expense of medium-term growth, even if such a fiscal path required debt write-offs to reconcile it with a declining public debt to GDP ratio, the conventional and appropriate overarching metric of debt sustainability.

In the context of the given framework, monetary conditionality needed to be adaptive. And the entire program should have been designed to secure resilience to risk of further adverse exogenous shocks.

But that is not what happened.

Instead, the IMF back-loaded the fiscal adjustment while mandating medium-term primary fiscal balances well above global best practice at the expense of medium-term growth potential, thus subordinating all other goals to full debt repayment, never even mentioning the exchange rate expressly or otherwise as a core object of macroeconomic policy.

And when its conditionality on the Central Bank of Kenya turned out to be misspecified in the evolving context, that was not corrected. So it also delivered a monetary stance which was too tight, impeding the necessary correction in the exchange rate, all at the expense of short-run growth as well.

In that context, the program's stated goals have proved elusive, as has the fundamental correction in economic orientation that was required. And the program's consequent underlying fragility has been most obviously reflected in the seismic ongoing social and political upheaval which it has now birthed.

### 1. Program Framing

Specifically, the IMF headlined its framing in 2021 thus:

> "The Fund-supported program will anchor the next phase of the authorities' pandemic response and a multi-year consolidation effort centered on raising tax revenues and firm expenditure control. By bringing the primary deficit below its debt-stabilizing level during the program period, debt as a share of GDP would be put firmly on a downward trajectory. Tax revenue would be brought back from current low levels to the levels achieved in recent years … "

With the pandemic already largely receding, there is no mention here of growth, competitiveness, economic orientation, drought, land, or stunting. Instead, again without justifying why these matters were disregarded, the IMF framed the challenge purely as putting public debt on a downward trajectory via adjustments to the primary balance, spearheaded by action on the revenue side, all supported by what in Kenya are perennial commitments to reform State Owned Enterprises.

This was not a matter of prioritization or division of labor with other international institutions. The most notable aspect of the IMF Staff Report which initiated the program is that, competitiveness aside, it does not even raise these other matters, let alone explain how they should effect policy on debt stabilization, nor prioritize among them nor, assign them to other institutions to address.

Instead, all too evident is a complete lack of curiosity to understand major prior macroeconomic transitions in Kenya or their implications for program design—or perhaps it was absolute conviction in the pre-conceived framing precluding any sense of need to verify it, or worst, a mindset unable to conceive that Kenya (Africa?) might, technically, be macro-economically distinct and complex.

Whichever it is, after a brief reference to the IMF's Covid SDDI debt service delay initiative—which Kenya reluctantly joined even though most other eligible countries declined and despite creditors' refusal to extend Kenyan payments falling due after mid 2021—the analysis reads like an elementary spreadsheet exercise in the standard debt equation tying the debt trajectory to a given growth and interest rate outlook, and primary balances.

Though IMF staff rightly emphasize risk of debt distress and the difficulties of attaining their primary balance targets, there is not so much as a whisper about general debt service re-phasing—let alone write offs—as an option to reconcile sustainability with growth, let alone any explanation of why such policy options were ruled out or any indication if they were even considered.

This last emerges a serious recurring theme throughout—of core strategic decisions and numbers not being justified by the IMF or, in many instances, discussed at all. Instead, they are implicitly presented as axiomatic or as *fait accomplis*.

**2. Misalignment and Front-Loading**

A partial exception to this lack of explanation is competitiveness, where the External Sector Assessment in the program initiating Staff Report uses the three standard metrics to assess misalignment.

However, the discussion is boilerplate. It does not consider let alone counter the methodological issues and evidence outlined above, nor evince any obligation to explain the 40 percent real appreciation over the prior decade—dismissing that, without reference to the number, as a recent "trend" (as if those don't have to be interrogated)—nor the behavior of export and import volumes relative to GDP or the large sustained external current account deficits alongside.

Instead, just "letting the three-component misalignment metrics sausage machine" spit Kenya out without actually thinking about what it was doing, IMF staff conclude that in April 2021, the Shilling was within 3 and 9.1 percent of its correct value. In so doing, they were oblivious to the absurd precision in their upper bound given that in applied macroeconomics, even a conservative margin of error is some +/- 5 percentage points around any central estimate of misalignment.

But the core implication of the staff failure to identify the extent of misalignment was that the fiscal adjustment path they recommended was too back-loaded. A sharp up front adjustment was needed to allow monetary policy—via interest rate cuts—to drive a correction in the exchange rate. But not so. Indeed, a proprietary study by Oxford Economics of some 200 episodes of fiscal adjustment finds that the path for the Kenyan fiscal balance was exceptionally back-loaded.

And staff did not so much as consider in their Risk Assessment Matrix the implications misalignment could have for core policy advice and debt sustainability if it turned out to be significant.

### 3. Medium-Term Primary Balance Target

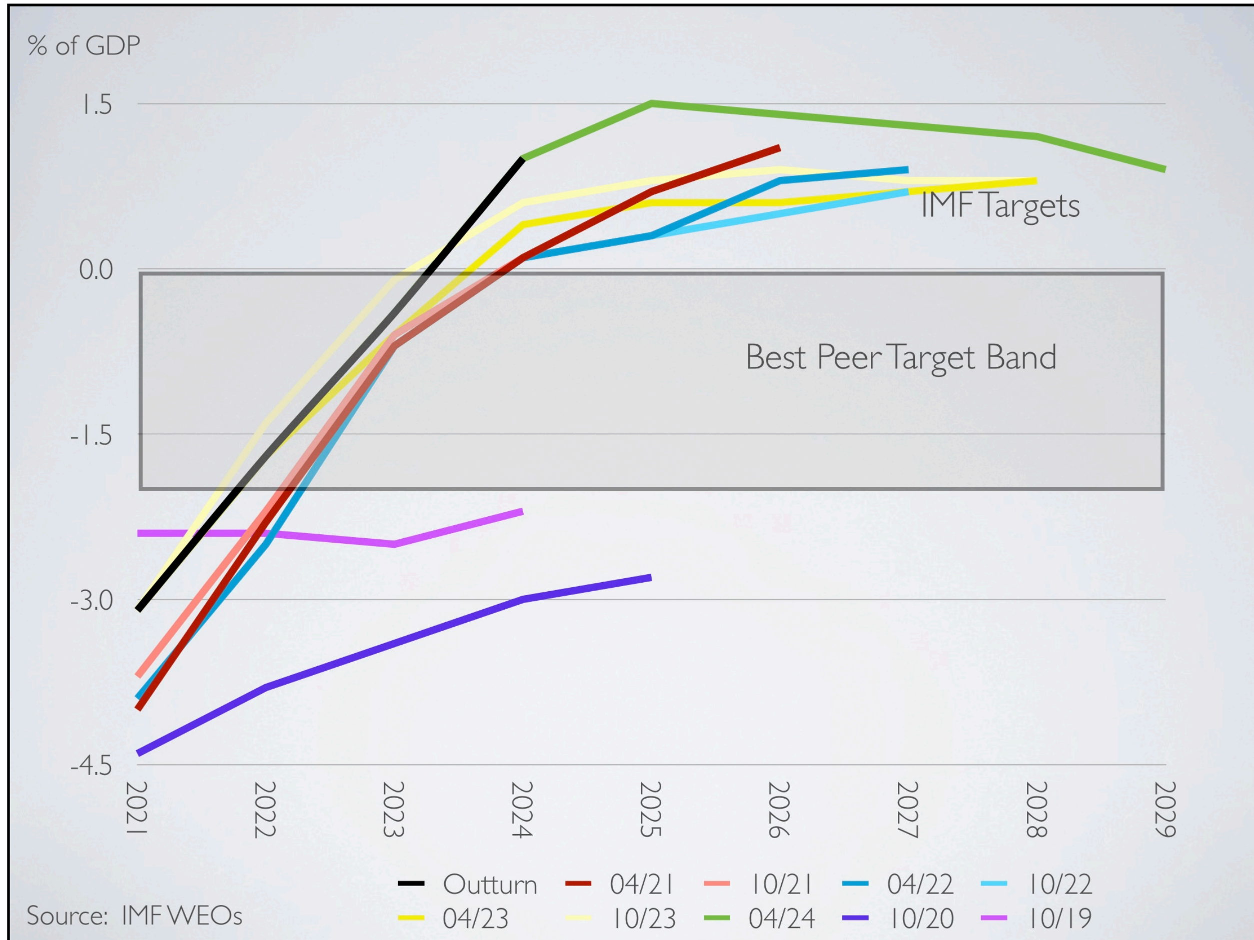
Furthermore, by anchoring their fiscal targets in public debt reduction rather than in misalignment and growth, the IMF also went far too far in its overall demands for fiscal adjustment.

In particular, the sole near constant in the program throughout is the IMF's medium-term target for Kenya's primary balance, set to be close to a surplus of around 1 percent of GDP. That number persisted despite multiple shocks since program initiation—including revised estimates of the 2021 debt stock, the outturn for the post-covid recovery in Kenya, and global interest rates rising higher than anticipated.

However, neither the initiating staff report nor its successors explain this all-but-unchanging pivotal target number—why not higher, why not lower? Furthermore, the texts do not even mention it (not even, remarkably, the program originating Debt Sustainability Analysis) beyond offering generic unnumbered exhortations about the necessity to put public debt "decisively" on a downward trajectory with "ambitious" fiscal policy.

An effort to reverse-engineer the IMF's rationale for that number by examining its evolution over time yields little light. Figure 14 reports the IMF targets for Kenya's primary balance across various vintages of the WEO, starting with two immediately prior to the program. The further to the right the lines extend, the more recent the WEO vintage. The initiating program is the red line, the most recent vintage is the green line, and the outturns, including staff estimates for 2024, are shown in black.

Figure 14. IMF Primary Balance Targets, in WEO Vintages




Immediately apparent is the dramatic change in the IMF targets at program initiation (red line) compared to immediately prior it (dark purple). In just six months from October 2020 to April 2021, the IMF raised its view of the necessary medium-term primary balance by 4 percentage points of GDP —a sum equivalent to 1/4 of Kenya's primary spending—without feeling any obligation to explain.

But following that extraordinary volte face, the original program targeted a medium-term primary surplus of 1.1 percent of GDP (Figure 14, red line). That was revised moderately downwards in subsequent reviews as summarized from each subsequent vintage of the IMF WEO, dropping to a little below 1 percent of GDP (blue and yellow lines), and up again in Spring 2024 (green line).

However, where the pre program targets were well below best peer practice for countries in Kenya's GDP per capita neighborhood, the program medium-term target numbers are significantly above.

In particular, based on WEO worldwide IMF data from 1990-2019, countries which in that period grew fastest at around Kenya's GDP per capita averaged primary deficits of between 0.2 and 2 percent of GDP (greyed box "Best Peer Target Band" in Figure 14). Relative to the center of that band, which indicates a growth-optimal medium-term primary balance at Kenya's level of GDP per capita of a

deficit of 1 percent of GDP, the IMF target for Kenya is now some 2 percentage points of GDP above global best practice having been well below that measure of best practice pre-program.

No rationale is provided or apparent for either of these deviations of core IMF targets for the primary balance from global best practice, nor for why the IMF targets dramatically changed at program initiation, and (so far) ever after.

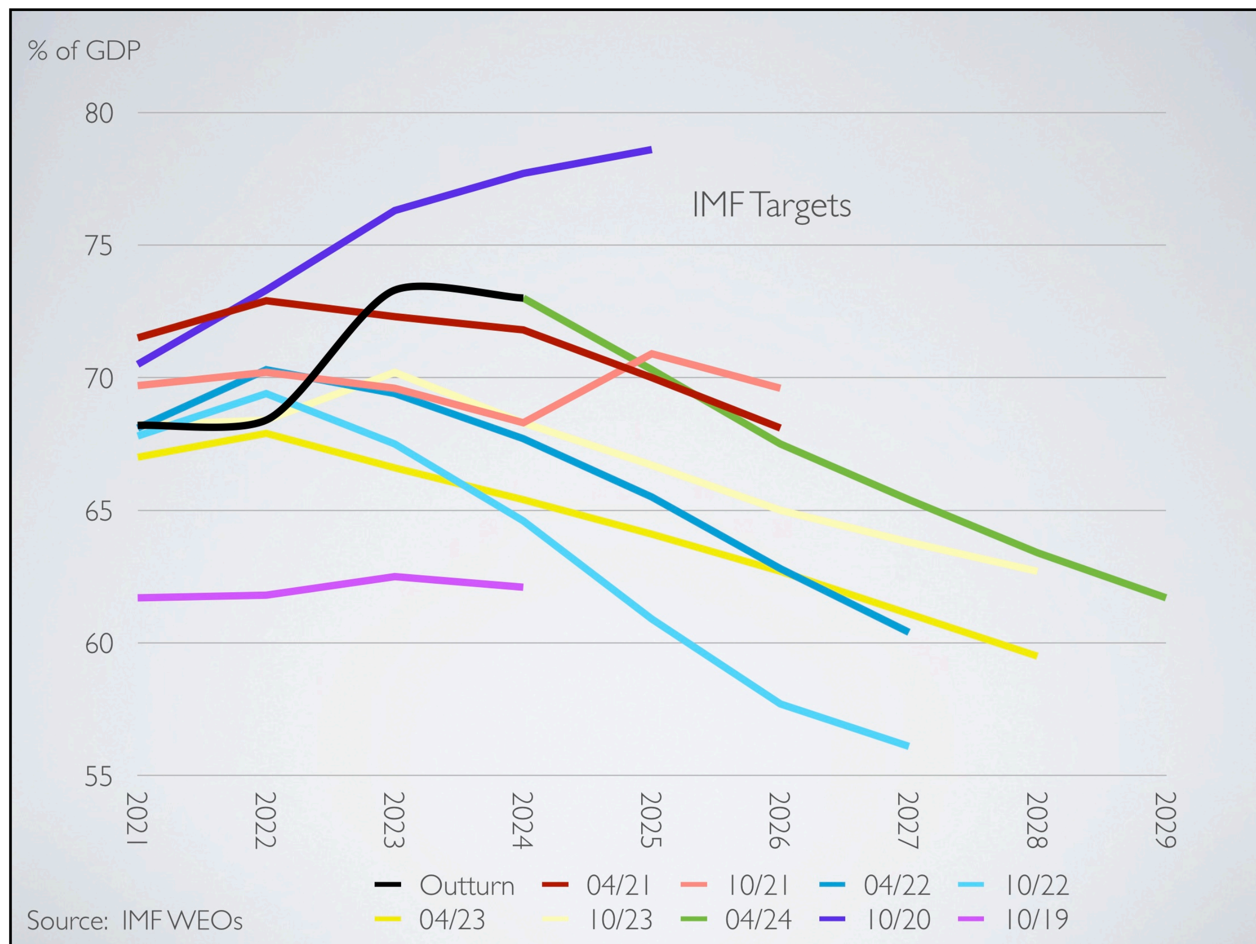
Given long growth underperformance in Kenya—derived in significant part from earlier deviations of primary balances from the target band (Figure 2)—the pre-program targets were set to continue that underperformance by undershooting best practice, while those in the program go well beyond what can be justified by such growth optimization.

## 4. Public Debt Outlook

Nor, even, can any of these targets be reverse engineered from the evolving outlook for public debt.

Even leaving aside that the public debt to GDP ratios are flattered—and significantly—by misalignment of the Shilling, the most notable feature of debt projections through each program review, again as summarized by each vintage of the WEO in the same was as above, is that the apparent anchor target of a primary surplus of a little below 1 percent of GDP was associated, according to IMF projections, with wildly varying projections for public debt ratios (Figure 15).

Figure 15. IMF Projections for Public Debt, in WEO Vintages



Thus, whereas the pre Covid targets saw public debt stable at a little over 60 percent of GDP (light purple line), the subsequent pre-program targets saw public debt rising sharply towards 80 percent of GDP—but with the IMF *lowering* its schedule of required primary balance targets from its prior vintage (Figure 15), formally indicating that it was unperturbed by that public debt outlook.

However, the program initiating staff report projected a debt ratio of 68 percent of GDP by 2026 (red line)—thereby implicitly justifying the volte face on the necessary medium-term primary balance.

Just a year later, the IMF projected public debt in 2026 some 10 percentage points of GDP below that (blue lines). Nevertheless, it left its primary balance targets broadly unchanged (Figure 14), without explaining why having just accepted debt at 68, 58 percent of GDP in 2026 was suddenly necessary.

In Spring 2024, with the debt outturn for 2024 estimated above target for that year (black line), the debt outlook for 2026 had reverted to the original program projection, with the medium term primary balance target raised a little higher, and the trajectory to that medium-target raised very significantly higher, and underlying sharp further tax rises in the 2024/25 budget (Figure 13, green line).

Given these enormous gyrations in the public debt to GDP projections with an unchanged primary balance targets as the program evolved, it is evident that specific debt ratio objectives do not underlie the IMF's calibration of the medium-term primary balance target of a little below 1 percent of GDP. Had they been, the medium-term primary balance target would have been significantly adjusted in 2022 in light of the then-projected precipitous fall in public debt ratios, and it was not.

Accordingly, it is hard to discern any rhyme or reason from reverse engineering these medium-term IMF program primary balance target numbers—they give every appearance of pure fiat, and chaotic fiat at that.

And they require justification if for no other reason than that they are clearly above—and significantly so—global best practice for growth and are bereft of evident connection to specific debt trajectories.

## 5. Fiscal Revenue Targets

And those targets also essentially drive the specific—and highly contentious—tax reforms to yield the program revenue targets.

In stark contrast to its treatment of the pivotal medium-term primary balance target and its relationship—if any—to the debt trajectory, the program initiating staff report was explicit and detailed about the targets for revenue derived directly from them. With the Covid-stimulus revenue measures already reversed before the program started, the aim was to reverse immediately all the stimuli revenue losses. Thus:

> "A key pillar of the strategy is to bring the tax-to-GDP ratio back to levels achieved in recent years (from 12.9 percent of GDP in FY20/21 to 15.6 percent in FY23/24), so as to generate resources to meet Kenya's development needs."

Though specific about motivation and numbers, the IMF case was nevertheless unpersuasive on both.

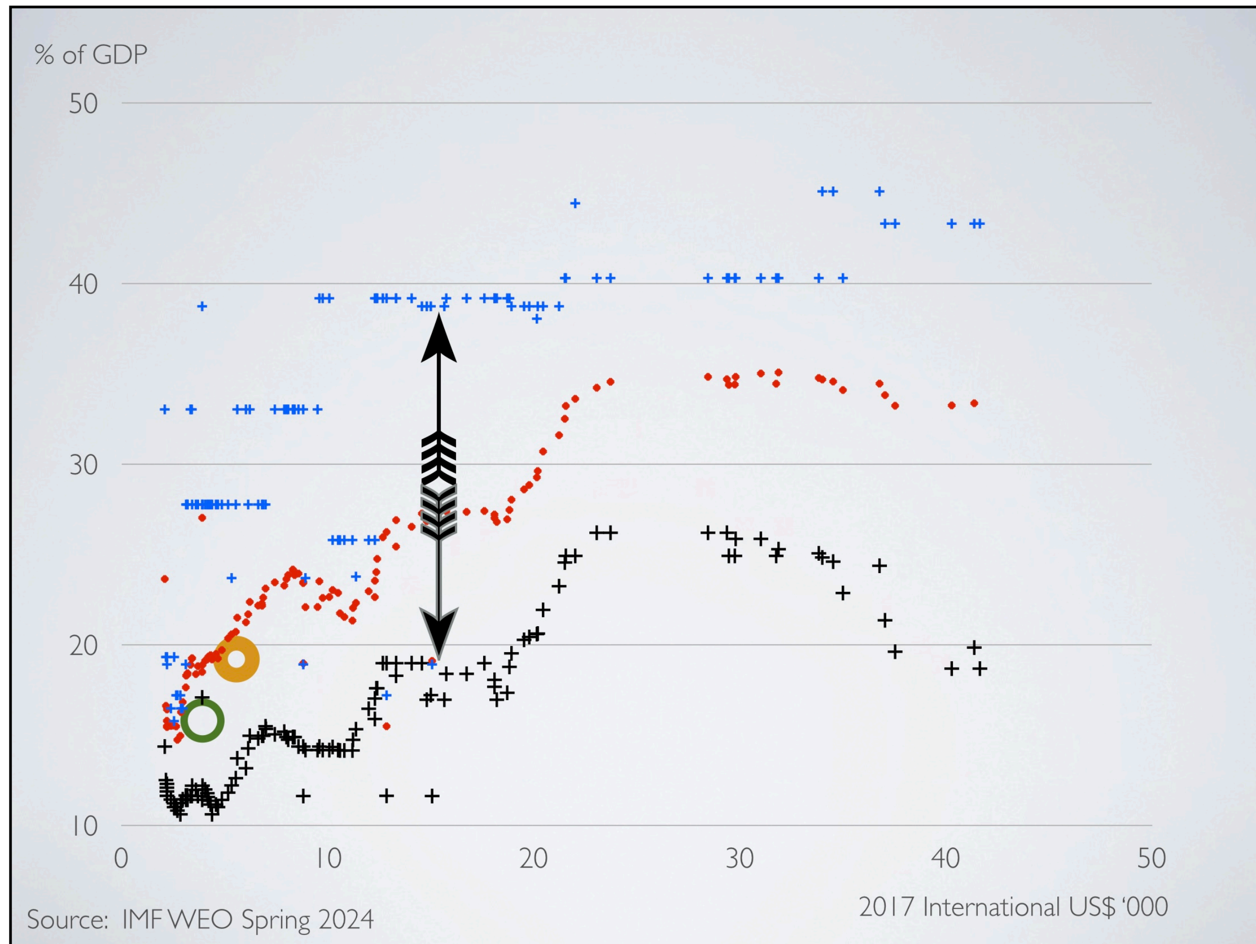
As much else, the key phrase "to meet Kenya's development needs" is never elaborated or explained, but is simply presumed to be self-evident, given the targets for the medium-term primary balances.

But it is not.

The fastest realGDP per capita growing countries globally from 1990 to 2019 secured that achievement with a wide range of revenue to GDP ratios. Thus, for each level of GDP per capita, the revenue ratios of the eight fastest per capita growing countries over that period can be ranked from highest to lowest, and their interquartile range plotted.

These data are shown in Figure 16.

Figure 16. Revenue Ratios in Fastest Growing Countries, 1990-2019




The blue dots show the upper end of the revenue interquartile range, and the black dots the lower end, with the red dots the average, all for the fastest real per capita growing countries 1990-2019.

The width of the interquartile range—indicated by the arrows, typically 20 percentage points—shows that the choice of growth strategy by the most successful countries has varied widely. Some, at the lower revenue end, have chosen to grow with limited impediments from taxation matched by similar low provision of public goods for development. At the other end of the spectrum, other similarly rapidly growing countries have achieved their success despite the impediments from high revenue ratios by matching them with generous and effective provision of public goods for development.

Thus, there is no "single optimal ratio" of revenue to meet a country's "development needs."

So any revenue objective has to be justified relative to the country's specific and chosen development strategy. And in Kenya, any case to raise revenue ratios must explain why the public's reservations, due to warranted concern with public waste and corruption, should be disregarded. The IMF does not do any of this for Kenya, let alone explain why the revenue targets in its program are so aggressive.

It compounded these omissions in mid-program by comparing Kenya's revenue ratio to that of other African countries, replicating an exercise often conducted by analysts and reported by the Kenyan authorities.

That comparator exercise misleads. The relevant peer group is not African countries—which not only includes many with very different levels of GDP per capita from Kenya but also some highly sub-par growth performers. Instead, the relevant peer group for this exercise (as for any aspirant marathon champion) is to not to follow the example of a mix of middle-of-the-roaders, whether African or not, but of the pack leaders, namely the globally fastest growing at Kenya's level of GDP per capita.

On that basis, Kenyan revenue ratio for 2021 (green circle, Figure 16) is a little below the best peer average, but close to the center of the interquartile range, thus showing no sign of being any sort of obvious outlier. After the originally mandated revenue measures including for 2024, the IMF projected Kenya's revenue ratio to increase to the average of the interquartile range (brown dot, Figure 16).

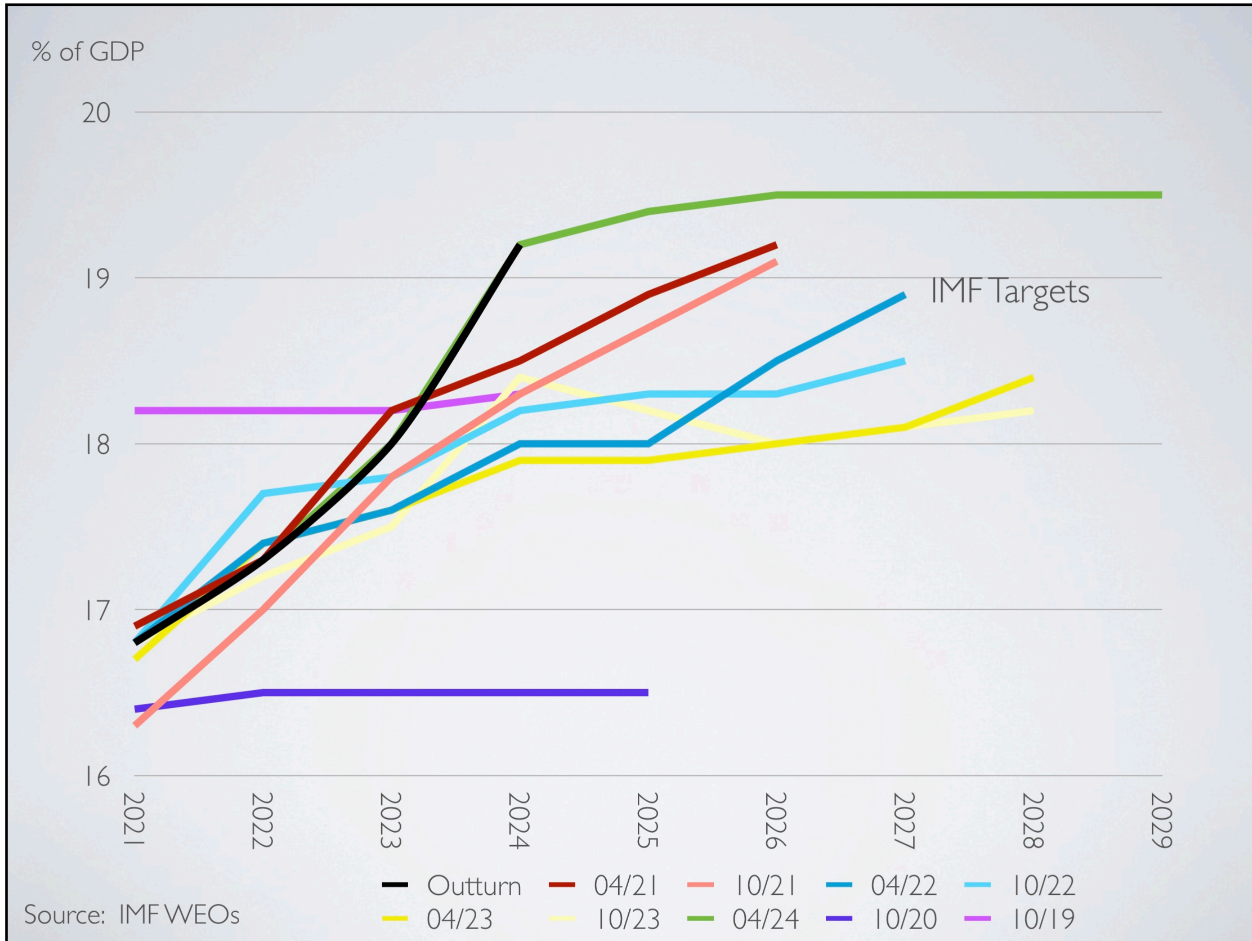
That change may look modest. But tax adjustment on that scale and timing, as is now all-too-evident, is the stuff of uprising—so its necessity must be fully elaborated. Yet no such explanation is supplied.

That does not mean the action is wrong, only that the necessity of those target numbers at that time has not been laid out. Nor has their incorporation in IMF conditionality at all—as opposed to their being left, along with expenditure totals, to the full discretion of the Kenyan authorities, both to be set subject to the IMF's primary balance targets.

In absence of those explanations, the inference is that the IMF has strongly mandated revenue ratio increases in the program not, as claimed, in pursuit of a "development agenda", but solely to shore up (in its judgement) prospect of delivery of its misspecified medium-term primary balance targets. And as those exceed the best growth optima, the inference is that the associated revenue targets, far from supporting a "development agenda" are, by association with those primary balance targets, hostile to it.

Thus, after wildly varying trajectories in pre Covid WEO vintages, the initiating program raised IMF targets for the revenue ratio sharply upwards by 3 percentage points of GDP (Figure 17, red line), then subsequent vintages of the WEO revised them somewhat down, until the March 2024 WEO revised them sharply upwards again (green line).

Figure 17. IMF Recommended Revenue Ratios, in WEO Vintages.




The practical consequences of all this are stark. Beyond headline tax policy changes—eg, abolition of the reduced VAT rate for fuel and of the zero-rating of bread—the Kenyan Institute of Economic Affairs records that the four Finance Bills from 2021 to the one for 2024 just rejected incorporated 66, 53, 84, and 69 changes to tax policy and regulations respectively.

Though the last of these was summarized prior to outbreak of mass protest by the President's Chief Economic Advisor as "we have to come through with a couple of things", this fruit of aggressive IMF revenue targets has even elicited a late caution from the IMF's conjoined twin, the World Bank.

And it is not only generating chronic cumulative instability in the tax environment, but by being driven under relentless external duress, is also undermining the proper checks and balances between the executive and the legislature.

Given that the primary balance was on program target for 2023 (Figure 14), the only apparent reason for the highly contentious and further very sharp increase in schedule of IMF revenue targets mandated in Spring 2024 is that the public debt outturn in 2023 was higher than targeted and that the IMF has, in light of outturns discussed below, marked down its medium-term growth outlook.

### 6. Monetary Conditionality

In this program context, the IMF required the Central Bank of Kenya to "consult" on its determination of its policy rate if headline inflation measured over 12 months deviated from its target band—of 5 percent +/- 2½ percent for three consecutive months.

That particular arrangement, a specific instance of the broadly standard means of reconciling necessary IMF program monetary conditionality with the independence of Central Banks subject to it, turned out to be seriously overtaken by events, notably by the Ukraine shock and droughts.

But no adjustments to the consultation arrangements were made in light of those events, leading eventually, as discussed below, to significant misspecification of monetary policy, notably from 2024.

## III. Outturns Relative to Program Projections

The overall critique of the design of IMF program conditionality is that fiscal adjustment was not front-loaded to rebalance with monetary immediately to facilitate the required exchange rate adjustment, but was instead backloaded, targeting excessive primary balance surpluses. That is reflected in significant deviations of outturns from the original IMF projections under its policies.

### 1. Deviations

This comparison between projections and outturns can be made meaningfully because the Kenyan authorities have gone to extraordinary lengths to comply with the IMF critical conditionalities—however ill-designed. All program reviews have been completed with almost all IMF critical conditionality—namely performance criteria and structural benchmarks—delivered on time and in full. So unanticipated exogenous shocks aside, outturns reflect IMF diagnosis and policy mandates, not failures of implementation.

This comparison of projections and outturns is summarized in Table 1, with outturns for 2024 taken from Spring 2024 IMF WEO.

Table 1. Deviations of Outturns From Program Projections, in percent, 2021-2024

| | 2021 | 2021 | 2022 | 2023 | 2024 |
|---|---|---|---|---|---|
| | Base Revisions | Deviation Adjusted for Base Revisions | | | |
| | | Difference in percent | | | |
| Global Real GDP | | 0.0 | -1.0 | -1.3 | -1.6 |
| Real Gross Domestic Product | | 0.0 | -0.9 | -1.6 | -2.9 |
| Consumer prices | | 0.0 | 2.6 | 5.6 | 7.8 |
| | | Difference in percentage points | | | |
| General Government Revenue, % GDP | -0.1 | 0.0 | 0.0 | -0.1 | 0.7 |
| General Government Total Expenditure % GDP | -0.9 | 0.0 | 0.4 | 1.0 | 1.6 |
| General Government Primary Net Lending/Borrowing | 0.9 | 0.0 | -0.4 | -0.7 | -0.1 |
| General Government Net Lending/Borrowing | 0.9 | 0.0 | -0.3 | -1.1 | -0.9 |
| General Government Gross Debt % GDP | -3.2 | 0.0 | -1.3 | 4.2 | 4.4 |
| Current Account Balance | 0.1 | 0.0 | 0.1 | 1.5 | 1.2 |

**Source: IMF WEOs, Spring 2021 & Spring 2024**

Thus, as reported in the green shaded cells, in 2024, the level of Global real GDP is set on Spring 2024 IMF staff projections to be 1.6 percent lower than was projected at IMF program initiation.

In that context, Kenyan real GDP is set to be 2.9 percent lower than projected. That is a significant shortfall—given that with real annual Kenyan growth typically around 5 percent, that is a projection error in just three years of over half of one year's typical growth. The IMF staff have not indicated that long-covid health or psychiatric issues among the employed play any significant role in this. And the trend underperformance of manufacturing and of wholesale and retail sales relative to GDP reflects the underlying misalignment problem and household income stress respectively (Figure 11).

Alongside, the consumer price level in 2024 is set to be 8 percent higher than projected by the originating program, in the context of exogenous shocks from Ukraine and droughts since 2022.

The increase in the revenue share in GDP is set to be 0.7 percentage points higher than programmed, but the increase in the spending share is set to be 1.6 percentage points higher, the combination leading to an overshoot of the fiscal deficit of 0.9 percentage points of GDP.

But that almost entirely reflects higher than programmed interest spending as the primary balance is almost exactly on the target set in the initiating program,

In that light, public debt ratios are set in 2024 to have risen by 4.4 percentage points of GDP more than initially programmed, but this is offset by the large downward revisions to the base in 2021 for this indicator, so that the headline public debt to GDP ratio is just 1.2 percent of GDP higher than originally anticipated.

Note, however, that with the fiscal squeeze in Kenya, the external current account balance is 1.6 percentage points of GDP stronger than originally anticipated, despite global output in 2024—and hence demand—being 1.6 percent weaker than was projected. So the shortfall in Kenyan real output relative to original projections was not because global output was weaker than projected. Despite global weakness, the external current account was stronger than projected, thus supplying greater than anticipated net external demand to Kenya.

So in 2021, the IMF considerably overstated Kenyan output potential and ability to carry its debt burden—very much the original sin of the entire program—by overstating its growth prospects, by misreading exchange rate misalignment and hence understating its public debt stock, and by imposing medium-term primary balance targets which compromise its growth potential.

These errors largely reflected the IMF's misdiagnosis of the Kenyan economy as discussed in Section I, and were material given that they arose shortly after Zambia defaulted and just before Ghana followed suit, both thereby triggering debt restructurings.

Nevertheless, these outturns relative to initiating program projections leave a question. If a fiscal consolidation was indeed required to deliver a large exchange rate correction, why was the actual real effective exchange rate correction so modest in 2022-23 and since largely reversed in 2024, when the targeted fiscal consolidation was excessive (Figure 4)?

The answer is that the critique of the primary balance targets refers to their impact on medium-term growth on the supply side, whereas the exchange rate, insofar as it responds to fiscal policy, primarily reflects its short-to-medium-term demand side effects. And not only was the targeted fiscal trajectory too backloaded but the outturn to 2024, measured by the change in the overall balance, was little less than even the IMF had targeted (Table 1). The remainder of the answer lies, despite headline inflation overshooting the target band for an extended period, in chronic over-tight monetary policy in the context of Ukraine, drought, and default risk, which has now become severe.

### 2. Inflation and Relative Prices

In concordance with IMF directives, the Central Bank of Kenya responded to the Ukraine shock, market fears of a default on the maturing Eurobond, rising global interest rates, and drought from 2022 by raising its policy rate in a series of steps from 7 to 13 percent to address headline inflation rising towards the top of the target band and then overshooting it (Figures 18 & 19).

Figure 18. Central Bank of Kenya Policy Rate, 2019-2024

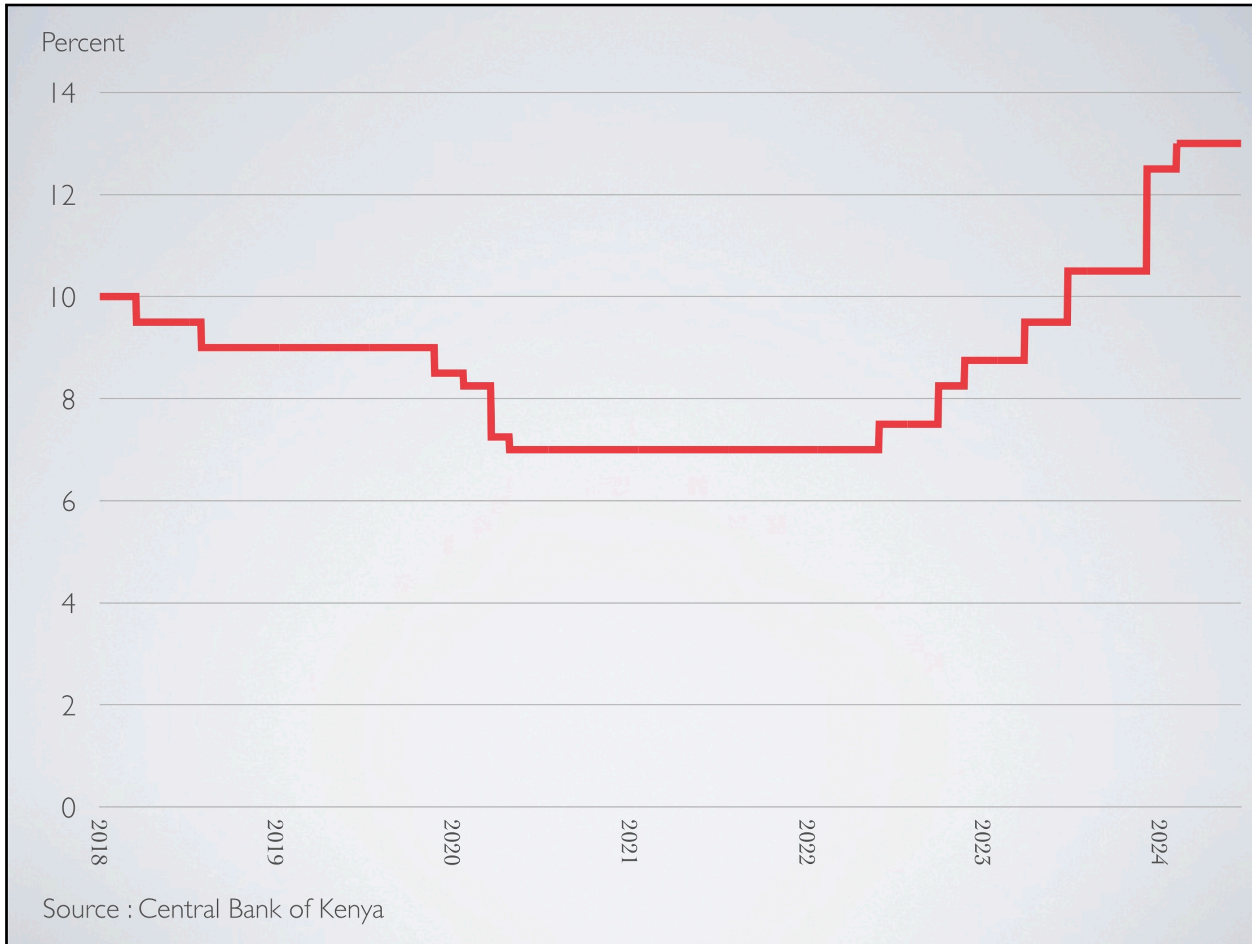
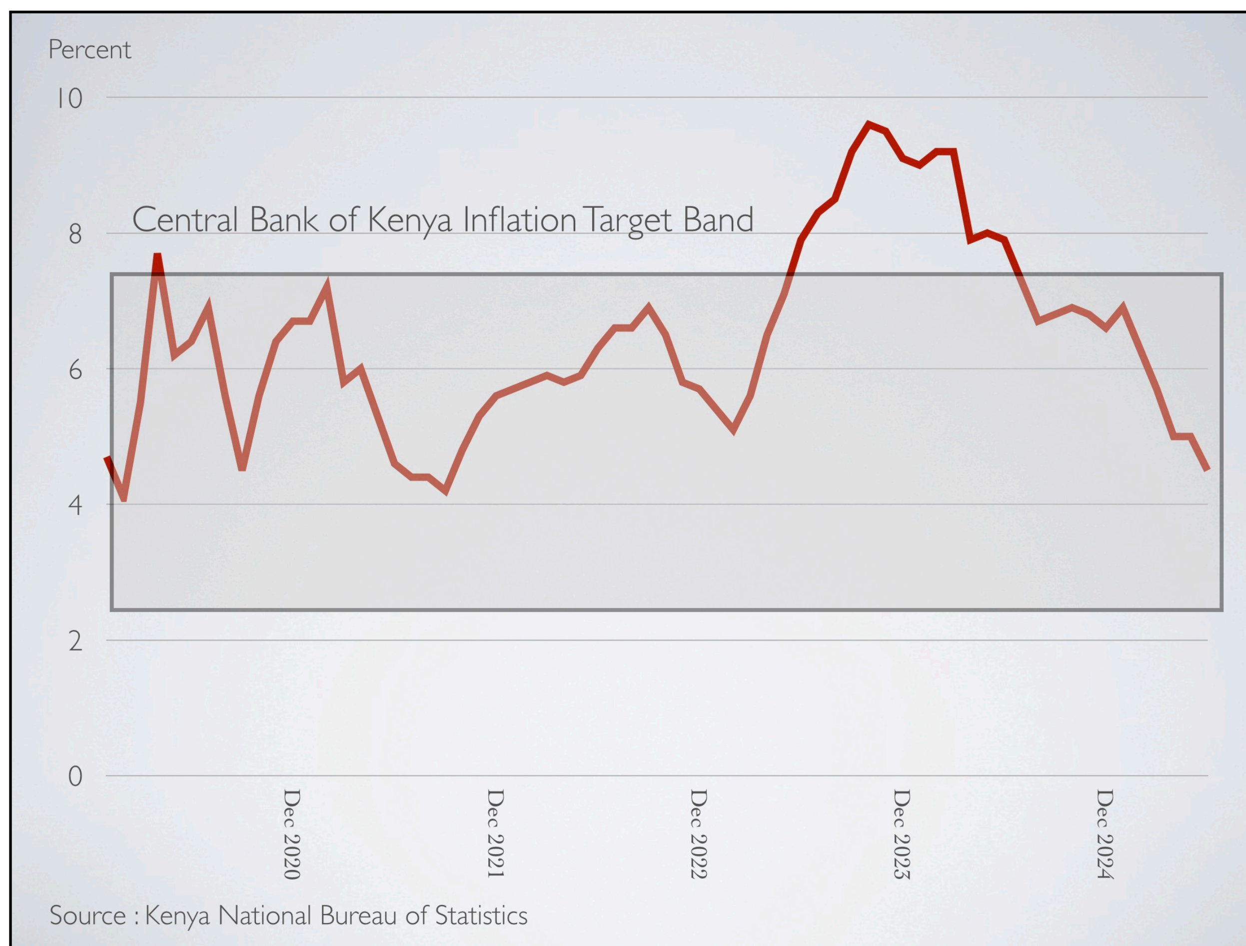


Figure 19. Inflation, 2019-2024




Conditions for monetary policymaking were difficult. But that merely raises the premium on high quality analysis, in the absence of which the policy responses were overdone.

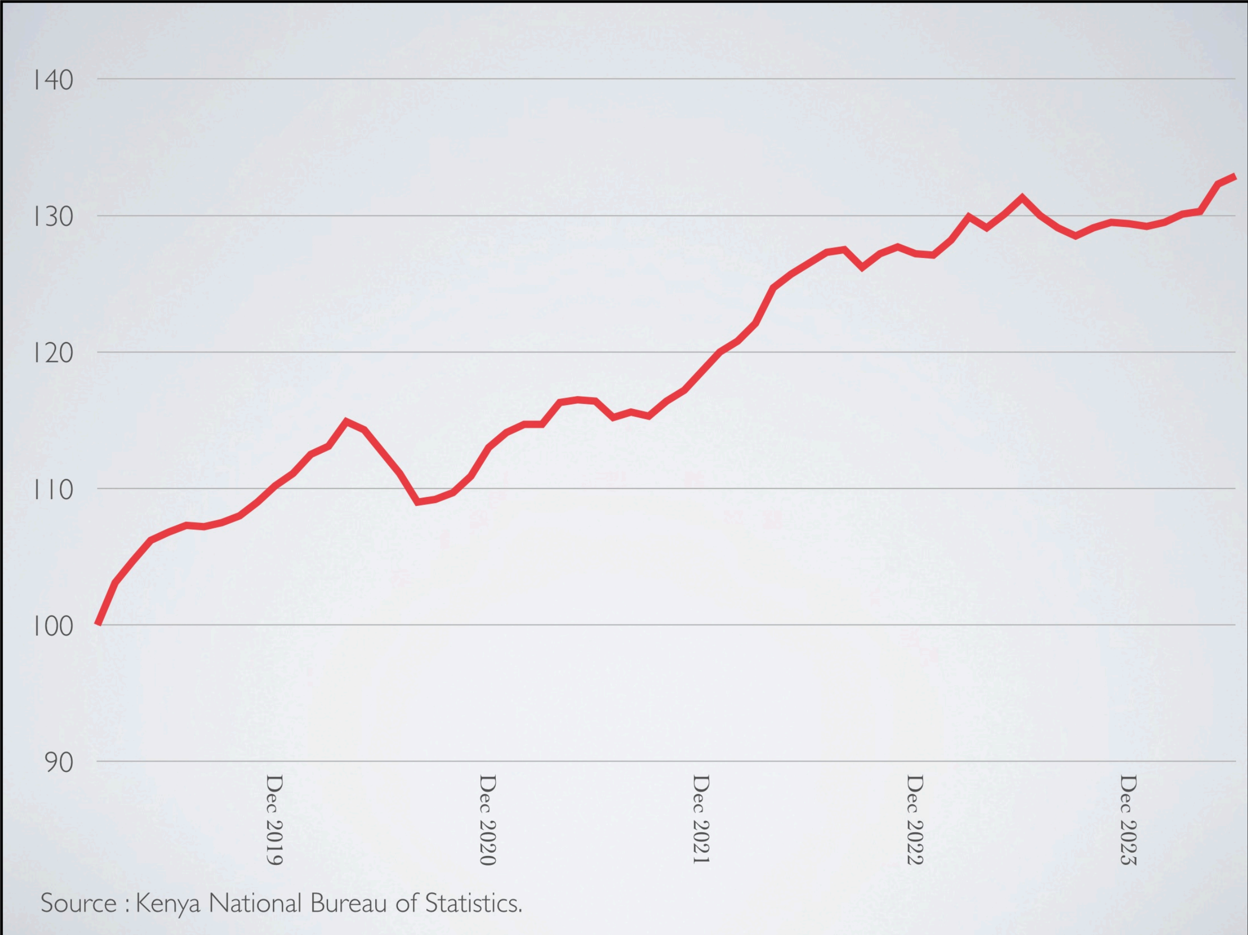
That excess occurred despite IMF staff getting three core matters in their monetary conditionality right: that there was no critical need for any reform of the Central Bank of Kenya's Inflation Targeting monetary framework; that the monetary consultation arrangement with the IMF should be symmetric; and that after supply shocks, monetary policy should be on the lookout for "second round" impacts on inflation.

But the IMF consultation clause was wrongly defined on a rolling three month average of the 12-month rates of inflation rather than on rolling averages of inflation over three months seasonally-adjusted annualized, thus all-but-guaranteeing that formal IMF interventions would be systematically "behind the curve". And following the supply shocks, even that was not redefined from headline onto a measure of underlying inflation.

These technical errors were compounded by the assessment that the exchange rate was not far adrift of fair value rather than significantly misaligned. So the IMF interpreted Shilling weakening as a sign of monetary stimulus and loss of investor confidence rather than as a necessary correction.

And the errors were further compounded by the overall IMF treatment of food price shocks as matters of general inflation rather than as reflecting large enduring but non-permanent relative price shocks. Indeed, IMF staff seem unaware—as they have not even reported the data, referring only to a "cost of living crisis" as if that is synonymous with inflation—that after the Russian invasion of Ukraine and local droughts, the relative price of food has risen by 30 percent (Figure 20).

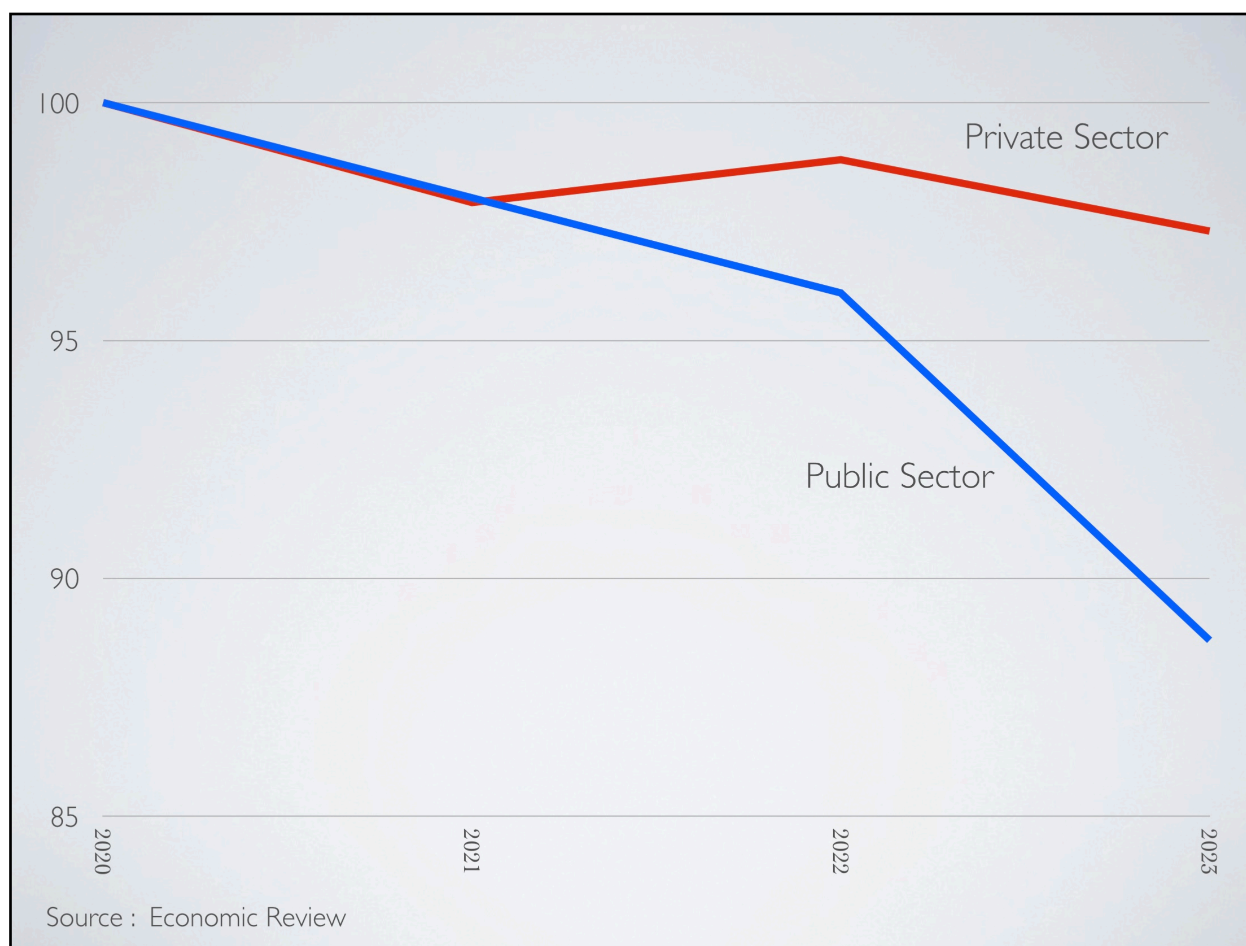
Figure 20. Relative Price of Food, 2019-2024




Nor, because they do not report these data either, is there any sign that they conducted ongoing checks on the critical "second round effects" metric, namely in wages.

On that, broadly, with trend real GDP and employment around 5 and 3 percent respectively, there is room for annual non-inflationary real wage growth of some 2 percent. However, average wages deflated by non-food prices have fallen continuously since 2020 to 2023, in both the private and public sectors Figure 21). Thus, there is no evidence of "second round effects" in data to 2023.

Figure 21. Annual Real Wages, Nominal Wages Deflated by Non-Food Prices, 2020-23

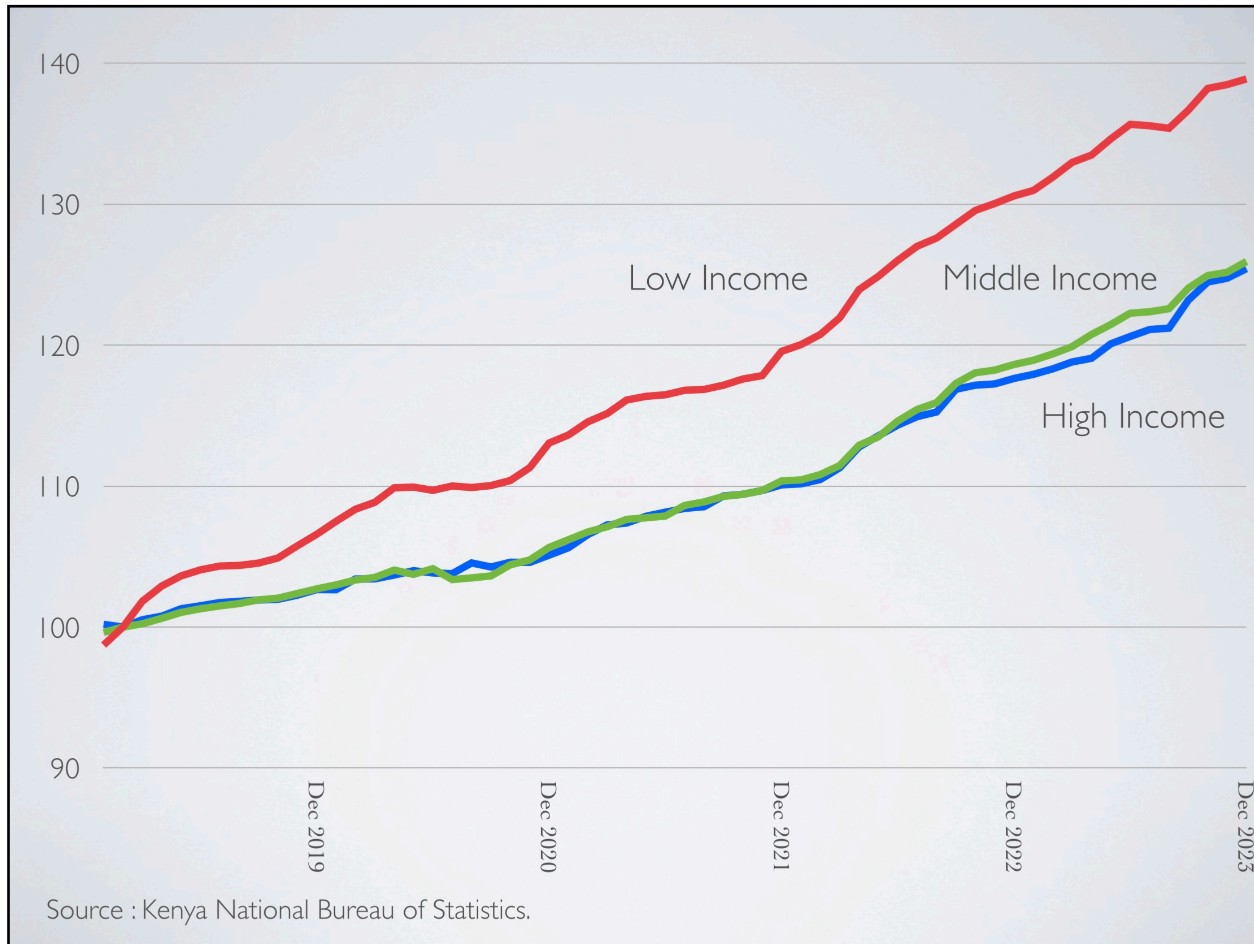



Nor is there informal evidence thereafter—including from wage settlements data, income tax receipts, or the Central Bank of Kenya's market information gathering process. But nowhere is this reflected in staff assessments. Despite their appropriate second-round warnings, the IMF staff simply do not report, assess, or address nominal or real wage data, nor explain why not.

And most remarkably, given the centrality of wage data to detecting the presence or otherwise of second round effects, the IMF staff report annexes assessing the quality of various key macroeconomic statistical series do not even list the Kenyan wage data series, let alone assess their quality.

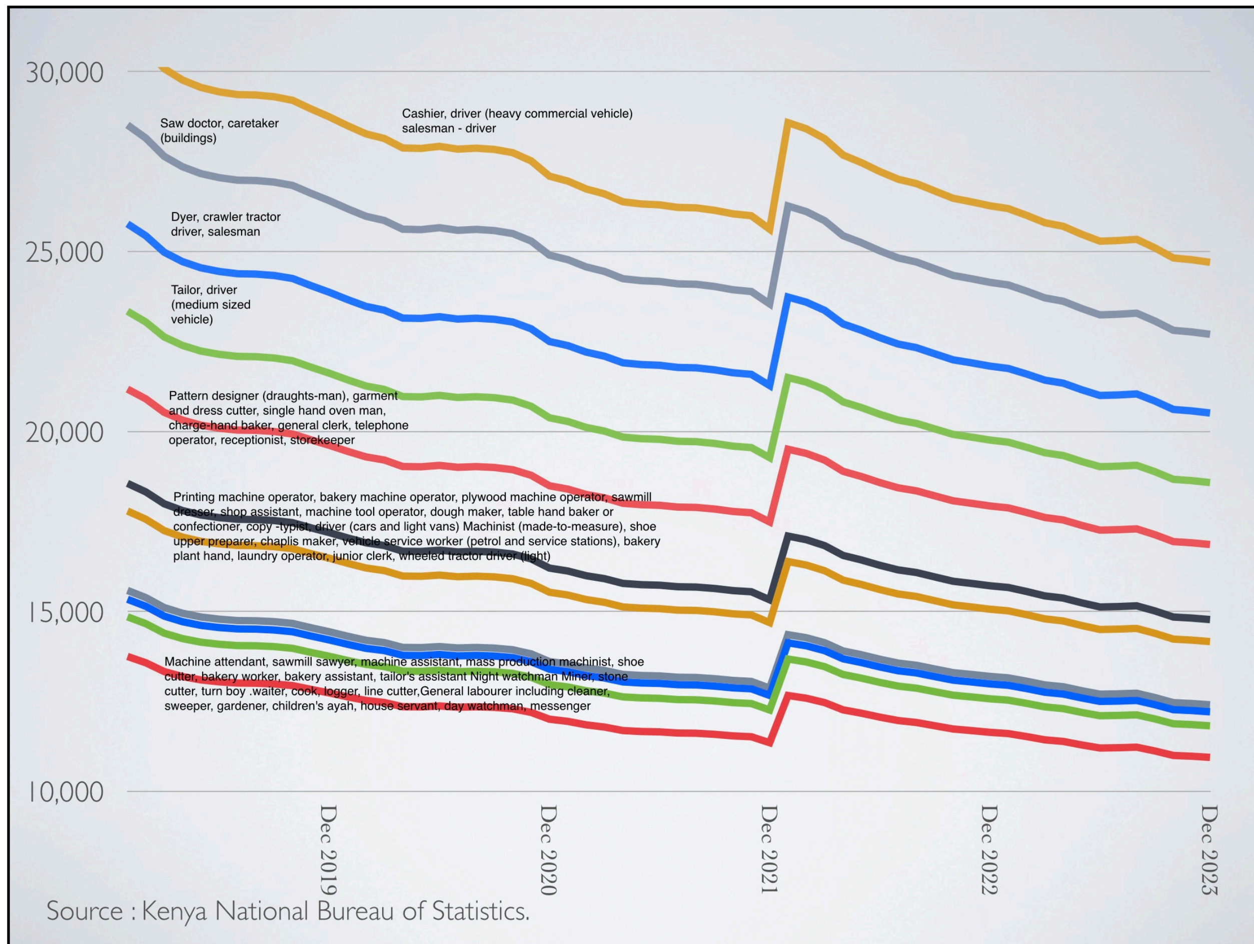
But with food weighted at 33 percent in the CPI basket, the enduring but analytically temporary food shock took the biggest toll on the poorest for whom that share in spending is highest. This is evident in the particular elevation of prices for low income groups in Nairobi (Figure 22).

Figure 22. Consumer Price Indices by Income Group in Nairobi, 2019-23




A measure of the toll on households at the low end of the income spectrum may also be inferred from city—Nairobi, Mombasa, Kisumu, and Nakuru—minimum wages, deflated by the Nairobi low income consumer price index. After the prior increase in early 2018, these fell a further quarter from January 2019 to December 2023 (Figure 23). With low income prices still rising disproportionately, nominal minimum wages were raised by just 6 percent in May 2024. All this further not only reflects the absence of second round effects even after 2022, but rather it suggests the stark contrary.

Figure 23. Real Monthly Minimum Wages, Cities, in 2019 Low Income Shillings, 2019-2023




In the context of major sustained relative price changes concentrated on the poor and of Malthusian living by many due to the fundamental mis-allocation of land, standard virtue-signaling IMF phrasing that "social spending" under the program is being maintained rings particularly hollow.

Given overall policy anchored by a determined delivery of a substantial (and in the medium term excessive) fiscal consolidation at IMF insistence, the appropriate IMF response to the food price shock would have been: to call for a temporary targeted fiscal program of income support for those on lowest incomes facing the biggest temporary real income shock; to welcome the accompanying exchange rate correction; and by re-specifying the monetary conditionality to focus not on the headline rate of inflation over 12 months but on the underlying rate as indicated by non-food inflation over three months, to direct the Central Bank of Kenya to "see through" the temporary supply shocks and make full use of the flexibility provided in its monetary framework in regard to its target horizon to do so.

But that is not what happened. Instead, the IMF accommodated no relief for the poorest, it kept the headline CPI as the metric for its consultation requirement rather than re-specifying it to non-food inflation, and accordingly it insisted on considerable monetary tightening in response to headline inflation numbers despite the absence of evidence of second round effects. Thus, after a series of small

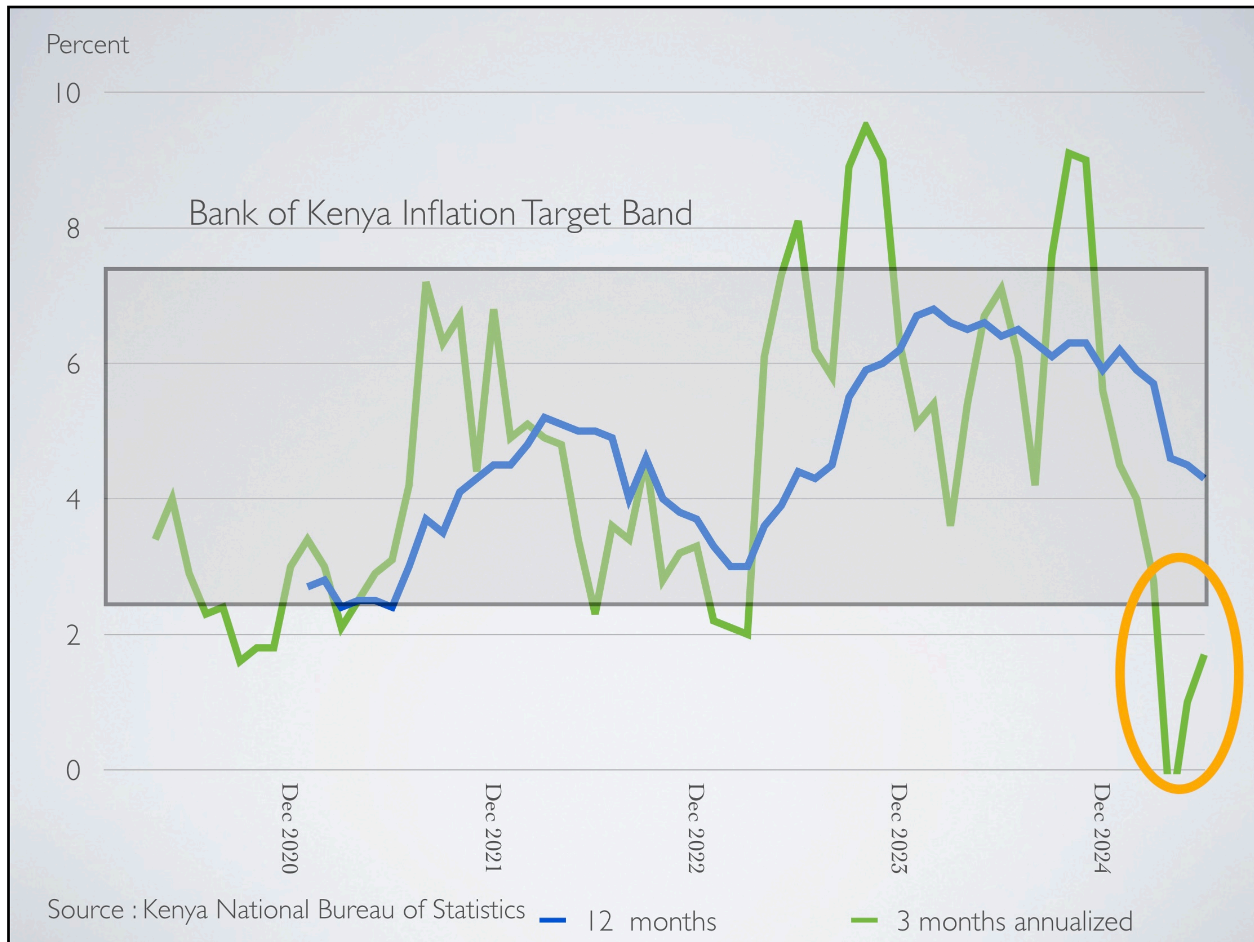
steps and after the IMF consultation clause triggered in June 2023, the Central Bank of Kenya raised its policy rate by 100bps followed by a further 200bps in December.

A consequence of that mis-prescription and those actions is that once the immediate risk of default had passed with issue of a new Eurobond at 10.6 percent in February 2024, the exchange rate began strongly appreciating, once again, even through the recent protests (Figure 24).

Figure 24. Daily Exchange Rate, Kenya Shillings per US$ 2019-2024

And an even more fundamental consequence of the entire episode concerns non-food inflation—Kenya's de facto core inflation in the context of the food supply shocks. That, measured over 12 months, remained within the target range throughout the IMF program, averaging close to 5 percent (Figure 25 blue line). But that number makes no correction the cascade of indirect tax increases occurring so that the underlying rate relevant for monetary policy is lower—and possibly considerably so.

Figure 25. Non-Food Inflation, 2019-24




And most recently, the rolling three-month average of its one month annualized rate (green line), again uncorrected for indirect tax increases, has fallen well below the target range for a significant period with almost all of its components trending this way over that period (circled, Figure 25).

Thus, despite the headline inflation rate, monetary policy has erred to over-tight. And after the most recent set of policy rate rises, that chronic problem has become acute: monthly non-food inflation is now significantly undershooting the target range and absent action looks set to continue doing so.

This last highlights once again the misspecification of the IMF consultation clause over 12 rather than three months seasonally-adjusted annualized, an error guaranteed to engender tardy IMF intervention.

All this directly contradicts the most recent IMF staff statement endorsing the current monetary stance. Even given uncertainty ahead of the February Eurobond issue, the increases in the Central Bank Rate from 9.5 to 13 percent—i.e., starting with the rise which took place as the IMF consultation clause triggered in June 2023—were overdone. The IMF should call for their reversal immediately.

And IMF staff in that statement also mis-report that a decline over recent months in headline 12-month inflation is partly the result of "lower food prices." 12-month food price inflation has indeed fallen recently, but bar a marginal drop in April more than fully reversed in May, aggregate food prices have not fallen over any interval. That uncorrected reporting error, on a matter so central to sound technical analysis of the appropriate monetary policy stance and to Kenyan political economy, appears to be symptomatic of much deeper flaws in IMF staff monetary analysis.

With the major real income consequences of the food price shocks thus unaddressed alongside excessive monetary tightening, a fundamental strategic error of the IMF in the program was to leave the originally scheduled timing of the revenue increases unchanged, as if that timing was immutable.

That decision compounded severe unanticipated uncompensated non-permanent-but-enduring income shocks for households from food prices with permanent adjustments from the slew of tax rises. The burden was heaviest on those at the low end of the income scale.

The combination has completely broken public support for the fiscal program—with recent proposed tax rises on bread, diapers, sanitary towels, motor vehicles, and fuel apparently the straws which broke the camel's back.

**3. International Food Price Transmission**

And the IMF also overlooked key policy issues arising from the composition of the food price shock.

IMF staff treatment of the food price shock as a challenge for inflation—requiring policy focus only on its second round effects—rather than a what it was, a set of enduring but non-permanent relative price shocks meant that they failed to identify root causes and hence the appropriate policy response.

Of the four components which dominate the food price aggregate, namely cereals, live animals and meat, milk and dairy products, and vegetables, the last has seen its prices rise the most, doubling since 2019. That largely reflects drought, which also drove up local meat and milk prices. All that warranted a temporary targeted income support program for the most affected (poorest) households (Figure 21).

But second to vegetables in price increases—up by 50 percent since 2019—with a significantly greater in weight in the basket are cereals. These, which include final goods, saw prices mostly track the Kenya Shilling value of the FAO global index of cereal raw material prices up following the Russian invasion of Ukraine. But that index of global cereal raw materials has fallen almost 20 percent during 2024, reflecting declines in the US$ index and the appreciation in the Kenya Shilling, without any corresponding fall in the cereals price index in Kenya through June, contra the IMF staff statement.

The transmission of global raw material cereals prices to the domestic markets of cereals final goods in Kenya is, apparently, malfunctioning if it has not actually broken down.

Given the centrality of food prices to the current Kenyan macro, to its political economy, and to the poorest, it is remarkable that this key matter has apparently not even been raised by IMF staff.

And that is all the more remarkable given their due attention to and insistence that global crude oil prices are properly and swiftly transmitted to the domestic market for final fuel prices via the orderly implementation of the domestic fuel price formula.

Even allowing for the distinction between raw material and final goods and possible systematic smoothing of noise in raw material prices and the exchange rate, the reason for the recent behavior of Kenyan cereals consumer prices in the global context is unclear. Obvious suspects include tariff and non-tariff barriers and other public policy interventions in local cereals markets.

If IMF staff ignored these grateful for the revenue raised, then they have doubly failed on this matter —prioritizing revenue over the outward orientation and efficiency of the economy and over the regressive effects of that revenue, notably given other food price shocks alongside.

Thus, given that the global cereal price US$ index of cereal prices is now broadly unchanged in real US$ terms from its pre Ukraine levels, rather than these foods compounding the case for temporary targeted income support in Kenya, they warrant urgent analysis to identify and, as needed, correct whatever may be impeding the transmission of falling global raw to domestic final prices now.

**4. Warming**

Following the election of a new President in September 2022, the IMF program was supplemented in mid 2023 by IMF credits under its global-warming-related Resilience and Sustainability Facility.

This added a raft of additional conditionality attached to each of its 10 "Reform Priorities".

But again, key strategic issues underlying the decision to extend this form of IMF finance were simply not discussed or addressed.

Most basically, it is not explained why these matters were of such immediate macroeconomic priority as to render access to essential immediate IMF finance conditional upon them.

This consideration does not mean that Kenya should desist from the administrative preparations related to prospect of further warming. At their sovereign discretion, the authorities are at liberty to proceed with those. But immediately needed IMF financing for the macro should not be contingent on matters which may or may not arise 20 or 40 years from now.

Then, whatever the case for administrative preparations on various matters for Kenya to better anticipate the hit it will take from the emissions of others, there is no staff discussion of the implications under the conditionality for Kenya's own emissions.

Thus, given that Kenya has in the last decade discovered a substantial oil field in Turkana, and that the President has indicated in mid-2023 that in light of climate concerns he had decided to "take another route" rather than develop it, the message to markets is that if Kenya were to discover more or more plentiful or more remunerative carbon assets, that it would forgo them. That stance runs directly contrary to immediate need to strengthen investor confidence in Kenya's macroeconomic program.

Were Kenya to follow through with such commitments to curb its emissions, this would overlook that the challenge of warming emanates from the global stock of emissions, not the flow, and Kenya's (and Africa's) contribution to the stock is negligible, and would remain negligible even were it and Africa to exploit their carbon assets to the full. By implicitly forgoing this income, a country in which one in five children are stunted would undertake to bear a grossly exaggerated—and likely Quixotic—share of the burden to address the problem. All these issues simply pass without comment from the IMF.

And of immediate concern are trade agreements, including the free trade agreement with the European Union, which in these circumstances impose various barriers (including CBAMs) on Kenyan exports if those exceed the Europeans' targets for their carbon content. The IMF is simply silent, yet again, on the de facto rendering of Kenya's carbon resources as stranded assets, and why on top of the long-standing fundamental misallocation of land, this represents a warranted additional constraint on Kenya's development and on prospects for success of its IMF program.

**5. And then, Floods**

Yet as the IMF's principal shareholders nevertheless impose severe emissions constraints on Kenya, they continue adding to their own hugely disproportionate contribution to the stock of emissions.

One symptom of that was unprecedented rains and flooding nationwide in April 2024—in which well over 250 Kenyans lost their lives and some 400,000 endured forced evacuations. For many citizens, this constituted the last straw.

The Kenyan authorities, initially, were caught completely off guard: the president welcomed the rains as answers to his prayers for droughts' end and promptly left for three days' African diplomacy; his top economic advisor observed that Kenyans die all the time and that government was not their agony aunt; and recovery has featured discriminatory clearance of people from riparian areas.

If the IMF, after warm words of concern, ends up treating the issue in the latest program review in similar de facto manner, it risks completely discrediting the program in the eyes of the general public.

The challenge for the IMF is not only to address the further upward jolt to food prices and the hit of yet-to-be seen scale and duration to output and revenue, but longer term, is also to address the profound inadequacies in Kenya's infrastructure, notably drainage, which the floods revealed.

It would be profoundly ironic—to put it mildly—were the IMF to press ahead with its "10 Administrative Reform Priorities" while insisting on above-best-practice primary balance targets which preclude infrastructure investments which recent flooding has revealed as essential. This would be a severe case of climate form over substance.

**6. Doom Loop**

Furthermore, having misspecified the original program fiscal conditionality by setting above best practice medium-term primary balance goals and unduly backloading the initial fiscal adjustment, and having compounded that with an excessively tight monetary policy especially from mid 2023, output and hence revenues are both systematically falling short of program projections and targets.

Instead of reading those as yet a further signs of misspecified conditionality, the IMF has evidently responded in 2024 by raising both its revenue ratio targets and its demands for further tax increases, both of which are reflected in the 2024 Finance Bill recently, after major public protest, withdrawn.

Far from fixing the problem, this doubling down on the fiscal side—described, repeatedly by IMF staff, as "correcting course"—compounds it. It adds further fiscal withdrawal to that from monetary policy, depressing demand further. If that is sustained, the revenue base for 2025 will also be further depressed. And the clearest symptom of this will be a continued significant undershoot of annualized seasonally adjusted one month rates of non-food inflation.

The first corrective action to exit this tailspin is not to raise revenue ratio targets and associated tax rates as in the original 2024 Finance Bill—it is a decisive relaxation of monetary policy, without delay.

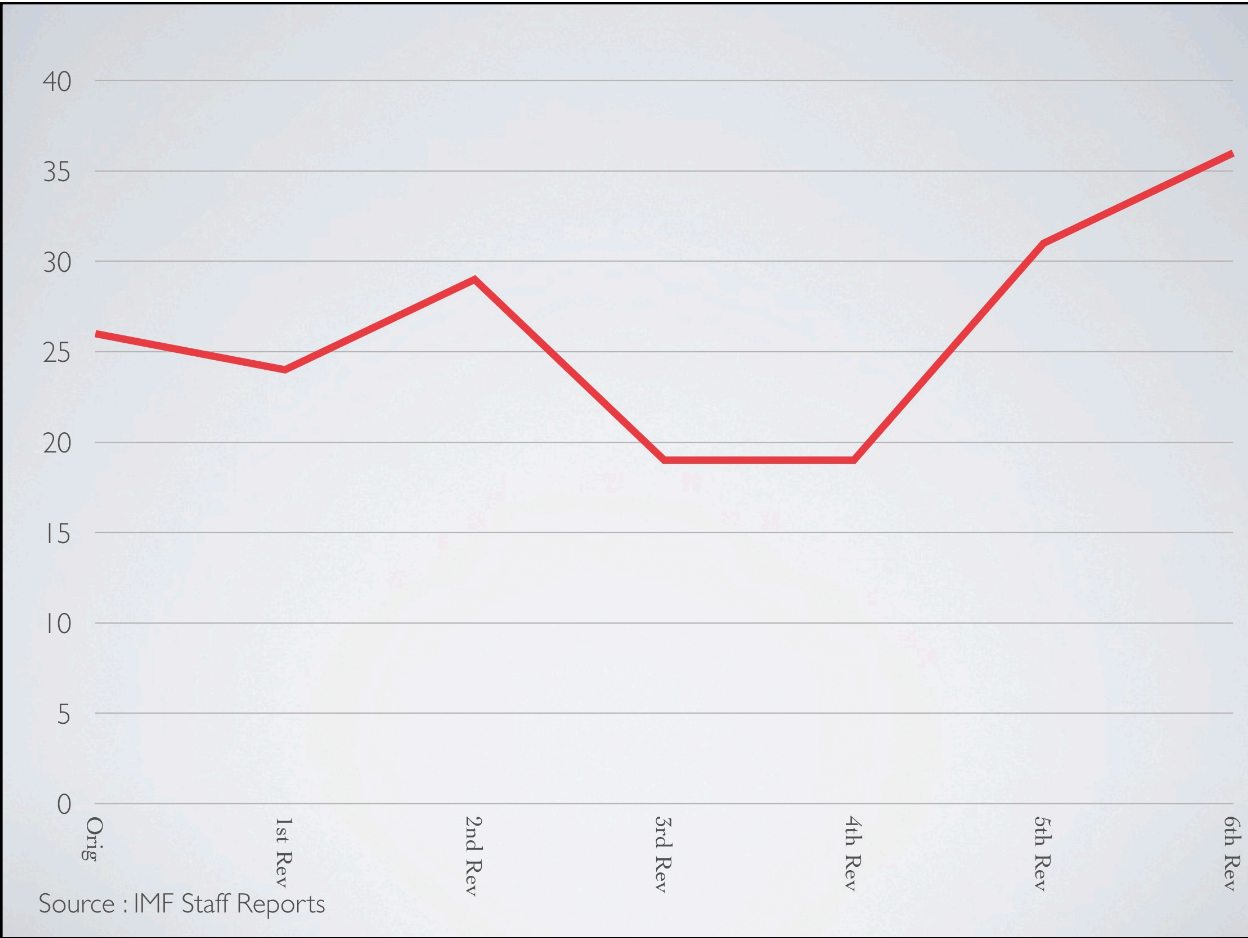
And the entire preceding discussion brings ever more sharply into question the strategic decision at program's outset, never discussed or explained then or since, to shun debt restructuring.

### 7. Christmas Tree Conditionality

With all of this, the program was seriously overladen with conditionality.

As listed by IMF staff, it started with 26 conditions, breach of any one of which could in principle have caused disbursements to stop (Figure 26). That number had ballooned by the 6th Review to 36, including those associated with borrowing under the Resilience and Sustainability Trust which began with the Fifth Review. As several of these were compound conditions, the effective number of conditions was typically considerably higher throughout.

Figure 26. Number of Formal Conditions at Origination and at Each Program Review




This does not just represent a failure by the IMF to focus on the macro-critical essentials. It also represents an undue intrusion into sovereignty and, in principle, it implies that immediately needed

financing could be stopped in view of considerations arising decades away in some cases. By littering the program with reasons why it could be stopped, the paramount purpose was compromised—namely to buttress private investor confidence in Kenya.

And the conditionality does not stop there; it is supplemented by multiple additional requirements imposed by the dominant IMF shareholders via such as the EU Economic Partnership Agreement with Kenya and CBAMs.

Partly in regard to such considerations, an informal guideline was adopted by the IMF following the Asian Crisis programs in the late 1990s—which featured similarly counterproductive excess conditionality. According to that, no more than 10 conditions should be attached to each program.

That guideline has been comprehensively breached in the IMF program in Kenya, with all the attendant consequences the guideline was intended to avert. This is the consequence of the IMF going far beyond its proper role of supporting Kenya with limits on macro policy to implicitly trying to run it.

And as final indictment, the blizzard of conditionality clearly failed to spare Kenya its current impasse.

## 8. Market yield spreads

On their own terms, the classic—indeed foundational—purpose of IMF programs is to catalyze (sometimes restart) private capital flows. Yield spreads thus provide the litmus test of whether that objective has been achieved.

With 300 basis points reflecting the differential between the inflation targets of the respective central banks, long term differentials between Kenya and the US remain well above pre program and even mid-program through 2023, despite determined efforts by the authorities to comply with all IMF-critical conditionality (Figure 27).

Figure 27. Yield Differentials, 10 Year Government Bonds, Kenya less US$, 2021-2024

So, far from zealous IMF mandated medium-term fiscal adjustment being rewarded, it is is reflected in the high yield differentials and the exorbitant yield required to float the refinancing Eurobond in February 2024; 10.6 percent compared to a yield of 7¾ percent for Senegal shortly thereafter.

Accordingly, it is not only the Kenyan citizenry which has delivered its verdict on the IMF program. Despite the overload of IMF conditionality, given the fundamental misspecification of the program and then its inappropriate—non—adjustment to Ukraine, droughts, and floods, markets are now even more deeply skeptical than they were at program's eve.

And that remains so even after refinancing the maturing Eurobond and confirmation that agreement with staff on the current program review had been secured.

## 9. Macroeconomic Judgement for 2024/25

To reset the program now, the starting point is that the primary balance outturn for 2023/24 of a deficit of some 1 percent of GDP was already at the best practice optimum for countries at Kenya's GDP per

capita. Alongside, there is clear evidence from non-food prices that underlying inflation is now significantly undershooting the Central Bank of Kenya target range.

Accordingly, there is neither a demand-management nor a growth-potential case for further fiscal tightening in 2024/25.

Instead, the underlying primary balance for calendar 2024/25 should target no change from 2023/24, rather than the 1 percentage point of GDP further consolidation originally mandated by the IMF. Furthermore, there is no demand management or growth potential case to continue the originally mandated consolidation to 2025/26 or later. It should be cancelled entirely.

In that context, there would be a case to add to the underlying primary deficit of 1 percent of GDP a temporary targeted program of income support for the poorest to address, finally, the food price shock.

Given all that and continued Shilling misalignment, immediate policy to get underlying inflation back up to target should be led by a 300 basis point cut in the Central Bank of Kenya policy rate, and by more when—as seems increasingly imminent—the US Federal Reserve lowers the Federal Funds Rate.

If, for whatever reason, the Central Bank of Kenya fails to deliver that, there would be a second-best case for an underlying modest relaxation of fiscal policy in 2024/25. And if the authorities end up implementing all or part of the IMF's originally mandated consolidation for 2024/25, there would be a second-best case for the Central Bank of Kenya to cut immediately by 400 basis points.

In context of this macroeconomic judgement, the only case for the further fiscal consolidation that the IMF originally mandated for calendar 2024/25 and beyond is pursuit of its sub-best-practice medium-term primary balance target. And the only argument for that would be if best practice medium-term balances cannot be reconciled with debt sustainability.

In that event, however, given the premium on raising Kenya's medium-term growth outlook to potential as indicated by its best performing peers, strategy should not focus on further underlying fiscal consolidation from 2023/24 but on pursuit of debt restructuring and write offs anchored by a medium-term primary balance target of a deficit of 1 percent of GDP. This "macroeconomic audit" of public debt, including issues of both ex ante and ex post transparency of debt acquisition and steps to improve expenditure efficiency, is needed now along with any "accounting" audit to be undertaken.

In light of this macroeconomic judgement and growth and debt strategy, the President was right finally to veto the 2024 Finance Bill. He subsequently announced that negotiations to replace it and the associated expenditure estimates for 2024/25 would be based essentially on no change in the overall fiscal balance relative to GDP relative to the 2023/24 outturn.

However, all of this is subject to ongoing negotiation, including with the IMF. At this stage, it remains unclear if the IMF has moved even as far as a merely symbolic partial rephasing of its mandated fiscal consolidation for 2024/25 matched by corresponding greater consolidation in later years.

But by diffusing some of the tension, the full agenda proposed above for 2024/25 would provide an appropriate macroeconomic backdrop against which Kenya can address the fundamental governance issues arising from the protests and the official responses in recent weeks.

## IV. Assessment

The IMF was right in early 2021 that Kenya needed a successor program to the Covid Rapid Credit Facility and that it should be anchored in fiscal adjustment.

But beyond that, the program was born in mis-diagnosis, notably of Kenya's underperforming growth, the exchange rate, the economy's orientation, and the public debt stock.

It has been bereft of any substantive explanation for its core medium-term primary balance or revenue parameters, or of the decision to shun public debt restructuring.

Targeted fiscal adjustment should have been front-loaded to let monetary policy drive exchange rate correction. But instead it was backloaded and the ultimate target balance was well-above best practice.

Despite the given rationale for rising revenue ratios to support government functions, they have been primarily in service of those sub-best-practice primary balance targets and have yielded chronic instability in tax structures.

And the program has been conducted intellectually chaotically by the IMF across its reviews, including that monetary conditionality was not respecified given large supply shocks.

Then mid-stream, a raft of conditionality on warming was bolted onto it without explaining why that was the macroeconomic priority at that point and not food prices, why Kenya's carbon assets should be stranded, or latterly reconciling the entire program with flood-revealed infrastructure imperatives.

And despite obsession with innumerable extraneous details and amid a major enduring food relative price shock, there has been absolute silence from the IMF on land.

Now, unenumerated by the IMF, real incomes are still falling, plummeting in some cases especially at the low end, and the program finds itself in a doom-loop—with output and revenue shortfalls generating tax adjustments which compound output shortfalls, and so on and on to uprising.

After three years and SDR 2 billion of disbursements, Kenya barely scraped floatation of a new Eurobond to refinance that maturing—but at an exorbitant yield—and broader yield spreads continue to reflect deep market skepticism. Signs are that the faith of the population has similarly been lost, notably among the young, heralding deserved generational reputational damage for the IMF in Kenya.

All of this represents a gross failure of IMF internal quality control. And as that has been persistent and systematic, ultimate responsibility rests with Management and the IMF Executive Board.

But instead of acknowledging and correcting it, the IMF de facto response is exasperation at market and public disquiet, insisting that Kenya "tough it out" with that indignant tone echoed, perhaps under duress, by some local officials.

That response cannot stand. It overlooks that the IMF celebrated the pre-program errors as "Africa Rising" in the mid 2010s, that vaccine Apartheid and relentless carbon emissions by its main Executive Board members have greatly aggravated difficulties, that the IMF turned a blind-eye to the opulence

in Kenya that it financed since 2020, and that while fiscal adjustment was unavoidable by 2021, incoherence in IMF-mandated adjustment was and is not.
And "tough it out" just begs the question of how tough is tough enough for them? With one in five children stunted, will two in five be tough enough?

The defiance in that rebuke is no impropriety. While there are times when public protest rails at painful but necessary macroeconomic adjustment, there are other times when it informs IMF macroeconomists—if they will hear—that they are in error. That is the case now.

In particular, as the original misspecified program with its unduly backloaded fiscal adjustment and systematically overstated output projections evolved, a further fundamental strategic error of the IMF was to leave the originally scheduled timing of the revenue increases and trajectory of primary balance targets essentially unchanged, as if the timing for those was set on tablets of stone.

By thus essentially ignoring the food price shocks, those decisions treated the consequent severe hit to household income as permanent, combining it with scheduled and doom-loop catch-up permanent increases in taxes, with the combined toll especially severe on the poorest.

And then, floods.

A critical consequence is that all this has put a reform-minded President into a position where he has appeared, up until now, to hear the IMF more than he hears Kenyans.

And the upshot of that is that Kenya now has to secure a belated fundamental economic reorientation as well as to resolve complex debt sustainability and governance issues simultaneously.

That is a challenging trio because the intended boost to business investment from reorientation will be discouraged by the difficulties inherent in resolution of the debt and the political challenges.

The answer is not to toss the IMF baby out with the bathwater—but it has to change tack, abruptly.

The first steps to reset the program are an immediate decisive relaxation of monetary policy, to respecify the IMF consultation clause onto non-food inflation, and a downward revision of the medium-term primary surplus target to best practice.

In that context, the apparent withdrawal of the mandated fiscal adjustment for 2024/25 of 1 percentage point of GDP is welcome. But that is just a half step until the IMF approves it and withdraws the requirement for subsequent mandated fiscal adjustment. That full package would set the stage for an immediate resumption of outward-oriented growth with inflation on target and combat protectionist pressures, including on foods.

On top of that, there is need and scope for a temporary targeted program of income support for low income households in respect of the still ongoing food price shock, accompanied by action to accelerate the transmission of global cereals prices to the domestic market.

If, as possible, all of that is insufficient to quell market disquiet or to reconcile debt sustainability with best practice medium term primary balance targets or to calm public protest, an immediate review by the IMF of the necessity and quanta of debt write-offs should be conducted—fully reflecting the

impact of corrected misalignment on the debt stock, and anchored in lowering the medium-term primary balance target fully to best practice, namely to a medium term deficit of 1 percent of GDP.

And the number of IMF conditions has to be cut drastically. Apart from the loss of focus, intrusion into sovereignty, and compromised message to markets from current requirements, the IMF team managing this program give every impression of being overwhelmed by the sprawling number of tasks they have assigned themselves—running across hundreds of State Owned Enterprises amongst many other matters. So when the macroeconomic ground shifts beneath them mid-course, they simply do not have the band-width to discern the implications and re-direct the program core as needed.

To fix that, the IMF should discontinue lending to Kenya from the Resilience and Sustainability Facility leaving the authorities to address those issues at their sovereign discretion, should replace the associated financing from the Extended Fund or Credit Facilities correspondingly, should specify aggregate fiscal conditionality only on the primary balance, and it should at global level loudly challenge CBAMs and such imposed by its dominant shareholders precisely because they penalize the countries, like Kenya, which even collectively are not responsible for the global stock of emissions.

And for the remainder of this program and any successors, the IMF should stop concealing the rationales for core strategic decisions and parameters—including the medium-term primary balance and immediate revenue ratio target numbers. Doing so substantively breaches IMF policy on transparency, under which only matters potentially disturbing to markets may be withheld (and only at the authorities specific request). It is also poor professional practice given that full disclosure is the last best assurance against serious technical and strategic error. And it is an unfortunate echo of times past when the fates of African populations were similarly determined elsewhere, without explanation.

More broadly, the IMF has often implicitly excused its second-best conditionality behind the mask that programs were "home grown"—with the unstated implication for such as Kenya that the authorities made the choice against debt write-offs.

But such authorities design their "home grown" agendas in a context—in this case the dysfunctional arrangements to resolve Sovereign Insolvencies approved collectively by the dominant members of the IMF Executive Board. Those constraints imposed on home-grown options from 2021 onwards represents the most fundamental failing of IMF operations in Kenya since then.

And the consequent social unrest now represents yet a further and increasingly severe indictment of those arrangements. That unrest should further motivate immediate fundamental reforms to the global sovereign insolvency architecture to anchor it in best practice medium-term primary balances.

There were no signs in the latest IMF staff statement that any of these adjustments were forthcoming until, from June, Kenyan youth took their exasperation from their phones onto the streets. Following that, the IMF like others has to consider its position. It has given no public sign to this point that it will even go as far as merely rephasing some of its mandated sub-best-practice primary balance targets for 2024/25 to subsequent years, and requiring that remaining losses of revenue from planned 2024/25 tax increases be fully matched by cuts to planned budgets.

If that is all it does, while leveraging protest to curb low quality spending is welcome, that leverage should not be used to deliver macroeconomically mis-specified budget balance targets beyond 2024/25. If it is, not only will policy remain sub-best-practice but the social turmoil will simply ratchet up again next year.

Accordingly, President Ruto should not regard advocacy of the full agenda proposed here either as ingratitude for what the IMF has done so far nor as extending yet another supplicatory black hand, but rather as Kenya—and Africa—demanding to be treated properly.

Nor should he, on Kenya's behalf, be resigned to half gestures from the IMF nor see them as some morality tale consequent the policy missteps of earlier administrations. Ultimately, there is no virtue or African pride in paying debt to the point of hunger and disorder, and absolutely no excuse—with dozens of young protesters dead and many more disappeared—for the IMF to fuel those flames.

Their doing so has become a major impediment to Kenya taking its rightful place as one family, one nation, one language—on long-run growth as in all long distance races—out in front.