Report

Age of choice

Kenya in the new development finance landscape

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Cover photo: Reuters/Thomas Mukoya, 2011. A construction worker erects a scaffolding on a tunnel along the Nairobi–Thika highway project, under construction near Kenya’s capital Nairobi, September 23, 2011. The road, which is being built by China Wuyi, Sinohydro and Shengeli Engineering Construction group, is funded by the Kenyan and Chinese governments and the African Development Bank.

Key messages

- **Development finance flows to Kenya increased nearly five fold between 2004 and 2014 in nominal terms, dominated by official development assistance (ODA).** ODA's share has, however, declined slightly, with the rise of China as a lender and with Kenya's recent access to international bond markets.
- **Speed of delivery is valued by the government, but not necessarily at the expense of cheaper financial terms.**
- **The government manages relations with all donors, including China, through the usual government external resource management systems, led by the National Treasury.** This was not the case in other countries reviewed for this project.

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Acronyms and abbreviations

AfDB	African Development Bank
DP	development partner
FDI	foreign direct investment
GDP	gross domestic product
HIPC	Heavily Indebted Poor Countries (initiative)
IAD	Institutional Analysis and Development
ICC	International Criminal Court
IDA	International Development Association (World Bank)
IFC	International Finance Corporation
IFMIS	Integrated Financial Management Information System
IMF	International Monetary Fund
KERP	Kenya External Resources Policy
LIBOR	London Interbank Offered Rate
MDB	multilateral development bank
MDRI	Multilateral Debt Relief Initiative
NGO	non-governmental organisation
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OECD-DAC	OECD Development Assistance Committee
OOF	other official flow
PFM Act	Public Finance Management Act 2012
PPP	public–private partnership
SWAp	Sector-Wide Approach
SGR	Standard Gauge Railway

Contents

Key messages 3

Acknowledgements 3

Acronyms and abbreviations 4

List of figures, tables and boxes 6

1 Introduction 7

1.1 Background 7

1.2 Methodology and research questions 8

2 How country context influences negotiating capital and strategies 10

3 Development finance in Kenya 13

3.1 Overview 13

3.2 International sovereign bonds 13

3.3 Bilateral non-DAC donors 15

3.4 Philanthropic and NGO assistance 16

3.5 Climate finance 17

3.6 Public–private partnerships 17

4 Arenas of negotiation 19

5 Government priorities 21

6 Negotiation outcomes 24

7 Conclusions 26

7.1 Development finance flows 26

7.2 Arenas for negotiations 26

7.3 Priorities for development finance and outcomes 27

References 28

Annexes **29**

Annex 1: List of interviewees **29**

Annex 2: Mapping external finance flows 2003-2014 **31**

List of figures, tables and boxes

Figures

Figure 1: Development finance 2002-2014 **14**

Figure 2: Sovereign bonds made up almost two-thirds of flows beyond ODA over 2012-2014 **15**

Tables

Table 1: Kenya sovereign bond issues **15**

Boxes

Box 1: Official development assistance (ODA) and other official flows (OOFs) **8**

1 Introduction

1.1 Background

Development finance has been changing rapidly over the past 15 years. Traditional official development assistance (ODA) from members of the Organisation for Economic Co-operation and Development's Development Assistance Committee (OECD-DAC) is becoming less important for recipient countries. Such trends have been driven by supply and demand factors.

In terms of supply, the development finance landscape underwent what Severino and Ray (2009) have described as a 'triple revolution' in actors, goals and tools. There are many new providers of development finance, including non-DAC donors, such as India and China, and philanthropic foundations, such as the Bill and Melinda Gates Foundation. There are also new goals, such as those related to climate change adaptation and mitigation, which have led to the creation of vertical funds to address such global and national challenges. Finally, complex new finance instruments have been developed to foster the involvement of the private sector, such as public–private partnerships (PPPs). A second factor on the supply side is that fiscal austerity in OECD countries has been putting pressure on aid budgets.

On the demand side, first, the number of low-income countries has shrunk over the past 10 years, as developing countries graduate to lower-middle-income country status. This has clear implications for the range of financing options, as ever more countries will be graduating out of concessional financing from the multilateral development banks (MDBs). In addition, several bilateral development agencies review their funding strategy once an aid-recipient country reaches middle-income country status, moving from grants to loans or phasing out their assistance.

Second, several countries in sub-Saharan Africa have obtained access to international sovereign bonds in the past 10 years, including countries that previously benefited from debt relief. While there are advantages in terms of the flexible use of funds, volumes and diversification/risk mitigation, international sovereign bonds are far more expensive than concessional and non-concessional loans offered by OECD-DAC member countries or the MDBs. Governments do not extensively borrow from harder MDB facilities, despite the low-interest environment in international markets.

This study is one of a set of case studies that examine the challenges and opportunities facing governments in managing this new context for development finance. It builds on and expands the framework developed in Greenhill et al. (2013), within which (Phase 1) the cases of Cambodia, Ethiopia, Fiji, Papua New Guinea, Vanuatu and Zambia were analysed. Schmaljohann and Prizzon (2015) summarise the key findings.

Taking stock of these first case studies, in 2015 a second phase of the project reviewed the experience of governments in accessing and managing development finance flows beyond ODA. These flows have four main characteristics:

- They are cross-border flows (so exclude domestic bond markets and taxation).[1]
- They are spent on a public or philanthropic motive (excludes foreign direct investment (FDI) and remittances).
- They are not managed via traditional bilateral and multilateral aid systems (so exclude ODA grants and concessional loans originating from OECD-DAC donors, but include multilateral public climate finance as its allocation is based on project- or programme-level competition).
- Potentially they are under the direct influence of – if not controlled by – the government and are in principle accounted for in government budgets. They are counted independently from the level of concessionality, and potentially have an impact on government budgets (such as contingent liabilities or PPPs). For example, this would be the case for issuances of sovereign bonds in international financial markets but not for FDI and personal remittances.[2]

1 Dimension of the domestic bond market and trends in tax revenues form part of the economic context analysis in Annex 2.

2 The volume and terms of these flows can be indirectly influenced, for example, via tax incentives or better macroeconomic investment conditions; the same would apply to export credits, which are primarily aimed at the private sector. We do not apply a balance of payments approach, i.e. reviewing all cross-border flows.

Applying these criteria, the flows analysed in this case study are: bilateral and multilateral ODA (from OECD-DAC donors); other official flows (OOFs) from DAC/multilateral development institutions, i.e. official transfers that fail to meet the ODA concessionality criteria (see Box 1) and/or that do not have a development focus; flows from non-DAC donors, both ODA and OOF equivalent; assistance from philanthropic foundations; climate finance (multilateral); international sovereign bond issuances; and PPPs. PPPs are an instrument not a source, but they provide a concrete example of how governments, aid agencies and the private sector can work together. Following this definition, we refer to 'providers of development finance beyond ODA': these are non-DAC donors, OECD-DAC (traditional) donors and MDBs when providing non-concessional assistance, philanthropists and multilateral climate funds. 'Traditional donors' are defined as OECD-DAC members and MDBs providing ODA. We looked into multilateral (not bilateral) climate finance since funding and delivery mechanisms are based on competitive processes.

To the best of our knowledge, there is no existing case study on how financing choices are made at government level (ministry of finance and/or planning), in particular those relating to cross-border/external flows, and there is very limited information on flows from development finance institutions, PPP instruments and their impact on debt sustainability and whether they are considered and managed in a different way to ODA. This series of studies aims to fill this gap. In the studies we will refer to central agencies (ministries of finance or national planning, or their equivalents) and line agencies. We assume that these will have different sets of priorities and types of engagement with the different actors. Against this backdrop, it is worth stressing that this analysis does not reflect civil society priorities, which may well differ from those of the government.

Box 1: Official development assistance (ODA) and other official flows (OOFs)

The OECD-DAC classification of ODA covers finance provided by official agencies, including state and local governments, or their executive agencies which is (a) administered with the promotion of the economic development and welfare of developing countries as its main objective; and (b) concessional in character and conveys a grant element of at least 25% (calculated using a discount rate of 10%).

OOFs do not meet one or both of these conditions. In December 2014 the DAC High-Level Meeting revised the criteria for concessional loans, meaning that, henceforth, only the grant element will be counted as ODA, and that a new set of discount rates and risk adjustment factors based on the income classification of a recipient country is to be used (OECD, 2014).

The policy of the Government of Kenya is to seek financing with a minimum 35% grant element (i.e. financial assistance that would count as ODA), in line with the concessionality requirements for International Monetary Fund (IMF) programmes in low-income countries. The IMF defines debt with a grant element of less than 35% as non-concessional.

Source: https://www.imf.org/external/np/pdr/conc/

1.2 Methodology and research questions

The methodology for the case studies is adapted from Fraser and Whitfield (2008) and Ostrom et al. (2001) (the Institutional Analysis and Development (IAD) framework). The key insight from Fraser and Whitfield, with contrast to much of the literature on the political economy of aid, lies in seeing the engagement between recipient country governments and donors as one of negotiation, since it is assumed that their objectives may diverge. Fraser and Whitfield (2008) also focus on the importance of both the economic and political context in shaping country and donor negotiations, and thereby negotiation outcomes. Drawing on the IAD framework, we also emphasise the importance of negotiation arenas, but rather than taking these as a given, we ask whether governments seek to engage with different kinds of providers of development finance in the same fora. We focus particularly on arenas related to in-country aid coordination (e.g. sectoral or technical working groups, regular high-level donor–government meetings), as these are often key fora in which donors and government engage in discussion of sectoral strategies, project identification, policy dialogue and conditionalities.

Section 2 highlights the main elements of the economic, political, governance and aid management system influencing the Government of Kenya's negotiating capital regarding various providers of development finance.

Drawing on this theoretical framework, Sections 3 to 6 seek to answer the following four main research questions for the case of Kenya:

- **Volume of flows** (Section 3): Does the country receive external development finance beyond ODA and has the volume increased since the early 2000s?
- **Arenas for the negotiation of development finance** (Section 4): In which fora does the Kenyan government seek to engage with providers of development finance beyond ODA, and what strategies does it employ to negotiate with them? How do these differ from the fora and strategies in which the Kenyan government engages with ODA donors?
- **Priorities and characteristics of development finance** (Section 5): What are the government's priorities for the types of development finance it receives and how do these change across ministries and sectors?

- **Outcomes** (Section 6): To what extent is the Kenyan government achieving its objectives in negotiating with the providers of development finance? How has the existence of development finance flows beyond ODA helped or hindered the country in achieving its objectives?

There are at least three reasons why Kenya was chosen as a case study. First, Kenya recently joined the ranks of lower-middle-income countries following the rebasing of its GDP by 25% in autumn 2014. In the medium term the country will be in a position to access only non-concessional financing from MDBs and will start seeing bilateral donors redefine their country strategies (or even devise exit strategies). Second, in 2014 the government successfully issued its first tranche of international sovereign bonds, with the largest debut among sub-Saharan African countries. Third, Kenya has had a turbulent track record with DAC donors since 2003 (and did not benefit from multilateral debt relief initiatives) so the government has proactively looked into alternative financing options, including, but not limited to, Chinese lending.

The case study methodology included a literature review and a visit to Nairobi, which took place from 29 June to 10 July 2015. The visit was in collaboration with Mr Njeru Kirira and his team at the Global Economic Investment and Financial Consultancy. Semi-structured interviews were held with 49 key informants.

2 How country context influences negotiating capital and strategies

Several elements of the economic, political, governance and aid-management context have shaped the negotiating capital of the Government of Kenya and in turn it's negotiating strategy with providers of development finance.

Kenya was reclassified as a lower-middle-income country in 2014. Its GDP was rebased in 2014, resulting in a 25% upward revision in the size of the economy (World Bank, 2014). This means that Kenya will also soon gain 'blend status' with MDBs and will be able to borrow from both their hard and soft windows. It is also expected that other lenders will start to harden their terms, further shifting from grants to loans. Kenya is now the fifth largest economy in sub-Saharan Africa, smaller than only Angola, Nigeria, South Africa and Sudan (World Bank, 2014). Kenya also acts as a trade, technological and financial hub for East Africa, and the Nairobi Securities Exchange is among the best in Africa (Kimenyi and Kibe, 2014).

Kenya has increased its spending on infrastructure development to support its Vision 2030 strategy and has faced spending pressures as a result of the 2010 constitution and the devolution process. In consequence, the fiscal deficit has substantially increased over the past decade. Investment in infrastructure is the top priority in Vision 2030, Kenya's 'long-term development blueprint', which aims to 'transform Kenya into a newly-industrialising, middle-income country providing a high quality of life to all its citizens in a clean and secure environment' by 2030 (Office of the Prime Minister, 2007). Because of the increase in the fiscal deficit, Kenya has sought to boost infrastructure spending from around 22% of government spending to well over a quarter (National Treasury, 2015a). The government deficit[3] was under 2% of GDP in all but one year during the 2000 to 2005 period, and increased to an average of 5.8% of GDP between 2012 and 2014 (IMF, 2015a). The implementation of the devolved government set out in the 2010 Constitution has also increased spending pressures. The government is now seeking to tighten fiscal policy by constraining the wage bill and increasing revenues (National Treasury, 2015a).

Despite the increasing fiscal deficit, Kenya's macroeconomic management is regarded as successful, with low risk of debt distress and conservative management of potential resource revenues. Kenya successfully completed a three-year IMF Extended Credit Facility in December 2013 that supported macro-financial and institutional reforms to build external buffers and maintain debt at sustainable levels. However, the economy remains vulnerable to security (including global terrorism) and weather-related shocks[4] and to changes in global financial market conditions. In January 2015, Kenya entered a 12-month blended Stand-By Arrangement and Standby Credit Facility to protect against potential balance-of-payment shocks (IMF, 2015b).

Kenya is classified at low risk of debt distress (IMF, 2014). The overall public debt has been stable since 2007 at below 45% of GDP (following a steep decline from 2002 to 2007 when it fell from above 60%), within the 50% of GDP limit set by the fiscal convergence targets of the East African Monetary Union Protocol, which forms Kenya's policy target. The government decided not to accept bilateral and multilateral debt relief under the Heavily Indebted Poor Countries (HIPC) initiative and the Multilateral Debt Relief Initiative (MDRI) in the 2000s to ensure access to markets. Recently, Kenya made major oil and gas discoveries, which could be comparable with those in Equatorial Guinea and the Democratic Republic of Congo, and which may provide significant foreign exchange and financing for the government. However, Kenya is taking a conservative approach to the fiscal management of these potential future revenues and is not yet factoring oil proceeds into its fiscal framework (IMF, 2014).

3 General government net lending/borrowing

4 Kenya is highly vulnerable to the impact of climate change. The Stockholm Environment Institute estimates that the cost of climate change in the country could be equivalent to a loss of almost 3% of GDP by 2030 (Norrington-Davies and Thornton, 2011).

Kenya has seen a significant increase in aid over the past decade, and a shift from grants to loans. Kenya saw ODA from DAC donors increase more than fourfold between 2004 and 2013. However, fast economic growth at the same time means that the ODA/GNP ratio only rose by two percentage points, from 4% to 6%, over 2004 to 2013. This increase was largely due to a rapid rise in loan financing; grant financing as a share of GDP has been more stable. Loans increased from 30% of annual ODA to 41% between 2004 and 2013, largely due to the rise in concessional loans from the MDBs and bilateral donors such as the African Development Bank (AfDB) and the Japan International Cooperation Agency (JICA).

Despite this rise in aid, Kenya remains less aid dependent than many other African countries. External financing is only a small proportion of Kenya's overall government expenditure, averaging 9% from 2010/11 to 2013/14, but it remains key to financing development expenditure. The government has generally funded almost all of its recurrent budget, but external funds financed an average 32% of Kenya's development budget from 2011/11 to 2013/14 (National Treasury Budget Policy Statements, various years). However, Kenya is far less aid dependent than its neighbours. Whereas ODA to the public sector averaged far more than a quarter of government spending[5] in all other East African Community Members[6] and in Ethiopia from 2004 to 2013, in Kenya the equivalent figure was 13%.[7] This lower dependence is largely a result of Kenya adjusting to limited donor support, rather than Kenya deliberately pursuing an aid exit strategy (IMF, 2008). The Kenya External Resources Policy acknowledges the need for continued ODA to support implementation of Vision 2030, but sets out an expectation that ODA will fall as a percentage of the budget as more domestic resources are mobilised (National Treasury, 2014).

Kenya was a strong ally of the West, but the end of the Cold War reduced political motivations for foreign aid, leading to a reduction in aid and a tempestuous relationship with donors. Kenya received 19 structural adjustment loans from the IMF and the World Bank between 1979 and 1996, and was one of only 12 countries to receive 15 or more such loans between 1980 and 1994, despite its repeated failure to meet conditions (Easterly, 2001: 107–115).[8] After the fall of the Soviet Union in 1991, aid was linked to pressure for democratisation and multi-party elections. However, donors did not disengage completely from Kenya, leading to an on-and-off relationship,[9] as the Kenyan government showed sufficient reform commitment to benefit from debt rescheduling. Subsequently, the government backtracked (IMF, 2008: 23), and aid was frozen or withdrawn in 1991 when the government did not meet Structural Adjustment Programme commitments, and again in the run-up to the general elections in 1997 and 2002 (Mwega, 2010).

Following a democratic change of government in 2003, donor relationships with Kenya continued to be complex. Donor relations with Kenya have been complicated by corruption scandals, which emerged first in 1993,[10] and after the change of government in 2003,[11] and 2008.[12] In spite of these scandals, Kenya's macroeconomic policies remained relatively prudent and gradual progress was made on reforms (IMF, 2008). While donors complain that they have not seen sufficient governance reforms, or punishment of those guilty of corruption, the government argues that it has implemented reforms and strengthened systems, and that this is reflected in the high, and improving, CPIA (Country Policy and Institutional Assessment) score that Kenya receives.[13] The results of the 2007 elections were contested, leading to widespread post-election violence, which only ended through international mediation to establish a

5 As measured by government final consumption.

6 Burundi, Rwanda, the United Republic of Tanzania and Uganda.

7 Data for ODA to the public sector from OECD, Credit Reporting System (CRS); data for government final consumption from the World Development Indicators.

8 Easterly describes how the reform of Kenya Railways, which had significant financial problems, and which he describes as an "embodiment of government patronage" was a continual reform requirement from the early 1980s but was never acted on by the Government (Easterly, 2001:107-109).

9 In 1995, *The Economist* gave this description of Kenya's relations with donors: 'Over the past few years Kenya has performed a curious mating ritual with its aid donors. The steps are: one, Kenya receives its yearly pledges of foreign aid. Two, the government begins to misbehave, backtracking on economic reform. Three, a new meeting of donor countries looms with exasperated foreign governments preparing their sharp rebukes. Four, Kenya pulls a placatory rabbit out of the hat. Five, the donors are mollified and the aid is pledged. The whole dance then starts again' (quoted in Easterly, 2001:117).

10 The Goldenberg scandal involved irregular payments from the Ministry of Finance and the Central Bank of Kenya during 1990-1993. Goldenberg International was a company that received payments as part of the scam. KSh21.6 billion were misappropriated, equivalent to $600 million (IMF, 2008).

11 The Anglo-Leasing scandal involved 18 fraudulent or flawed security contracts, with payment for goods that were overpriced or not delivered. The contracts totalled approximately $750 million and were agreed during 1997-2004 (IMF, 2008).

12 Support to the Kenya Education Sector Support Programme was suspended after an audit revealed in 2009 that over a six-year period as much as KSh5.5 billion ($63 million) of free primary education school capitation grant funds had gone missing. http://www.cgdev.org/blog/held-hostage-funding-proven-success-global-development-hold-kenya

13 Kenya's CPIA score improved from 3.6 in 2005 to 3.8 in 2014. This was above the average for IDA countries (3.3), and above the average for non-IDA countries (3.5). Only five IDA-eligible countries had a CPIA score above Kenya's in 2014. However, within the CPIA score, Kenya received its lowest scores (3.0) on measures for property rights and rule-based governance, and transparency, accountability, corruption in the public sector (World Bank World Development Indicators). Similarly, Kenya's score for control of corruption on the Worldwide Governance Indicators is low and declined slightly over 2004-2013, and in 2014 Kenya ranked in the bottom fifth of countries on Transparency International's Corruption Perceptions Index.

government of national unity. The failure of the government to establish a domestic tribunal led to an International Criminal Court (ICC) investigation which resulted in eight indictments, including the Deputy Prime Minister Uhuru Kenyatta and Minister William Ruto. The subsequent victory of Kenyatta and Ruto in the 2013 general elections led to a cooling of relations with the West, which is seen as the sponsor of the ICC cases. The ICC's withdrawal of the charges against President Kenyatta in December 2014, together with regional security developments, helped maintain the relationship with the West.

Kenya remains a key partner with the West because of its regional role in promoting security. After the election of President Mwai Kibaki in 2002, Kenyan foreign policy became more assertive in protecting its national, especially economic, interests, culminating in an offensive military incursion into Somalia in 2011 (McEvoy, 2013).[14] This allowed Kenya to 'securitise' its relationship with the West, maintaining Western support for its security role, but at the same time, internal dissent was suppressed and politics became more authoritarian (Fisher and Anderson, 2015). Analysis of donor behaviour in Kenya suggests that stability is favoured over 'basic principles of democracy and justice' – donors have a record of not enforcing stated conditions for support and have been reluctant to use any potential leverage they may have over the government (Brown and Raddatz, 2014).

China is an increasingly important partner for Kenya. Relations with China have become closer since 2002, since the change of government. Trade between the countries has rapidly increased (the increase in Chinese financing for Kenya is described in the next section).[15] The Chinese embassy in Kenya is one of its largest in Africa, both in terms of size and employees. China views Kenya as a gateway to the region, making it a key focus of China's trade and economic strategy in Africa (Onjala, 2008). For Kenya, given the history of relations with Western donors, and the centrality of governance conditions in much of the conflicts in this relationship, there are obvious attractions in a partner that does not require governance conditions.

14 After entering Somalia, Kenya's troops subsequently joined the African Union AMISOM mission, together with Ethiopian, Ugandan and Burundian troops. In April 2013, Kenya had a total of 4,402 troops on the ground in southern Somalia, each being paid for by the EU at a rate of $1,028 per month.

15 Kenya's imports from China doubled over 2010-2014 and now are a comparable size to imports from western Europe (Kenya National Bureau of Statistics, 2015: Table 7.9).

3 Development finance in Kenya

This section reviews the evolution of development finance to Kenya over the past decade. The flows include those from bilateral non-DAC donors, OOF, multilateral climate finance, philanthropic assistance, international sovereign bonds and other private flows, such as from PPPs. Total development finance includes ODA plus these other flows.

3.1 Overview

Development finance flows to Kenya have increased steadily over the past decade, but remain dominated by ODA. In line with the overall expansion of aid flows after the 2002 Monterrey Financing for Development conference, development finance flows to Kenya increased from $750 million in 2004 to nearly $6 billion in 2014. Flows to Kenya remain dominated by ODA from OECD-DAC members and multilaterals, which accounted for almost 76% of total development finance over the decade 2005-2014. The largest OECD-DAC bilateral donors are the US (27% of gross ODA in 2014), the UK (8%), France, Germany and Japan (all 4%). The largest multilateral donors are the International Development Association (IDA) (20%), the African Development Fund (8%) and the EU (7%).[16]

Development finance flows beyond ODA come largely from sovereign borrowing. As Figures 1 and 2 show, flows beyond ODA are dominated by the issuance of a sovereign bond in 2014. Assistance from China has become increasingly important[17] and China is the most important non-DAC partner for Kenya. Chinese development assistance for Kenya has risen strongly over the past decade, making China one of Kenya's main development partners, with annual lending on a par with that from large multilateral agencies such as the EU or the AfDB. China's lending has mainly been through grants and concessional loans, but has recently expanded into non-concessional loans for the Standard Gauge Railway (SGR) project.

OOFs have increased in importance over the past decade. They are split evenly between bilateral OOFs from DAC member countries and OOFs from multilateral organisations. The main multilateral provider is the International Finance Corporation (IFC), which provided more than two-thirds of OOFs over 2012-2014.

Flows beyond ODA are likely to be dominated by sovereign borrowing and by Chinese loans in the immediate future due to the large size of the issuance and the size of the SGR loan compared with other flows. However, as Kenya starts to make use of its blend status to borrow from the hard windows of the International Bank for Reconstruction and Development and the AfDB, this composition is expected to change.

3.2 International sovereign bonds

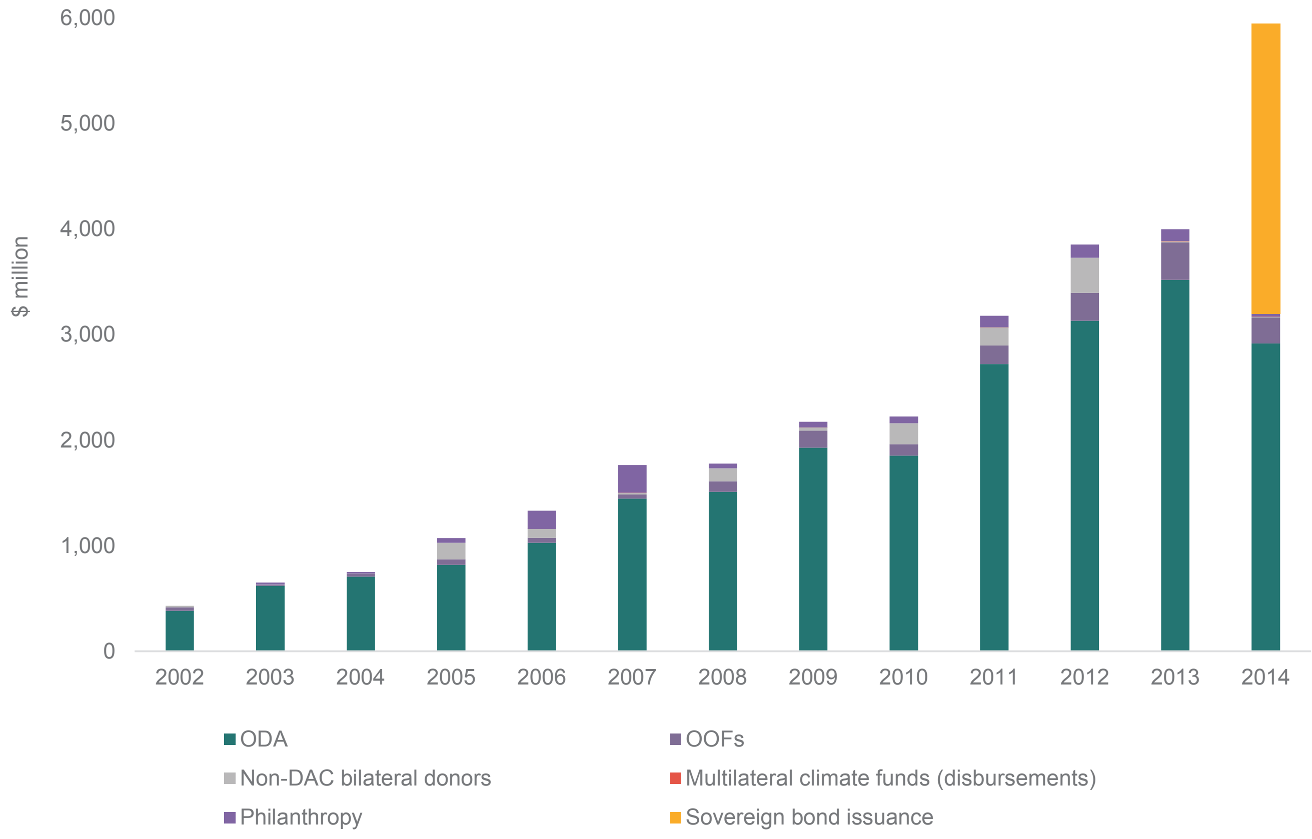
Kenya issued its first sovereign bonds in 2014, having planned to do this since 2007. Kenya had first started planning to go to the markets in 2007, following improved economic management under President Kibaki. Following the post-election violence in 2007-2008, planning for sovereign borrowing was halted. The violence meant the government was not in a position to seek financing from the international markets, as its credit rating was downgraded to a B. The global financial crisis caused a further delay while credit markets stabilised, and in 2012 the government took a syndicated bridging loan of $600 million from commercial banks ahead of elections in 2013.

The primary rationale for international borrowing was to finance infrastructure. Improved growth, the completion of a three-year IMF programme in November 2007, and the Africa Country Infrastructure Diagnostic, which showed a huge investment gap of $2 billion per annum (Briceño-Garmendia and Shkaratan, 2010: 31), prepared the ground for the idea that Kenya was ready for more borrowing for infrastructure. The bond was needed to help finance the ambitious plans set out in Vision 2030, which were beyond the level of financing that Kenya's traditional lenders could offer (either because they do little bilateral infrastructure financing, as is the case with the US and the UK, or because they could not scale up their resource to match Kenya's ambition, as was the case with the AfDB

16 It should be noted that all these figures are from the OECD aid statistics and are for total aid to Kenya, which includes aid that is not on budget.

17 Figure 2 understates Chinese support for Kenya (under non-DAC bilateral donors) as it uses data from AidData, which only run up to 2012. AidData valued Chinese support to Kenya at $326 million in 2012. Data from the Kenyan budget suggests that Chinese support remained at similar levels in 2013 and 2014. If this is taken into account, non-DAC bilateral donors would have accounted for 20% of flows beyond ODA over 2012-2014.

Figure 1: Development finance 2002-2014



Source: OECD aid statistics; AidData; Foundation Center Database; Climate Funds Update Database.
Notes: ODA includes: ODA in the form of grants and concessional loans from DAC donors and multilateral organisations net of multilateral climate funds. Non-DAC bilateral donors includes: data from AidData for flows from Brazil, China, Saudi Arabia and South Africa, and for non-DAC bilateral donors who report to DAC.

and World Bank, which set country allocations based on set formulae). This justified the need for non-concessional borrowing. However, there were further considerations that also influenced the government's decision to take on this more costly source of financing.

The Government of Kenya also hoped to diversify funding sources by gaining access to international markets. Kenya had never received debt relief, and the Kibaki government made the decision in 2003 that it would repay Kenya's external debt in full to send a signal to the markets (see Section 2). From interviews with government officials, we understood that the Kenyan government felt that donors had imposed governance conditions, and that sovereign borrowing would allow access to finance to be determined by the market rather than by donors' decisions.

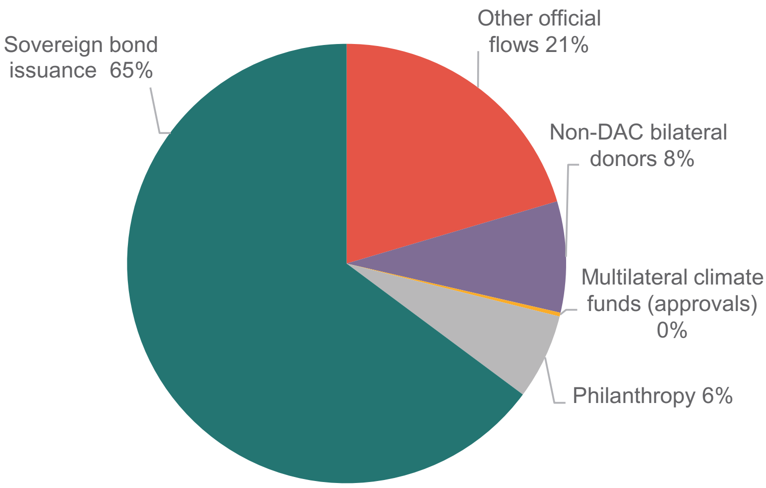
It was also hoped that sovereign borrowing would set a benchmark for international borrowing by the private sector, and reduce the pressure on the domestic debt market. By setting a benchmark for private international borrowing, it would allow large private sector firms and parastatals to borrow internationally (National Treasury, 2015b: 4).[18] It was hoped that shifting the government, parastatals and large private firms from borrowing domestically would bring down the cost of credit for local firms.

Kenya's June 2014 issue was the largest debut bond issue by an African country. The $2 billion issue consisted of $1.5 billion with a 10-year maturity, and $500 million with a five-year maturity.

Kenya's sovereign bond has performed well compared with regional peers. Following the issuance, the bond yield in the secondary market has declined less than comparable

18 One interviewee disputed this rationale, noting that large firms were already able to access international markets at cheaper rates than the government obtained even before the sovereign bond was issued.

Figure 2: Sovereign bonds made up almost two-thirds of flows beyond ODA over 2012-2014



Source: OECD aid statistics; AidData; National Treasury; Foundation Center Database; Climate Funds Update Database.

securities, such as Zambia's and Ghana's. This reflects Kenya's unique position among frontier markets: (a) Nairobi is a recognised hub in an expanding regional market; (b) it has sound policies, a strong tax base and an active market for government securities reflecting a fiscal policy framework largely independent of grants; and (c) there was conscientious preparation, including the making of difficult decisions such as adapting legislation and assuming minor liabilities previously in litigation (IMF, 2014: 7). This allowed a $750 million re-tap (i.e. selling more of the same bond issue) in December 2014 at a yield 100 basis points cheaper, which was oversubscribed by 394% (National Treasury, 2015b: 18).

Table: 1 Kenya sovereign bond issues (2014)

Size ($ million)	Yield (%)	Maturity (years)	S&P rating
1,500	6.88	10	B+
500	5.88	5	B+
500	5.90	10	B+
250	5.00	5	B+

Source: Tyson, 2015; National Treasury, 2015b

3.3 Bilateral non-DAC donors

Kenya has a high profile in South–South Cooperation, hosting the UN High-Level Conference on South–South Cooperation in Nairobi in 2009 and in 2013. Within the government, South–South Cooperation is coordinated through a Standing Committee on South–South Cooperation, with representation from across government and from a number of parastatals, including research institutes, that engage in this area.

A South-South Centre was established in 2012 to coordinate and promote South–South and triangular cooperation activities. However, during a recent review on rationalising state corporations, it was recommended that the centre's activities be transferred to the Ministry of Devolution and Planning.

Among Southern providers, China has become one of Kenya's most significant sources of development assistance. However, this is not the case for any other non-DAC donors. India remains a relatively small donor, and initial negotiations have started with Brazil for the first small project in Kenya.

China

China is a major provider of assistance to Kenya. In terms of annual loan volumes, China is a similar-sized lender to the AfDB. Kenya's recent budgets show, on average, loan financing from China at $295 million a year from 2011/12 to 2014/15. Other estimates of Chinese development assistance are consistent with these amounts. Dreher et al. (2014) estimate that Chinese assistance averaged $162 million per year between 2000 and 2012, and $232 million per year since 2005. These financial flows are predominantly for transport (39%) and energy (24%). Mwega (2010) documents the growing significance of loans and grants from China following the election of a new government in 2002, with China becoming one of the largest contributors of development assistance by 2005. China is Kenya's second largest bilateral creditor, accounting for 37% of bilateral debt (National Treasury, 2015b).

The shift to China is driven by a combination of political and economic factors. After the 2008 financial crisis on the supply side, aid from European donors was perceived to be falling,[19] whereas aid from China was not. Chinese loans are perceived as easier to access: they can be arranged and delivered more quickly than other finance, and do not come with conditionalities, except for being tied. However, even this was not perceived as a huge drawback as Chinese firms are also able to win contracts in open procurement from other providers of development assistance, providing evidence of their capacity. On the demand side, after the 2013 elections, the government 'looked East' as it sought partners who were not connected with the ICC, building on ties established during the Kibaki government, which had first started exploring relations with China as it sought to boost investment in infrastructure projects.

The Standard Gauge Railway (SGR), financed by China, is a landmark project for Kenya. The SGR project from Mombasa to Nairobi will cost $4 billion. Of the total cost, 90% is being financed by China Exim Bank through a $1.6 billion concessional loan (2% interest) and a $2 billion semi-concessional loan (at six-month LIBOR[20] plus 3.6%). To put the size of this project in context for both Kenya and China, it is larger than total ODA to Kenya in 2013, Kenya's total development budget in 2014/15 was around $5 billion and between 2010 and 2012 China gave a total of around $2.7 billion in concessional loans per year.[21] The loan did not pass the Kenyan government's normal 35% grant element threshold (as a package, the two loans have a grant element of around 25%), but was taken on because of the importance the government places on the project. The government only expected to receive sufficient financing for such a project from China, and considered the terms far better than could be accessed on the capital markets (where the yield was 6% to 7%).

With the exception of the commercial loan for the SGR, Chinese support is largely concessional. The bulk of it is provided on terms that meet Kenya's requirement that financing has at least a 35% grant element. Typical terms are fixed interest rates of around 2%, a seven-year grace period and a 13-year repayment period.

India

In contrast to China, India is not yet a major development partner to Kenya, despite the importance of historical ties and the current trading relationship, where India is Kenya's largest provider of imports (Kenya National Bureau of Statistics, 2015: Table 7.9). India's focus is on the energy and textile sectors, and it has provided a few concessional loans in these areas. The 2015 Kenyan budget reported a $69 million loan for the energy sector.

Arab donors

Kenya receives small amounts of financing from Arab donors. These include the Arab Bank for Economic Development in Africa (BADEA), the OPEC Fund for International Development (OFID), the Kuwait Fund and the United Arab Emirates. Of these, BADEA and OFID are the largest partners, providing up to $10 million per year in loans, with the remainder being smaller partners providing less than $5 million per year.[22] Loans are concessional. These donors usually co-finance projects together, typically for infrastructure. While this enables larger projects to be financed, it also means projects take considerable time to be negotiated as this co-financing must be negotiated with each donor. Because these donors do not have country offices, negotiations must be carried out with non-resident head offices.

3.4 Philanthropic and NGO assistance

Despite Kenya's status as a hub for several philanthropic organisations, philanthropic assistance is not a major source of development finance. According to data from the Foundation Center,[23] US grant-making organisations provided more than $1 billion to 544 organisations in Kenya between 2003 and 2013. This is equivalent to just 6% of net ODA. However, philanthropic organisations based in Kenya do not focus solely on Kenya. As a regional hub, Kenya also hosts headquarters and regional offices for organisations financed by philanthropic foundations. For example, Nairobi is the headquarters of the Alliance for a Green Revolution in Africa (AGRA), and for the African Agricultural Technology Foundation (AATF). More than 60% of the financing tracked by the Foundation Center was for just these two organisations. However, while Kenya hosts AGRA, it is not a focus country for AGRA's programming (these are Burkina Faso, Ethiopia, Ghana, Tanzania, Maili and Mozambique). Data for the Bill and Melinda Gates Foundation are now included in the OECD-DAC statistics. These show the Gates Foundation provides around $60 million of aid per year. However, more than half of this is for AGRA, so in reality these funds are not for Kenya. Similarly, the agricultural research undertaken by AATF is a global public good, rather than aimed at specifically benefiting Kenya. Other philanthropic organisations, such as the Clinton Health Access Initiative, are largely funded by official donors (with the exception of the Gates Foundation), so this financing cannot be characterised as philanthropic flows.

19 Gross ODA disbursements fell slightly in 2010, but have continued to grow strongly since then.

20 The six-month LIBOR rate stood at 0.49% on 31 July 2015.

21 http://www.chinaafricarealstory.com/2014/07/chinas-second-foreign-aid-white-paper.html

22 BADEA, OFID and UAE report to OECD-DAC, as does Kuwait. Data has also been taken from the Government of Kenya's 2014/15 development estimates.

23 http://webapps.foundationcenter.org/intl/?_ga=1.31147071.1201478938.1432025796

3.5 Climate finance

Kenya receives relatively little climate finance, but is receiving large amounts of mainstream ODA to invest in green energy. According to Climate Funds Update, $56 million of climate finance has been approved since 2003, but only $6.5 million has been disbursed.[24] However, far larger amounts of conventional development finance are being reallocated to fund climate programming. Several bilateral donors finance climate programming from their mainstream ODA envelopes, for example Agence Française de Développement, which aims for 50% of its global lending and 30% of its lending in Africa to be for climate change (Agence Française de Développement, 2011). The Kenyan government established the Geothermal Development Corporation in 2008 to develop geothermal energy sources. We understand from interviews that it has received more than $600 million in financing from sources such as MDBs and bilateral development finance institutions. As a result, in 2015, geothermal energy accounted for most of Kenya's installed energy generating capacity, and Kenya now produces the second largest amount of geothermal energy in the world, after Iceland. This is leading to falling power prices for Kenyan consumers and is also benefiting the balance of payments as Kenya needs to import less fuel for thermal power plants.

This is not expected to change in future, with climate finance continuing to play a limited role. There is little evidence of 'new and additional' climate financing being forthcoming. New climate finance funds, such as the Green Climate Fund, are viewed as having cumbersome procedures, making it difficult to access their financing. This is contrasted with the Climate Investment Fund, which is administered by the World Bank and the AfDB, two institutions with track records in lending operations. Over the past five years the price of Clean Development Mechanism Certified Emission Reductions has collapsed. While Kenya has around 20 registered projects with the Clean Development Mechanism, the fall in the price of the carbon credits has limited the potential for this source to provide a significant level of financing.

3.6 Public–private partnerships

The expansion of PPPs is a priority for the Government of Kenya. The key rationale for creating PPPs is to plug the resources gap that prevents the funding of all the infrastructure projects the government would like to undertake, to address the estimated $2 billion per annum infrastructure investment deficit (Briceño-Garmendia and Shkaratan, 2010: 31). The Kenyan government is nearing its 50% of GDP debt limit (see Section 2), and thus has limited fiscal space to take on large amounts of new borrowing. The attraction of PPPs is that the private sector absorbs the up-front cost of building infrastructure, so this debt is on private sector entities' balance sheets, rather than the government's. A further advantage of PPPs is to bring in private sector efficiency and improved management.

PPPs so far have been most successful in the energy sector, but the government is also pushing to scale up partnerships in the transport sector. There has been a rapid expansion in the number of PPPs since the implementation of a coherent policy framework. The PPP Policy was published in 2011, and was the basis for the 2013 PPP Act. All active PPPs in Kenya are in the energy sector. There are 13 power generation projects, with a total value of more than $3 billion (National Treasury, 2015a), generating more than 900 MW. By unbundling the energy sector (separating the generation, transmission and distribution functions and phasing out subsidies in the late 1990s and early 2000s), the policy environment to attract private investment into the sector improved. The government is now seeking to do the same for the transport sector.

However, this is a greater challenge: whereas power projects create an income stream as consumers ultimately pay for power, for the road sector, tolls must be established and may not be high enough to make projects commercially viable. To address this the government is establishing a viability gap fund. It is also developing a tolling policy and strategy for toll concessions on several major roads, and has developed a road annuity programme for rural roads to finance a significant expansion of the network with an initial tender targeting 3,000 km of roads on top of the existing 14,000 km network. The objective was that the private sector would design, finance, build and maintain the roads for 10 years, with the government paying over this 10-year time period. However, the government announced in October 2015 that it was dropping this programme on value for money grounds, as the bids came in at far higher cost than conventional procurement.[25] This demonstrates a key concern around PPPs: whether the value for money of these investments has been properly estimated, and how the cost compares to the cost of using other financing sources, such as conventional government debt. While studies of comparative value for money are required under the PPP Act, they are not publicly available.

Support from the MDBs and from multilateral development finance institutions has been critical for establishing a successful PPP framework in Kenya. The World Bank has provided a number of advisors to the PPP Unit within the National Treasury, and has provided funding for feasibility studies for PPP projects. Just as important

24 It is not clear whether this is due to data limitations (commitments have been recorded but not disbursements) or whether disbursments have not in fact been made. Regardless, even the approved amounts of climate finance are much smaller than the conventional ODA being used for climate mitigation purposes.

have been financing provisions. National government will not provide sovereign guarantees for any investments in order to ensure these are not on the government's balance sheet. To reassure investors, the Multilateral Investment Guarantee Agency, the African Trade Insurance Agency (based in Nairobi), the IFC and the AfDB have provided insurance and partial risk guarantees. Despite this, there are concerns around contingent liabilities, and Kenya's Stand By Arrangement with the IMF includes a commitment to enhance the capacity of the National Treasury's Debt Management Office to analyse contingent liabilities, including those from PPPs (IMF, 2015b).

25 'Ministry ditches costly annuity model in 10,000km road project', *Daily Nation*, 12 October 2015.

4 Arenas of negotiation

This section describes the main arenas in which governments seek to engage with different providers of development assistance. The focus is on arenas related to in-country aid coordination (e.g. sectoral or technical working groups, regular high-level donor–government meetings), as these are often key fora in which donors and government discuss sectoral strategies, project identification, policy dialogue and conditionalities. We also review the extent to which providers of development finance beyond ODA (notably non-DAC donors and philanthropic organisations) participate in these arenas.

There are three main arenas of government–development partner negotiation in Kenya.

- **The 'Summit' or High-Level Development Partnership Forum** is an annual event chaired by the Deputy President, and attended by government ministers, county governors, ambassadors and country directors, civil society and the private sector.
- **The Aid Effectiveness Group** is a monthly technical group consisting of heads of agencies and senior technical officers from government ministries, co-chaired by the National Treasury and a development partner. It also includes representation from the Council of Governors[26] (of counties), parliament, the private sector and civil society.
- **Sector working groups** are based on the sectors used in the government's Medium-Term Expenditure Framework and should be held at least quarterly, co-chaired by government and development partners, to discuss sector priorities and implementation of programmes. Relevant county departments and representatives from the Council of Governors are also now starting to attend these groups.

Development partners meet on a monthly basis. The Development Partners' Group is a meeting of ambassadors and country directors to review and follow up on the effectiveness of their support. Issues raised at this meeting should be channelled to the Aid Effectiveness Group or the Summit.

There are contrasting views on the effectiveness of these aid coordination structures. On the one hand, it was argued that concerns raised in the Aid Effectiveness Group are taken up in the Development Partnership Forum and ministers are held to account if they do not follow up the commitments agreed there. On the other hand, it was argued that while the structured process is useful, it is technocratic and dominated by the National Treasury, which makes it hard to make changes.

New donors attend the Summit but do not attend the other aid coordination fora. All development partners, including non-DAC donors, such as Arab countries, China and India, attend the Summit. However, it is noted that they go to listen to government and to other development partners, rather than to speak. Non-DAC donors do not attend the other meetings. China argues that they do not attend because the nature of South–South cooperation is different, and these groups are based on a North–South view of aid. But neither development partners nor the government showed clear understanding of China's view. The Aid Effectiveness Group is attended by 16 development partners. The key criticism was not the non-attendance of non-DAC donors, but rather their lack of transparency in setting out what they finance.

However, the government manages relations with all donors, including China, through the usual government external resource management systems, led by the National Treasury. Even where donors do not attend the aid coordination fora, their support is still managed through the National Treasury's Directorate of External Resources. The Treasury expects each partner to have a medium-term (three- to five-year) country plan that is aligned with the second Medium-Term Plan of Vision 2030. Where a development partner does not attend aid coordination fora, this is negotiated directly with the National Treasury, and with line ministries through the Treasury. Line ministries expressed hope that new development partners would attend the Aid Effectiveness Group and sector working groups, but also noted that because they generally provided infrastructure and other hardware, rather than recurrent supplies or technical assistance, coordination of this support is easier and thus attendance at the sector working groups less important. The fact that relations with all donors are managed through the Treasury's external resource management processes means the government has accurate information available on non-DAC donors in its budget documents. However, this largely related to loans. The Treasury has established a database (E-Promis) to

26 The Council of Governors was established by the Intergovernmental Relations Act 2012 and provides a forum for inter-county consultation, information-sharing and consideration of matters of common interest, among other functions.

track all donor spending, including off-budget projects, but this was perceived to be inaccurate (e.g. inconsistent with OECD-DAC data) and not up to date.

Philanthropic donors are not part of the aid management structures and processes, so the government is not mapping philanthropic assistance. This task would be extremely complicated because of Nairobi's role in hosting philanthropic organisations, meaning that many of the flows that Kenya receives are for programming in other countries in the region.

The restructuring of Kenya's aid coordination mechanisms to incorporate county governments is a work in progress. Kenya's devolution process has introduced a new county-level of government with wide-ranging responsibilities in agriculture, health, water and rural roads. Donor support to these areas will eventually need to transition to the counties. Counties can access grant financing, although there is currently a moratorium on borrowing because according to the Public Finance Management Act 2012 (PFM Act), the national government must provide guarantees for any county borrowing, but the framework for this is not in place. The Kenya External Resources Policy (KERP) was revised and reissued in 2014 (National Treasury, 2014) to take into account the need to involve the new county governments in the management of external resources. It included a commitment to restructure the aid coordination arrangements to include county governments. Counties attend the Summit, and its resolutions help ensure that development partner support for counties is in line with national priorities, but detailed guidelines on how counties will engage with the aid coordination structures in Kenya have not yet been issued. It has however been agreed in principle that counties will be represented on sector working groups, perhaps through the Council of Governors. In practice, some development partners are already negotiating directly with counties, and DANIDA is the first development partner to provide funds direct to counties (rather than going through a line ministry). While this may help ensure donor support is better aligned with Kenya's institutions, it may also make it harder for line ministries to coordinate support in their sectors.

5 Government priorities

This section sets out the Government of Kenya's priorities for the terms and conditions of development finance – specifically the qualitative aspects that the government seeks to achieve in negotiating with the providers of development finance.

Mobilisation of additional finance is the top priority. The justification for this is the big push for public investment in the infrastructure sector set out in Vision 2030 and the second Medium-Term Plan 2013-2017. This was strongly emphasised in all the interviews with senior government officials. The KERP stresses the 'need for additional resources to finance the deficit in the development budget' (National Treasury, 2014: 9, 1.1.4) among its main motivations. The 2009 Foreign Policy Framework includes policies 'designed to increase capital in-flow through harnessing and retaining existing sources of development assistance and FDI while attracting new sources' (Ministry of Foreign Affairs, 2009: 23, 50A).

These objectives are translated into concrete policy actions with the Government of Kenya actively seeking additional sources of financing for nearly a decade. Examples include the issuance of international sovereign bonds (see Section 3.2) in 2014, the strategy of 'looking East' by expanding relations with emerging lenders, such as China and India, and the establishment of a carbon credits unit to explore the potential of attracting additional funding through the clean development mechanism. All these actions also fit into a strategy of diversifying the government's debt portfolio, led by the Debt Management Office (DMO). The DMO has been evaluating other sources of finance to tap into, including Islamic finance and Kenyan shilling denominated bonds. However, a publicly available assessment of benefits and constraints for each option is not yet available.

Traditional development assistance remains important in the government's financing strategy. For instance, Vision 2030 aimed for donor support to rise steadily to 'about 4% of GDP by 2012/13 and remain above that level through 2030' (Ministry of Devolution and Planning, 2013: 11). As set out in Section 2, Kenya's development budget remains substantially dependent on aid flows, although Kenya's aid dependency is lower than in neighbouring countries.

The Paris Declaration on Aid Effectiveness principles, such as alignment and harmonisation, are still among the top priorities. The government officials we interviewed reiterated the primary criterion that each development partner's country strategy has to be aligned with Vision 2030 and the second Medium-Term Plan 2013-2017, the Medium-Term Expenditure Framework, the County Integrated Development Plans and sector plans. Alignment of development assistance with national priorities is also one of the rationales and objectives of the framework developed in the KERP, together with the mobilisation of additional resources. The KERP was meant to 'ensure alignment of development partners country strategies with GoK national priorities – putting in place a more strategic, coherent and better coordinated development assistance and institutional framework to achieve higher absorptive capacity'. In addition, the 2012 PFM Act (section 47(8)) requires all donor funds to the government to be on budget.

The same priority applies to the case of climate finance. Officials within the Ministry of Environment and Natural Resources have expressed a strong preference for development partners to use the National Climate Change Response Strategy as the national framework behind which to align all climate change financing (Norrington-Davies and Thornton, 2011).

Harmonisation of activities and coordination of development partners were also repeatedly mentioned as top priorities for the terms and conditions of development assistance, both in the interviews with government officials and in the KERP (National Treasury, 2014: 9, 1.2.1) which includes the restructuring and strengthening of ODA coordination structures among its interventions. Furthermore, these priorities are expected to apply to non-state actors. The KERP aims to guide 'reporting of external assistance that is channelled to non-State Actors to give a harmonized, transparent and accountable framework to the GoK to enable effective coordination, alignment, harmonization and management of the country's macroeconomic framework for national development' (National Treasury, 2014: 8, 1.1.1). The 2013-2017 Medium-Term Plan (Ministry of Devolution and Planning, 2013: 115) also recommends that development partners improve predictability of aid flows and absorption of aid funding but neither of these priorities for development assistance arose prominently in the interviews we held with government officials.

Ownership did not prominently feature in the interviews. In other countries analysed for this project (Schmaljohann and Prizzon, 2015) ownership of development programmes – or development projects that are demand-led – featured prominently, and was often the top-ranked priority among senior government officials, both in central and line agencies. The KERP

(National Treasury, 2014: 9, 1.2.5) 'emphasizes the key leadership role of the Government in the entire process of project identification, design, negotiation, disbursement, execution and appraisal of external resource flows and in the promotion of national ownership and leadership'. However, in the interviews we conducted, ownership of development programmes did not feature prominently as a de facto government priority for development assistance. The lack of emphasis on the ownership of the development agenda might be due to the fact that the Kenyan government has been rather successful on this agenda in the past.

In policy documents the preferred instrument for external assistance is general and sector budget support through the Sector-Wide Approach (SWAp) arrangements and programme-based approaches, but this was less so in the interviews. Again the KERP emphasises that 'un-earmarked sector budget support shall be encouraged', with project support to be evaluated on a case-by-case basis based on the sustainability of the project and the 'potential to achieve national development priorities' (National Treasury, 2014: 18, 3.5.2). This preference for budget support – and less so for project aid – has been interpreted as a signal of the government's strong prioritisation of demand-led development and ownership of development projects (Mwega, 2010). However, in most discussions with government officials in both central and line agencies, the underlying rationale had more to do with reducing transaction and administrative costs more generally rather than with strengthening country ownership. There appeared little demand for general budget support. The history of governance conditions attached to general budget support meant that, according to one government interviewee, the preference was for project aid, which does not tend to have such conditions attached.

The Kenyan government has a financing strategy for using concessional and non-concessional financing, applying principles of prudent debt management and portfolio diversification. The 2015 Medium-Term Debt Management Strategy operationalises the principles and objectives set out in the 2012 PFM Act, in the Medium-Term Plan and in Vision 2030. This includes channelling external borrowing to finance development projects, ensuring sound financial management and sustainability of external debt. According to the constitution and the PFM Act, both levels of government can only borrow to finance development expenditure and not for recurrent expenditure (PFM Act 2012, sections: 15(c) and 107 (a) and (d)). The ceiling of loans – both domestic and external – is set in the national government's Medium-Term Debt Management Strategy submitted to parliament on or before 15 February each year. The annual envelope of external borrowing is approved by parliament each year as part of the approval of the annual budget.

To reduce borrowing costs, the latest Medium-Term Debt Management Strategy (National Treasury, 2015b: xii) also includes an approach on expanding external official sector borrowing together with a lengthening of maturity. The strategy is quite precise on this point, stating the preferred balance of domestic and external borrowing to central government budget (55% domestic and 45% external over total borrowing) and the composition (28% on concessional terms and 17% on non-concessional terms) of total borrowing. The larger share of external debt on concessional terms, nearly twice as much as non-concessional, reflects the government's preference for concessional financing, as stated in the Medium-Term Debt Management Strategy.

The preference for loans on concessional terms is unsurprising given the more favourable financial terms and conditions. However, there are several reasons why the Kenyan government also negotiates and accepts loans at quasi-market or even market terms. First of all, non-concessional loans are expected to finance projects with high expected risk-adjusted rates of return, including critical infrastructure. At the same time, non-concessional financing is negotiated for projects that would otherwise not be undertaken due to a lack of concessional financing (National Treasury, 2015b: xi), especially in the energy sector (2015b: 3). In the interviews with government officials, it was often mentioned that non-concessional financing is justified for projects that demonstrate revenue streams and high social returns. Last but not least, borrowing on commercial terms is meant to minimise costs and mitigate risk (2015b: 3).

With Kenya expected to join the ranks of blend countries and be able to borrow from hard windows of MDBs, the share of non-concessional borrowing is very likely to expand over the medium term. On the supply side, concessional assistance falls in countries reaching middle-income status (see Kharas et al., 2014), both because of the transition towards the harder windows of MDBs and because bilateral development partners tend also to reduce ODA to middle-income countries in order to focus resources on low-income countries deemed to be more in need of assistance. This trend is found in several of the other *Age of choice* case studies, notably Viet Nam. This is a forecast rather than a current trend for Kenya as it only graduated to lower-middle-income country status at the end of 2014 (see Section 2). On the demand side, as noted above, a key priority for the Kenyan government is to secure more concessional financing to support the development plans in Vision 2030. There is widespread awareness among senior government officials that concessional financing will be falling in the medium term and that non-concessional finance will be needed to replace this. However, it is worth noting that concessional and non-concessional funding can be combined within the same project, again considering the rates of return (economic and social) of different tranches.

Speed of delivery is valued, but not necessarily at the expense of less expensive financial terms. In other cases reviewed in this project, notably Cambodia and Ethiopia, the government's preference is for more favourable terms and conditions, but it is willing to sacrifice these terms to access funding resources and projects that can be rapidly negotiated and implemented. There is often a trade-off between favourable and less expensive financial conditions and the slower speed of negotiation and delivery of projects. In the case of the Kenyan government, senior government officials offered diverse views. Some expressed a strong preference for concessional resources, notably from soft (or concessional) windows of MDBs, despite these taking a longer time to negotiate and implement than funding from, for example, China Exim Bank, which is more expensive (higher yield, lower maturity and shorter grace period) but whose contract negotiations have been rated as much faster. Others expressed a preference for faster contract negotiations and procurement even at the expense of cheaper financial terms. For instance, one of the reasons for the Kenyan government to move into international financial markets was the need for resources to be disbursed quickly and be immediately available. Indeed, funds were transferred into Central Bank accounts right after the issuance. The preference expressed by government officials for speed of delivery is also justified by the pressure to seize the benefits and economic impact generated by each project as early as possible. Several government officials argued that concessional and non-concessional loans often have similar total actual costs if the impact of the delays which often characterise projects funded by concessional funding are taken into account. Any foregone benefits and the additional direct administrative costs involved in managing them make concessional funds as expensive as non-concessional funds.

The growing number of development partners is not perceived as an issue. The government focused on the positive benefits of the strategy of diversifying development partners and instruments in terms of the greater financial resources available. The additional pressure this puts on the aid management structures within the National Treasury and line agencies was not seen as a concern. Government officials stated that they had sufficient capacity to deal with and manage new development partners effectively, and that pressure on government departments is reduced because development partners often coordinate their interventions between themselves. The government's main aid management concern was large and frequent visiting delegations from development partners. The KERP has now introduced a period – which coincides with budget preparation – when development partners' missions are strongly discouraged.

The government views Chinese assistance as supporting its priorities and delivering quickly. However, some donors felt China was not playing fairly by their rules, and instead promotes its own national and commercial interests. Their key concerns were the lack of transparency in Chinese aid and how it is tendered, especially the fact that Chinese financial assistance is tied, whereas most Western assistance is not. They also had concerns that Chinese projects are of poor quality. However, as noted in Section 3.3, there is little evidence to back this up, as Chinese contractors are able to win projects tendered in open competition with other development partners.

There is limited evidence regarding the government's preference for the role of technical assistance. In the interviews with government officials, the role of technical assistance was very rarely raised. For this reason, we do not have sufficient evidence to evaluate whether there is any specific preference for the type of technical assistance to be delivered to Kenya. However, there is some evidence that the government does value technical assistance and it will be necessary to support the county governments. The government considers itself to make good use of technical assistance, putting into practice the recommendations made. There were also concerns that non-concessional finance is not accompanied by technical assistance, as concessional finance tends to be.

6 Negotiation outcomes

The analysis in Section 2 highlighted the economic, political and governance contexts within which negotiations occur, while Section 5 set out the government's priorities for development finance. This section evaluates the extent to which the Kenyan government achieved these priorities.

The government managed to expand its financing sources away from ODA. However, demand for finance, concessional in particular, is still high and access to finance can also be limited by the debt targets. In Section 3, we outlined how Kenya expanded its funding sources over the past decade, increasing the share of development finance flows beyond ODA. Raising more resources to support its medium- and long-term development plans is a top priority for the Kenyan government, especially on concessional terms. However, demand is high and the funding gap is far from being met: several development partners mentioned that there are instances when government requests cannot be met, because of funding ceilings from both bilateral and multilateral donors (IDA and AfDB; Kenya is the AfDB's largest borrower). At the same time, the debt-to-GDP ratio is close to the ceiling set by parliament, which means that the government may face constraints in accessing new borrowing in order to keep debt at a manageable level.

The diversification strategy has not always been successful. While the government was particularly successful in the first two issuances of international sovereign bonds, its other alternative funding options have been less so. In the case of diaspora bonds,[27] the tool performed below expectations for various reasons including interest rate volatility, political risk and lack of trust between the government and the guarantor (Kamau and Kimenyi, 2013). In the same vein, because of a sharp fall in the price of carbon credits, the financing of climate change mitigation projects with carbon credits never really took off (see Section 3.5).

Alignment occurs as a result of a broad set of priorities. From the interviews and the review of the literature (notably Development Initiatives, 2014), we found development partners' projects and assistance were aligned with Vision 2030 and the Medium Term Planss. However, as stated by Development Initiatives, 'the country's priorities are so broad that development partners could easily locate most of their work within the framework of goals even without deliberate intention to align' (2014: 7). We understood there were examples of projects not necessarily aligned to key priorities.

No donor provides budget support and there is limited use of country systems, although this is improving. The government's other stated preferences, which are part of the Paris Declaration on Aid Effectiveness principles, are also difficult to achieve. No donor provides budget support to Kenya, except for IMF Special Funds (OECD, 2015). There are a couple of reasons for this. First, the largest development partner to Kenya – the US – does not include budget support among its aid modalities more generally. Second, the legacy of corruption scandals and the donors' perception that the government responded inadequately to them (discussed in Section 2) continue to affect the relationship between development partners and the government. Despite improvements since then, there are still concerns related to fraud, corruption and misappropriation of funds and the ineffectiveness of monitoring systems. The 2012 PFM Act and the Integrated Financial Management Information System (IFMIS) were both intended to increase transparency and effectiveness of public finance management systems. However, according to Development Initiatives, development partners still 'prefer to use their own procurement, evaluation and reporting frameworks, citing weaknesses and inadequacy of GoK systems as well as loopholes that make it possible for corruption' to occur (2014: 14).

A financing strategy is in place, but there is a lack of a strategic approach to managing finance and its different providers. Based on the analysis in Section 2, the Kenyan government could be expected to start from a strong position in aid negotiations. Kenya has a geostrategic position in the East Africa region and in the fight against terrorism in the region. It has a lower dependency on aid than other countries in the region, which has been a result of tense relations with development partners since the early 1990s rather than a deliberate aid exit strategy, meaning that it can more credibly threaten to reject aid. Its past record on managing external debt without requiring debt cancellation measures or debt rescheduling on concessional loans[28] via the HIPC and MDRI initiatives, unlike most of its neighbours, also helped to ensure access to markets,

27 Currently, domestic government bond issuances are available to any person or institution, resident or non-resident, including Kenyans in the diaspora. However, to be eligible to invest, non-residents must have a local account with a commercial bank and investment bank.

28 Kenya accessed debt relief in the form of rescheduling of non-concessional loans held by Paris Club members.

meaning that it is not solely dependent on aid donors. In line with this, 'the GOK remains assertive – albeit with a considerable level of flexibility – in the manner in which it deals with the international community. It was largely in control of mechanisms and processes for development of country priorities and plans and apt in demanding that DPs [development partners] align assistance accordingly' (Development Initiatives, 2014: 7). However, this study found contrasting responses. Some donors considered that the large financing needs for infrastructure development meant that the Kenyan government is not considered to be in a strong position to negotiate hard but accepts what is on offer. Against this, government officials cited instances when the National Treasury has requested a development partner to redefine the terms and conditions of a loan in order for it to be classified as concessional, suggesting there is some bargaining power. Other donors acknowledged that they had to be realistic in that Kenya's lower dependency on aid meant that they were important, but not vital, to the government, and that the relationship had to be structured on that basis.

We also understood from interviews with development partners that the division of labour, both across and within sectors, is de facto managed by development partners rather than driven by the government. The National Treasury has had little success in trying to enforce the division of labour across sectors by limiting the number of sectors in which donors are active, as required by the KERP, which aims to 'ensure that DPs are actively engaged in at most four sectors' (National Treasury, 2014). Some development partners also argue that there is limited information and understanding across government about the sectors and projects in which each donor is active. More fundamentally, it is not universally agreed that government should drive the division of labour process, and instead this should be donor-led, as donors themselves best know their comparative advantage and thus the role they can play is supporting the second Medium-Term Plan. There are examples of improvements in harmonisation, such as EU Joint Programming. Again there may be exceptions to the principles of prudent debt management and financing principles outlined in the previous section.

The presence of China does not appear to have affected the Kenyan government's relationship with the other development partners. Once compared with other countries reviewed for this project and despite the large scale of Chinese development finance to Kenya, we did not find any strong evidence of China's presence or the rise in international sovereign bonds as an alternative source of finance helping to strengthen the Kenyan government's negotiating position vis-à-vis traditional partners.

Bilateral negotiations take place rather than coordination with non-DAC donors. Section 4 described how non-DAC donors, notably China, India and several Arab donors, are active in Kenya but do not regularly participate in the coordination fora, and that when they do participate, their involvement is primarily intended to gather information on development cooperation activities in the country. According to the Kenya Joint Assistance Strategy (KJAS), 'a number of new development partners remaining outside the harmonization framework [the emerging non-OECD bilateral partners, vertical funds, but also foundations and international NGOs] largely work independently of the broader community of development partners' (Food and Agriculture Organization, 2007: 17). In the case of non-DAC donors, such as China, this would suggest that relations and negotiations are managed primarily on a bilateral basis.

The Kenyan government manages relations with all donors, including China, through the usual government external resource management systems, led by the National Treasury. In other countries reviewed for this project the main arena for negotiations with China is the Prime Minister's or President's Office, but the Kenyan government's negotiations with Chinese authorities are primarily led by the National Treasury, reflecting the power of this department within the government. Management of all development partners through the National Treasury – and so through the same structures and processes – means that government can more effectively coordinate development partners.

7 Conclusions

The main messages and recommendations emerging from the Kenya case study are set out below.

7.1 Development finance flows

Main messages

- Development finance flows to Kenya have been rising over the past decade, from $750 million in 2004 to $6 billion in 2014. While ODA still dominates the total envelope, the share of flows beyond ODA has been expanding. The Kenyan government has diversified by issuing international sovereign bonds and is 'looking East' towards China. Kenya placed the largest debut international sovereign bond issue in sub-Saharan Africa in 2014. China is also now a major provider of assistance to Kenya, of a scale similar to the AfDB.
- Other external development finance flows are more difficult to map. They include philanthropic assistance and climate finance. According to data from the Foundation Center,[29] US grant-making organisations provided more than $1 billion to 544 organisations in Kenya between 2005 and 2014. This is equivalent to just 5% of ODA. In the case of philanthropic assistance, the high volumes from US-based foundations have to be analysed bearing in mind that Kenya is a regional hub and that much of these flows then target other countries in the region.
- Kenya receives relatively little climate finance. According to Climate Funds Update, $56 million of climate finance has been approved since 2003, but only $6.5 million has been disbursed. However, far larger amounts of conventional development finance are being reallocated to fund climate programming, as is the case of the Agence Française de Développement.
- Government officials perceive the rising number of financiers and increased fragmentation overall as a positive development, rather than a potential challenge in managing more complex relations. However, Kenya seems to be largely handling concessional and non-concessional financing through different strategies – the KERP, and the Medium-Term Debt Management Strategy, respectively. With middle-income country status, Kenya is likely to find concessional finance declining, replaced with non-concessional financing.

Policy recommendations

- We would recommend that the External Resource Department factors non-concessional financing into its framework and strategy, especially in terms of access, management, complementarities and priorities for these flows, building on the Medium-Term Debt Management Strategy, to anticipate future likely changes in the composition of its external funding.
- Second, we would encourage the National Treasury/External Resource Department to re-establish the publication of a development cooperation report (also beyond official donors) which would create incentives for this regular update and allow information-sharing on a systematic basis between central and line agencies and development partners.
- Finally, there is scope for the National Treasury/External Resource Department to improve tracking of climate finance flows and philanthropic assistance to achieve an overall picture of flows from external sources that are potentially available to the government (and the country), and/or can fill financing gaps that the government might not be able to cover, thus avoiding potential duplications. The E-Promis system (which aims to improve the mapping of philanthropic and NGO flows), and the coding/classification of climate adaptation and mitigation projects in IFMIS, should improve tracking of philanthropic and climate finance flows, respectively.

7.2 Arenas for negotiations

Main messages

- Coordination in the aid management systems with DAC donors has improved since the early 2000s. We recommend strengthening information-sharing between central government agencies and development partners on projects with county-level governments to avoid jeopardising these gains on aid management.
- Non-DAC donors were found to attend some levels of the aid coordination system – especially at a higher/diplomatic level – but their participation is limited to learning about others' activities in a passive mode, leading to negotiations essentially taking place at bilateral level only. The government manages relations with all donors, including China, through the usual government

29 http://webapps.foundationcenter.org/intl/?_ga=1.31147071.1201478938.1432025796

external resource management systems, led by the National Treasury, and not via a separate structure or at higher political level. The fact that relations with all donors are managed through the Treasury's external resource management processes means the government has accurate information available on non-DAC donors in its budget documents. However, this largely relates to loans. Discussions with Arab donors can only be bilateral, as they do not have country offices, meaning negotiations must be carried out with non-resident head offices. Philanthropic donors are not part of the aid management structures and processes.

Policy recommendations

- We would encourage the External Resource Department to expand the opportunities for policy dialogue between different stakeholders (including the philanthropic organisations and NGOs) and create incentives for active participation of all development partners at the different levels. More opportunities for policy dialogue across donors would help to reduce the burden on government officials, even by simply improving information-sharing on activities and priorities.

7.3 Priorities for development finance and outcomes

Main messages

- The Kenyan government has well-articulated priorities for the terms and conditions of development finance. They include (i) mobilisation of additional finance for the large public infrastructure investment programme set out in Vision 2030 and the second Medium-Term Plan 2013-2017; (ii) standard Paris Declaration on Aid Effectiveness principles, such as alignment and harmonisation with the national plans; and (iii) a preference for external assistance disbursed via general and sector budget support through the SWAp arrangements and programme-based approaches (at least on paper, as this did not emerge in the interviews with government officials).
- The government has been successful in accessing additional finance; most of the projects are aligned with national priorities, but these are also quite broad. A different outcome was achieved in the case of budget support, no development partner disburses funds via this modality and there is limited or no use of country systems by some large development partners.
- International sovereign bonds raised funds that could be quickly disbursed to finance large infrastructure projects. However, additional financing using this instrument may not be sustainable in the long term. Borrowing costs may rise in the medium term (they hinge upon low interest rates in OECD countries and good macroeconomic performance in Kenya). The appetite from Western investors might disappear when interest rates in OECD countries go up; at the same time, the Kenyan government is very close to hitting the 50% debt to GDP ceiling approved by parliament, which also limits the expansion of non-concessional borrowing.
- The preference for rapid contract negotiations and project implementation and the potential trade-off between quick negotiations/implementation and financial costs featured prominently in several case studies for this project. A more nuanced story emerged in the case of Kenya. The official Medium-Term Debt Management Strategy places priority on concessional funding, yet several government officials argued that concessional and non-concessional loans often have similar total actual costs if the impacts of delays that often characterise projects funded by concessional funding are taken into account, exemplified by additional direct administrative costs for their management and the opportunity costs of projects not yet in place or fully operational.
- We found no evidence to suggest that funding from China primarily (the 'look East' policy) de facto strengthened the negotiating capital of the Kenyan government vis-à-vis traditional donors, i.e. the Kenyan government cannot impose its own conditions on traditional partners regarding financial conditions and sectors, as we saw in other countries with strong ownership of development projects reviewed for this project, notably Cambodia and Ethiopia.

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Annexes

Annex 1: List of interviewees

Name	Organisation
Yves Boudot	Agence Française de Développement
Samuel J. Kamara	African Development Bank
John W Makokha	African Agricultural Technology Foundation
Adam Gerstenmier	The Alliance for a Green Revolution in Africa
Irene Njiru	Central Bank of Kenya
Mwenda M'Marete	Central Bank of Kenya
Gerald Macharia	Clinton Health Access Initiative
Jason Braganza	Development Initiatives
Karen Rono	Development Initiatives
Tony Gardner	Department for International Development
Cheng Chen	Embassy of the People's Republic of China
Caleb Indiatsi	Geothermal Development Corporation
James Maina	International Monetary Fund
R. Armando Morales	International Monetary Fund
John Mutua	Institute for Economic Affairs
David Muthike	KenGen – Kenya Electricity Generating Company
Dr Moses M. Ikiara	KenInvest – Kenya Investment Authority
James Bowen	Kenya National Highways Authority
Annie Wangui	Korea International Cooperation Agency
Eunsub Kim	Korea International Cooperation Agency
Njeri Kibathi	Korea International Cooperation Agency
Joshua Opiyo	Ministry of Devolution and Planning
Sabina Maghanga	Ministry of Devolution and Planning
Eng. Joseph K. Njoroge	Ministry of Energy and Petroleum
Eng. Lawrence N. Simitu	Ministry of Environment, Water and Natural Resources
Elkana N. Ong'uti	Ministry of Health

Name	Organisation
Philip Wachira	Ministry of Transport and Infrastructure
Hon. Eng. Nicolas Gumbo	National Assembly
Dr Ayub Macharia Ndarugu	National Environment Management Authority
Wangare Kirumba	National Environment Management Authority
Dr Geoffrey Mwau	National Treasury
Albert Mwenda	National Treasury
Bernard Gibet	National Treasury
Charles N. Kairu	National Treasury
David Komen	National Treasury
Eng. Stanley K. Kamau	National Treasury
Felister S. Kivisi	National Treasury
Henry Mutwiri Riungu	National Treasury
Kennedy N. Nyachiro	National Treasury
Peter Odhengo	National Treasury
Stephen Makori Onchoke	National Treasury
Phyllis Ndunge Makau	Parliamentary Budget Office
Joe Okudo	Royal Danish Embassy
Rashpal S. Kalsi	Royal Danish Embassy
Wanjirũ Gikonyo	The Institute for Social Accountability
Patricia Bacchi	US Department of the Treasury Office of Technical Assistance
Catherine Andang	United States Agency for International Development
Conrado Garcia	United States Agency for International Development
Patricia Jane Ochieng	United States Agency for International Development
John Randa	World Bank

Annex 2: Mapping external finance flows 2003-2014

Gross disbursements in $ million (current US$)	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
ODA	382.11	620.85	706.99	817.64	1,026.71	1,445.12	1,509.54	1,929.89	1,854.33	2,720.11	3,132.63	3,518.63	2,916.08
ODA DAC members	293.41	385.77	495.87	527.40	803.69	926.19	1,070.00	1,301.04	1,284.72	1,676.46	2,003.54	2,079.39	1,688.46
Grants	262.89	358.24	428.75	479.55	710.36	801.91	962.82	1,179.46	1,120.06	1,521.03	1,742.65	1,639.36	1,485.72
Concessional loans	30.53	27.53	67.11	47.84	93.33	124.28	107.18	121.58	164.66	155.43	260.89	440.02	202.74
ODA multilateral donors	88.70	235.08	211.12	290.24	223.99	520.93	439.54	629.02	569.62	1,045.15	1,129.09	1,441.24	1,232.58
Grants	21.24	77.37	111.74	151.36	165.64	210.99	227.29	178.41	247.43	271.70	346.80	427.83	373.45
Concessional loans	67.46	157.71	99.38	138.88	58.35	309.94	212.25	450.61	322.18	773.45	782.29	1013.42	859.12
Development finance flows beyond ODA	47.42	31.37	43.50	255.91	306.04	325.74	267.48	245.36	370.25	482.46	722.79	480.32	3,038.52
Other official flows	33.28	6.67	23.59	52.61	48.70	39.24	100.67	160.61	108.60	176.45	263.69	356.21	246.55
Bilateral DAC OOFs	22.38	0.26	10.63	23.50	32.77	23.16	69.83	116.67	7.64	32.36	71.24	109.92	200.58
OOFs multilateral	10.90	6.41	12.96	29.11	15.93	16.08	30.84	43.94	100.96	144.09	192.45	246.29	45.97
Non-DAC bilateral donors	14.14	4.78	3.23	157.21	82.71	15.84	123.15	30.99	196.48	172.65	332.53	9.92	4.01
Non-China ODA	7.48	4.71	2.76	8.87	4.74	15.84	5.35	12.32	5.82	6.82	6.86	9.92	0.00
China ODA	4.06	0.07	0.09	148.34	8.33	0.00	117.80	18.67	139.84	148.94	325.67	0.00	0.00
China OOFs	2.60	0.00	0.38	0.00	69.64	0.00	0.00	0.00	50.82	16.89	0.00	0.00	0.00
Multilateral climate funds	0.00	0.00	0.00	0.00	0.97	2.00	0.00	0.17	0.00	1.50	0.00	2.00	4.96
Philanthropy	0.00	19.92	16.68	46.09	173.67	261.87	43.67	53.59	65.17	108.36	126.57	112.19	27.96
Sovereign bond issuance	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	2,750.00
Total development finance	429.54	652.22	750.49	1073.54	1332.76	1770.86	1777.02	2175.25	2224.59	3202.57	3855.43	3998.95	5954.60

Source: OECD aid statistics; AidData; Foundation Center Database; Climate Funds Update Database.
Note: ODA is net of multilateral climate funds disbursements.

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Cover photo: Reuters/Thomas Mukoya, 2011. A construction worker erects a scaffolding on a tunnel along the Nairobi–Thika highway project, under construction near Kenya's capital Nairobi, September 23, 2011. The road, which is being built by China Wuyi, Sinohydro and Shengeli Engineering. Construction group, is funded by the Kenyan and Chinese governments and the African Development Bank.

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