THE COUNTY GOVERNMENT OF THARAKA NITHI

A Prosperous, Industrialized and Cohesive County

FOURTH

COUNTY DEBT MANAGEMENT STRATEGY PAPER

Promoting Development and Sustainable Economic Transformation

FEBRUARY 2018

Vision

A prosperous, industrialized and cohesive County

Mission

Enhance sustainable socio-economic growth and optimal utilization of resources

Core Values

As Tharaka Nithi County, we are committed to championing these core values as the guiding codes for our operations:

ICT^2

Integrity

Straightforwardness, ingenuousness, honesty and sincerity are an integral part of our undertakings which we shall firmly adhere to in every duty to our society.

Inclusiveness

We believe in equity and equality. As a County we do not regard status or personal preferences but approach our work as guided by principles of fairness and non-bias. People from diverse backgrounds or communities are involved in the County development and we incorporate the needs, assets, and perspectives of communities into the design and implementation of county programs.

Citizen-Focused

We consistently endeavor to create enduring relationships with our citizens; in so doing our approach goes beyond standard citizen participation principles and makes their input an integrated, formalized part of setting county projects/program goals, performance measures, and standards.

Creativity and Innovativeness

We thrive on creativity and ingenuity. We seek the innovations and ideas that can bring a positive change to the County. We value creativity that is focused, data-driven, and continuously-improving based on results.

Transparency and Accountability

We will remain accountable to our stakeholders and will acknowledge responsibility for our actions and decisions. Thus we shall always endeavor to be transparent, answerable and liable at all times.

Team Work

Every person is important and has a part in county development. We endeavor to build a workplace environment that cultivates person's uniqueness, encourages staff participation, collaboration and integration of diverse skills and capabilities

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To obtain copies of the document, please contact:

County Trasury Budget Office
The Tharaka Nithi County Treasury
County Head Quarters
P.O Box 10 - 60400
KATHWANA, KENYA
Tel: +254-714 972 178
Website: www.tharakanithi.go.ke
Email: countytreasury@tharakanithi.go.ke

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INTRODUCTION TO THE 2018 ANNUAL DEBT MANAGEMENT STRATEGY

The 2018 MTDS is the fourth to be prepared by the County Treasury and is consistent with the overall macroeconomic framework discussed in 2018 CFSP, and reflects the inter-linkages and feedback effects between the MTDS and the macroeconomic framework affecting county environment given events and occurrences influencing the national economy. Within a medium-term planning period, the County Government will assess sustainability of debt and potential risks when implementing the MTDS.

This MTDS improves on the existing debt management strategy (MTDS 2017) by highlighting assumptions underlying the analysis, sources of loans to the County Government and highlights some of key structural and macroeconomic risks that may have implications for the choice of a preferred MTDS.

Legal Basis for the Publication of the Debt Management Strategy

The Debt Management Strategy is published in accordance with Section 123 of the Public Finance Management Act, 2012. The law states that:

On or before the 28th February in each year, the County Treasury shall submit to the county assembly a statement setting out the debt management strategy of the county government over the medium term with regard to its actual liability and potential liability in respect of loans and its plans for dealing with those liabilities.

The County Treasury shall include the following information in the statement:

a) The total stock of debt as at the date of the statement;
b) The sources of loans made to the county government;
c) The principal risks associated with those loans;
d) The assumptions underlying the debt management strategy; and
e) An analysis of the sustainability of the amount of debt, both actual and potential.

As soon as practicable after the statement has been submitted to the county assembly under this section, the County Executive Committee member for finance shall publish and publicize the statement and submit a copy to the Commission on

A. Macroeconomic Assumptions

1. Kenya economy is expected to show strong macroeconomic performance despite the headwinds from the regional and international markets. According to world bank kenya economic update the Kenyan GDP growth is projected to 5.5% a 0.5 percentage point mark down from the 2016 forecast. kenya faces a marked slowdown in credit growth to the private sector. At 4.3%, this remains well below the ten-year average of 19% and is weighing on private investment and household consumption. Kenya being a net oil importer, The rise in global oil price compared to the lows of 2016

has a dampening effect on economic activity. however in the medium term, economic growth is projected to rebound to 5.8% in 2018 and 6.1 % in the year 2019.This growth is anchored in improved structural reform, rising energy prices, rising food prices as a result of drought. However, steady inflation and management of interest rates by the Central Bank of Kenya will regulate the medium term economic performance of the country. Additionally, the exchange rate is expected to remain competitive.

Tharaka Nithi County microeconomic performance is expected to mirror that of National Government. The county government priorities include infrastructure development with focus on road infrastructure and rural electrification, accessible healthcare, transformative agricultural practices as well as reducing poverty- caused by -factors such as unemployment, inequitable distribution of resources and poor political agendas which are the biggest inhibitors of development.

The county government equitable share has come under pressure from increasing demand for infrastructural development while stabilizing recurrent expenditures. The increasing wage bill has been managed by the County Treasury where the county government effectively ceased usage of overdraft facilities to mitigate short term cash flow shocks caused by late release of exchequer transfers. This perennial phenomenon was partly attributed to delayed disbursement of funds by National Treasury and low ratio of County Own Revenue (CORe) to equitable share which stood at 6.2 percent for FY 2018/19 and expected to increase marginally to 7.4 per cent in the medium term.

Adverse exogenous shocks affected County Government revenue collection and weakened the overall fiscal position as reported in County Budget Review and Outlook Paper (CBROP) for FY 2017/18 and 2018 CFSP.

During the FY 2016-17 the County had a total revenue basket of Kshs 3.84 billion comprising of Kshs 3.39 billion from exchequer as equitable share of domestic revenues raised nationally, Kshs 98.69 million realized from conditional grants, Kshs 78.57 million being revenues raised locally (CORe) and an additional Kshs 69.1 million which was the amount negotiated as additional allowances for Health Sector Workers. In addition, the County had Kshs 199.43 million as balance brought forward from FY 2015-2016. The table below summaries the resources available to the County Government in FY 2016-17.

No.	Conditional Grant	Estimate FY 2016/17 (CARA, 2016) Kshs	Actual Receipts in Kshs	Percentage Actual Receipts as per annual allocation (%)
1	Road Maintenance Fuel Levy Fund	52,017,792	52,017,792	100
2	Free Maternal Healthcare	29,853,703	32,085,000	107.5
3	DANIDA Grant	6,165,000	6,165,000	100
4	User Fees Foregone	8,419,197	8,419,197	100
5	World Bank Grant	44,654,343	-	-
	Total	**141,110,035**	**98,686,989**	**69.9**

In MTEF 2016/17-2018/19, the county treasury has established elaborate measures which include elimination in the budget of the donor funds that are fully committed, capped and rationalized recurrent expenditure to 70% in order to mitigate increasing pressures on development resources and finally instituted stringent revenue raising measures that eliminated possible revenue leakages. This notwithstanding, the County Treasury is proposing measures to stem underperformance in collection of CORe in additional to proposing new revenue streams through the proposed Finance Bill 2018.

B. Principal Risks to the Debt Portfolio Real Sector Considerations

The county economy is highly susceptible to weather related exogenous shocks, especially drought in the lower altitude areas of Igambang'ombe ward and larger Tharaka Constituency. The ability of the County Government to continue supporting county development and social protection initiatives in the face of such shocks is an important consideration. For the last four years, the County Government has provided in its budget a contingency fund that can be used to mitigate such risks with a disaster framework being developed. In the context of the 2018 MTDS, the County Government is seeking diversification of financing resources through establishing a platform for exploiting the domestic debt market as well as international financial market. Therefore, through this year's DMS the County Government will be able to borrow through concessional agreements and engage in other Public-Private-Partnerships (PPP) where debt is a consideration in order to finance development projects.

Balance of Payments Risks

Nationally, the overall balance of payments position improved to a surplus of US$ 879.7 million (1.2 percent of GDP) in the year to November 2017 from a deficit of US$ 821.4 million (1.3 percent of GDP) in the year to November 2016 due to the improvement in the financial account that more than offset the widening current account deficit. This reflects the widening of the trade account balance and the increased payments to foreign investors (due to high interest payments) despite an improvement in the secondary income account balance particularly increased workers' remittances.

Although the County balance of payments is not being tracked, the hailing access to trade credit could constrain both the exportation and importation of commodities as a share on international trade. The Tharaka Nithi Investment and Development Corporation and Tharaka Nithi Grain Millers Ltd with combined efforts of other private players will boost the export trade relating to grains, tea and coffee ensuring farmers realize better prices.

The ranking of Kenya to a lower middle income country will continue to have major implications on the sourcing of financial resources to finance development projects. For instance, foreign direct investment flows to Kenya were forecasted to increase gradually as multinationals leap towards higher profit margins and improved access to trade credit. However, due to prolonged campaign period experienced in 2017 there is a likelihood of an economic slow-down and decreasing investment on development projects. In this regard, Tharaka-Nithi is likely to benefit from this favorable rating as it seeks to mobilize foreign investors having interest in Kenya.

In addition, the Kenya Shilling will continue to strengthen against the major currencies and the onus is on the National Treasury to cushion domestic currency against bullish effects which are likely to cause inflationary pressures on domestic market.

The balance of payment risks implies moderate exchange rate risks going forward. From the perspective of the 2018 MTDS, this suggests the county government can borrow in either domestic currency or foreign currency depending on the advice of the National Treasury and without unnecessarily dictating the currency.

Fiscal Risk Management

The County Government's fiscal position is pre-sumptuously vulnerable. Despite the fact that many of the balance of payments risks earlier evaluated indicated moderate risk exposure, the fiscal position may significantly get affected in eventuality of risk incident. The implementation of the Tharaka Nithi Investment and Development Corporation is likely to be slow and the corporation will face teething challenges likely to derail it from immediate achievement of the targeted outcomes. Despite reassurances of food stability from the bumper harvest in 2017-18 spending pressures would still increase based on rollout of school feeding programme and universal healthcare. The uncertainty in donor inflows results to a wavering fiscal position, and county government access to international capital market is also uncertain with the new changes to international policy experienced after the American presidential election and Brexit.

This vulnerability suggests that the County Government may need to consider diversifying its revenue streams and establishing a vibrant business environment for its residents through accessible and harmonized business registration processes that encourage entrepreneurship and business growth. Debt management considerations suggest the need to diversify financing sources and increase market capacity to help absorb such shocks. The County Government will target to establish and continue to improve its relationship with willing donors, prioritize on optimizing expenditure, build cash buffers, and enhance implementation efficiency, while creating fiscal space to accommodate potential increases in debt. More importantly, the county will continue to strengthen the overall public financial management framework to control the scale of explicit contingent liabilities.

Monetary Risk

The recent rise in the world prices of fuel and food will cause inflationary pressure it's a clear indicator of that money risk still exist. If balance of payments risks were to materialize, sharp depreciations will have the potential to cause inflationary pressures. Achieving low inflation will be essential for domestic market development so as to reduce volatility of exchange and interest rates. As a result, the County Government would count on the measures taken by the National Treasury to mitigate inflationary pressures.

C. Assumptions underlying the 2018 MTDS

i) Legal Framework

County government borrowing shall be guided by the following principles

a) Increased need to ensure stability of domestic financial markets;
b) promotion of inter-generational equity in the sharing of burdens and benefits of public borrowing;

c) established use of properly regulated criteria for evaluating the eligibility of county government need for additional funding for development programs
d) the exercise of prudence, transparency and equity in utilization of public funds.

The county government may borrow from time to time within and outside Kenya such sums of money in such amount and on such terms and conditions as to interest, repayment, disbursement or otherwise as the County Executive Committee Member may think fit, in any of the following ways, as is acceptable under the Public Finance Management Act, 2012 Section 140:—

(a) by issuing County Treasury bonds;
(b) by bank overdraft facility from the Central Bank of Kenya; and
(c) by any other loan or credit evidenced by instruments in writing.

Any borrowing by a county government under paragraph (2) (a) and (c) of this regulation shall require a national government guarantee pursuant to section 58 of the Act. In foregoing, the National Treasury has cleared way for County Governments to borrow from Central Bank and the repayments directly deducted from accruing exchequers.

Any borrowing shall be in accordance with section 142 of the PFM Act 2012 and shall be guaranteed by the Cabinet Secretary and that guarantee shall be charged to the county equitable share of the revenue raised nationally. The county government may borrow in pursuant to the requirements of sections 140 of the PFM Act 2012 for the purpose of:

(a) financing county government budget deficits; or
(b) cash management; or
(c) refinancing outstanding debt or repaying a loan prior to its date of repayment; or
(d) mitigation against adverse effects caused by an urgent and unforeseen event in cases where the Emergency Fund has been depleted; or
(e) meeting any other development policy objectives that the County Executive Committee Member shall deem necessary, consistent with the law, and as County Assembly may approve.

In setting debt limit and Pursuant to section 50(5) of the PFM Act 2012, a county public debt shall not exceed twenty percent (20%) of the county government's most recent audited revenues, as approved by county assembly.

The annual debt service cost of a county government shall not exceed fifteen (15%) percent of the most recent audited revenue of that county government, as approved by county assembly.

Pursuant to Section 141 (2) of the Act, 2012, the debt limit at any given time shall not exceed the nominal value of the total county public debt that is determined county assembly within the limits set under Section 50 (5) of the Act and in accordance with fiscal responsibility principles under regulation 25 of the these Regulations.

The debt limit under paragraph (1) of this regulation shall be specified annually in the county fiscal strategy paper and the medium term debt management strategy paper.

The annual new government debt shall be consistent with the debt limits set out under paragraph (1) of this regulation.

For the purposes of monitoring compliance with the limits under paragraph (1), the amount of county government debts which are not denominated in Kenya shillings shall be recalculated at the prevailing exchange rate of the Central Bank of Kenya.

ii. External Borrowing

During 2018/19 FY the national government acted on the need to empower counties and increase their development rate by increasing fiscal responsibilities and encouraging them to form county-oriented capital intensive investments.

In the forgoing the following assumptions regarding characteristics of external borrowing underlie the 2018 MTDS:

- All concessional external loans will be priced at a fixed rate of 0.75 percent, with a 40-year tenor and at least a 10-year grace period. These loans are assumed to be denominated in SDRs. A similar benchmark is used by the National Treasury.
- In the financial year 2018/19, the County Government may tap quasi-concessional sources of financing, the assumption is that these loans will be variable rate, effectively priced at LIBOR + 100 basis points, carrying a tenor of 20-years with a 5-year grace period and denominated in USD.
- Domestic commercial bank borrowing is also assumed to be a variable rate and denominated in KES. It is assumed that these are bullet loans

short-term tenor. These loans will be priced off LIBOR plus the assessed risk credit spread over the tenor period.

- Quasi -concessional and commercial borrowing that was assumed to begin 2018/19 and to remain capped at 10 percent of net financing.
- Concessional borrowing would remain at 30 percent of total net financing needs in the medium term.

Net external borrowing for financial year 2018/19 is estimated at 10 **percent of total county revenue** and is expected to increase marginally to 12 percent of total county government revenue in the MTEF. Commitments made during this period will be honored. However, as a priority, the county treasury does not foresee the need to engage in any form of external borrowing.

iii. Domestic Borrowing

Pricing of domestic borrowing is to be derived from the underlying forward National Treasury curves and taking into account anticipated inflation differential to adjust for the exchange rate differentials and the assumed premium to capture liquidity, inflation risk, and other risk effects. However, where domestic borrowings are likely to be in form of loans guaranteed by the National Treasury including Treasury Bills and Treasury Bonds the maturity structure of the portfolio will be lengthened to minimize refinancing risk. Additionally, the National Treasury has cleared a window for counties to borrow through the Central Bank of Kenya.

Domestic borrowing, mainly pending bills from previous financial years of Kshs 385.8 million, is about 5 percent of total county revenue in financial years 2018/19 and is expected to increase to 10 percent in short run up until.

(iv). Debt Sustainability

The most recent debt sustainability analysis carried out by the National Treasury concludes that the country's risk of debt distress remains moderate despite popular opinion indicating that the rate of borrowing is spiraling due to the high cost of infrastructure investments that began in 2013. Debt sustainability is assessed in relation to policy-dependent debt burden thresholds. Kenya is classified as a medium performer in terms of quality of its policies and institutions as measured by a three-year average of Kenya's score on the World Bank's Country Policy and Institutional Assessment (CPIA) index. In our context, the county is expected to start investing through debt which is established based on demand for revenue-yielding investments in comparison to internal sourcing of funds currently being practiced through credit supplies.

The current national debt-to-GDP ratio (47 percent) is low indicating debt sustainability is not a serious concern. Under stress tests using different scenarios which consider significant fall in real GDP, rise in primary balance, 30 percent depreciation in Kenya shilling and 10 percent of GDP increase in borrowing, Kenya's level of debt is considered to remain within sustainable levels.

In similar yardstick, Tharaka Nithi has continued to develop policies that target to match expenditures to available cash flows. The county has not incurred any commercial debt in past three financial years besides bank overdraft facilities that were used to manage short term cash flow challenges experienced in 2016 and prior years.

The extent to which the county opts to exercise caution is warranted to ensure that public opinion is factored in forging a favorable public debt situation that persists over the medium-term. The possible recourse to domestic debt financing by investment-hungry counties could further increase the domestic interest rate, and put pressure on this position. Recourse to non-concessional external financing could also prove difficult and may increase the risk of debt distress. The borrowing envisaged under the 2018 MTDS will be undertaken with caution taking into account these factors.

(v). Implementing the 2018 MTDS

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

The development and implementation of debt management strategy needs a robust legal framework. The present legislation does not include anything on debt management strategy and the long-term objectives the strategy should be based on. Provisions on long-term debt management objectives, requirement of debt management strategy development, annual reporting to the County Assembly on the debt management strategy and the debt management activities, and the purposes for which the Government can borrow need to be included in this legal framework.

The institutional arrangement for public debt management will be strengthened. The Budget Unit in collaboration with Economic Planning Unit both of the County Department of Finance and Economic Planning will remain the focal point in developing a comprehensive medium-term debt management strategy for the entire County debt portfolio, regularly updating this strategy, and monitoring that all borrowings and debt-related transactions are within the guidelines and risk parameters of this strategy. In addition, the units will be responsible for the official debt recording system.

Prudent management of the County Government debt portfolio requires a high caliber workforce. In this regard, County Government should be committed towards building capacity, strengthening and retention of skilled staff in debt management. As part of risk mitigation strategies being considered there is need to improve the skills level of the two departments with a possibility of establishing a separate unit in charge of Debt Management.

Any significant deviation from the current strategy leading to heavy borrowing will need clear justification and approval from County Assembly. The County Government will establish an appropriate balance between meeting its own development objectives and the macroeconomic objectives earlier outlined.

The publication of the 2018 MTDS is key component to enhancing transparency in governance, especially on cash management strategies. Mechanisms for regular monitoring of its implementation are yet to be established. At a minimum, the strategy will be reviewed annually to determine whether key underlying assumptions remain valid. In addition, if there are significant changes in market conditions, the strategy will be reviewed.

In supporting the County Government to achieve development objectives, a number of donor funding programs are being contemplated. For example, the County Treasury will seek support in implementation of public finance management reforms supporting a wide range of activities, including support in economic planning, budgeting, expenditure monitoring as well as public participation in governance. Therefore, it is the commitment of the County Treasury to bolster efforts in implementing PFMR including capacity building in debt management.

CONCLUSION

The 2018 MTDS is a robust framework for prudent debt management. It provides a systematic approach to decision making on the appropriate composition of external and domestic borrowing to finance the budget in the financial year 2018/19, taking into account both cost and risk. The debt strategy complements the proposed national medium term debt sustainability framework which is concerned with long-term sustainability of national debt. Whereas the contemplated debt level is sustainable, long-term debt sustainability depends on a number of factors such as growth in total revenue, sound macro-economic policy mix, policies and guidelines issued by the National Treasury on prudent debt management.

The 2018 MTDS has considered the macro-economic, and global and domestic market environment and related vulnerabilities and **recommends a mixed composition of debt towards long term with favour of external debt in the medium term**.

This is the fourth DMS the County Treasury is presenting as part of the Budget process. This initiative will be implemented going forward with the aim of enhancing the transparency and accountability in the utilization of county resources.