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1982



Office Memorandum

cc: Mr. Beaudage
Mr. Kanese - Mesa
Mr. Loser

TO : Managing Director,
Deputy Managing Director

FROM : Julio M. Jiménez *JM*

SUBJECT : Kenya--Use of Fund Resources *BJ*

DATE: December 21, 1982 *60*

In my debriefing to you on the above subject (dated Dec. 17, 1982) mention is made of the financing which Kenya expects to derive from the Donors' Conference to be held in early January. Kenya is aware that if there is a shortfall in the expected assistance, additional measures will be required on their part, prior to submitting the paper for Board consideration, so that the balance of payments will be fully financed.

Consequently, we intend that the paper on the proposed arrangement will not be issued until after the Conference is held and we are assured that the projected financing gap is fully met and that whatever additional measures are needed are in place as prior actions.

cc: ETR *✓*
FAD
Mr. Carter







Office Memorandum

MR FINCH

Handwritten initials

Handwritten mark

TO : Mr. Jimenez

DATE: December 21, 1982

FROM : W.A. Beveridge *Handwritten initials*

SUBJECT : Kenya

As you will see from the attached memorandum, I have difficulties with one aspect of your back-to-office report. I would plan to send this note after you have looked at it. If you prefer, you may wish to send it to management in your own name.

Attachment

cc: Mr. Finch

Handwritten initials

December 21, 1982

To: Managing Director
Deputy Managing Director

From: W. A. Beveridge

Subject: Kenya

I wish to draw your attention to one aspect of Mr. Jimenez' back-to-office report (dated December 17).

After referring to the uncertainties about obtaining \$100 million of exceptional financing during a donors' meeting scheduled for early January, the report (first full paragraph, page 3):

The Kenyan authorities are aware that any shortfall in the expected assistance will require additional measures on their part and this situation will be fully analyzed during the first review of the program and the needed policy actions incorporated with the new budget commencing July.

This approach would not be consistent with practice and is not consistent with the briefing paper. The briefing paper required as a prior action

closing of the resulting gap in the 1983 balance of payments through additional aid resulting from the London Aid Conference or, failing which, through other measures.

My recommendation is that the likely amount of exceptional financing be assessed after the January meeting and that if there is likely to be a shortfall, the Kenyan authorities take additional action to close the gap before the paper is submitted to the Executive Board.

cc: Mr. Carter

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Wm - Beveridge



Office Memorandum

NOV 12 1982

mb

November 12, 1982

Wm

To: Managing Director
Deputy Managing Director

From: *J.B.* Zulu and W. Beveridge *W.B.*

Wm
NOV 12 1982
mb

Subject: Kenya

The Minister of Finance of Kenya, Mr. Magugu, will call on you at 6:00 pm today. He will be accompanied by The Governor of the Central Bank, Mr. Ndegwa, the Secretary to the Cabinet, Mr. Nyachai, and the Permanent Secretary of the Treasury, Mr. Mule.

Following our meetings with them we had broad agreement with the Kenyan delegation with respect to the size and difficulty of their present economic and financial problems. The Kenyan authorities have indicated their understanding of the need to take decisive measures. However, they feel that the scale and timing of the measures suggested by the staff would cause social and political difficulties. Therefore, they have suggested that the measures be scaled down initially and implemented over a longer period of time. The Minister may wish to press this point with you. We have pointed out that given the size of the financing gap which they face, the authorities' approach would not properly address their problem. Substantive measures are needed as prior actions and in order to give an adequate signal of the willingness to confront the problems. They have the most difficulty with the size and timing of the exchange rate adjustment (20 per cent in foreign currency terms) and increase in interest rate (4 percentage points).

cc: Mr. Carter





Office Memorandum

TO : Managing Director
Deputy Managing Director

DATE: November 10, 1982

FROM : J.B. Zulu *JZ*

SUBJECT : Kenya

The Kenyan authorities have requested a new stand-by arrangement to replace the present inoperative one. For this purpose, a delegation headed by the Minister of Finance will visit Washington beginning November 10th. You are scheduled to meet with the Minister on Friday, November 12th at 5:45 P.M. Attached you will find the brief for guiding the discussions on a possible program and the subsequent negotiations in Nairobi. The brief has been approved by Mr. Beveridge (ETR), Mr. Tait (FAD), Mr. Wittich (TRE), and Mrs. Lachman (LEG).

Attcht.

INTERNATIONAL MONETARY FUND

KENYA

Briefing Paper - Use of Fund Resources

Prepared by the African Department
and the Exchange and Trade Relations Department

(In consultation with the Fiscal Affairs, Legal, and Treasurer's Departments)

Approved by Justin B. Zulu and W.A. Beveridge

November 5, 1982

I. Introduction

On August 1, 1982 Kenya suffered an attempted coup. Although the uprising was quickly quelled, damage resulted from the looting which followed the rebellion. More importantly, in the aftermath there has been a decline of confidence, apparently speculation against the shilling, with a significant weakening of Kenya's balance of payments position. Apart from regaining political control, the response of the authorities to the difficult situation has been slow, and the delay has sidetracked Kenya's medium-term adjustment effort. The Government of Kenya is now desirous of overcoming the present situation and has asked for further Fund support. Consequently, a mission composed of Messrs. J.M. Jiménez (head-AFR), J. Simpson (AFR), L. Doe (FAD), and D. Lipton (ETR) will begin referendum negotiations on an 18-month stand-by arrangement (which will replace the current arrangement), in an amount of SDR 155.3 million, equivalent to 150.0 per cent of quota, with a Kenyan delegation which will visit Washington at the beginning of November. Negotiations are expected to be finalized by a mission, made up of the same staff members plus a secretary, which will visit Nairobi in early December for about 10 days. A senior staff member of the Immediate Office (AFR) may participate in the final discussions. It is expected that, in the interim between both contacts, an emergency donors conference, chaired by the U.K. authorities, will be held in London, from which Kenya can derive additional

balance of payments support. An invitation will be forthcoming for Fund participation at this conference.

II. Performance Under the Current Stand-By Arrangement

On January 8, 1982, the Executive Board approved Kenya's request for a one-year stand-by arrangement in an amount of SDR 151.5 million, representing 146.4 per cent of Kenya's quota. The arrangement is now inoperative. Kenya met the performance criteria established for end-January and reached understandings on fiscal, import, exchange rate, and interest rate policies during a review which was completed by the Executive Board on June 9, 1982. At that time credit ceilings for end-June 1982 were approved; small upward revisions were made to the indicative targets that had been established earlier to take account of temporary needs. Kenya drew SDR 90 million under the arrangement. At the time of the review, Kenya's request for a purchase of SDR 60.4 million under the decision on compensatory financing of export fluctuations and fluctuations in the cost of cereal imports, relating to a net shortfall for calendar year 1981, was also approved. The drawing was made on the basis of estimated data for six months. Given the more recent revised balance of payments data for 1981, a repurchase of part of this drawing is likely to arise. As of September 30, 1982, the Fund's holdings of Kenya shillings, excluding those under the oil and compensatory financing facilities, reached 281.1 per cent of quota, while the recent drawing under the CFF raised the Fund's holdings of Kenya shillings under the CFF to 125 per cent of quota.

X Kenya made great efforts to keep to the adjustment objectives of the current program, despite the nonobservance of the June credit ceilings. Developments prior to the recent coup attempt led the staff to conclude that there was likely to be a reduction in the current account deficit of the balance of payments roughly in line with the program's objective. Moreover, due to a good harvest, which unexpectedly generated food surpluses, the rate of growth of GDP was also picking up, as programed, although the rate of inflation remained stubbornly high.

As part of the program the authorities put into effect, prior to Board approval, an important array of pricing measures: the exchange rate was devalued by 15 per cent in September 1981 (following a devaluation of 5 per cent earlier in the year); interest rates were increased by 3 percentage points; producer prices were reviewed and some increased; and a significant number of controlled retail prices were adjusted upward. A new import system was put into effect, which simplified procedures and reduced administrative discretion. The system was further streamlined in June 1982 with the transfer of 20 per cent of the items in the restricted schedules to the schedule of free importable items, in accordance to the Government's objective to liberalize the system fully in five years. Significant adjustment was also recorded in the budgetary field. On the basis of the Government's strict adherence to the overall expenditure targets agreed in the program, involving a reduction in outlays in real terms of about 14 per cent, the overall deficit was reduced from 9.5 per cent of GDP (10.3 per cent excluding grants) in 1980/81 (July/June) to the program's objective of 6.2 per cent (7.2 per cent excluding grants) in 1981/82. However, partly as a result of a large shortfall in foreign financing, caused by a reduction in drawings and larger amortization payments, and an inability to place as many Treasury bills as expected in the nonbank sector, the credit ceilings established for June were exceeded. There were also delays in preparing a realistic 1982/83 budget, which put off restructuring the program prior to the attempted coup.

III. Recent Economic Developments

Even before the recent disturbances, there was evidence of an erosion of confidence in the political system of Kenya, which was having a negative impact on business activity and on the ability of Kenya to attract foreign investment. Thus, while significant progress was being made in adjusting the current account, there was a growing weakness in the capital account, with the result that the

overall balance of payments deficit was expanding, with the private sector failing to take up the slack in activity resulting from the Government's tight expenditure policy. Confidential data compiled by the Central Bank of Kenya indicated that in 1981 and 1982 there was a substantial net authorized disinvestment by foreign firms operating in Kenya. The coup attempt on August 1 has further accentuated the decline of confidence.

After the significant progress recorded in 1981/82, there appeared to have been a weakening in the fiscal performance in the first quarter of the 1982/83 budget. Moreover, the continued high level of domestic inflation, in a setting of fixed exchange and interest rates, has eroded the incentives generated by the measures undertaken at the start of the present program. At the same time, Kenya's balance of payments position has reached a position of severe pressure, with the Central Bank's gross foreign assets falling to SDR 159 million, equivalent to about a month of 1982 imports at the end of September, compared to SDR 209 million at end-1981. The decline in gross foreign assets would have been larger had not the authorities halted the automatic issuance of import licenses. The authorities claim that this action was taken in order to guarantee Kenya's debt service payments. In fact, even at the present reduced level of import approvals, there is the likelihood that gross foreign assets of the Central Bank will decline further before the end of the year.

Without additional measures, the short-term projections for the balance of payments and the budget show mounting disequilibria. The recent events have resulted in a downward revision of the export projections prepared earlier for 1982 and for the medium term. As a result of the increasing difficulties being faced by Kenya in disposing of its excess coffee in the nonquota markets, sales are taking place on the basis of a discount of about 60 per cent from quota market prices, compared to a discount of about 40 per cent assumed in the current program. Moreover, there are indications of a loss of competitiveness in the

p8
tea sector and exports are now expected to be less buoyant than previously projected. There has also been a weakening of nontraditional exports, which the authorities blame on the suspension of the export compensation scheme in June. However, even at a reduced export level, the pressures on central bank reserves are excessive. The authorities feel that this is also the result of the under-invoicing of exports and delays in repatriation of export earnings.

Following the coup attempt, the Government of Kenya sent a letter to its main donors asking for additional assistance. One country, the United States has already provided emergency assistance and there are indications that other countries would be prepared to follow suit. The aid donors conference planned for November will be an important element in providing needed resources on which to mount a new adjustment effort. Kenya's debt service ratio (including IMF) is estimated at 24 per cent in 1982.

IV. Proposed Program

Kenya's present economic and financial situation is heavily affected by a loss of confidence and by an increase in speculation. Consequently, an important element in the improvement of the Kenyan economy is a return of confidence. Such an outcome would be facilitated by the reinstatement of a serious program of adjustment, which could be supported by additional financing from the international community, including the Fund.

The progress made in the first half of the current program indicated that the thrust of the program was correct in bringing a sustainable balance of payments position in the medium term. Consequently, a future program with Kenya should bring Kenya's adjustment effort to the track it was on earlier in the year, reinforcing it with meaningful and convincing actions at the start to give an added guarantee that it will stay on track. This would involve the following elements.

- (1) A return to the promotion of export oriented growth in conjunction with

making the domestic manufacturing sector more competitive. This will require a reversal of the appreciation of the real effective exchange rate which has occurred since the present program was launched (about 15 per cent) plus a small margin through a devaluation of about 20 per cent in foreign currency terms; a rationalization of the import system which should also be consistent with Kenya's commitments under the SAL program with the IBRD; a review of producer and regulated prices, to ascertain that production incentives are maintained and that there are no subsidies in regulated prices; and an upward adjustment in interest rates of 3 per cent.

(2) A further reduction of the ratio of the overall budgetary deficit to GDP, from 6.2 per cent in 1980/81 (7.2 per cent excluding grants) to 4.7 per cent in 1982/83 (5.9 per cent excluding grants) through additional revenue and expenditure measures; and the strengthening of the forward budgetary procedures and the drawing up of a medium-term investment program.

(3) An improvement in the financial performance of statutory bodies, particularly the marketing boards, which may require the closing or restructuring of some enterprises.

(4) The continuation of cautious credit policies, with an increasing amount of credit oriented to production.

(5) Two reviews (which will be performance criteria) of the program to assure early detection of any difficulties. These actions are expected to lead to a further adjustment in the current account deficit of the balance of payments from 7.9 per cent in 1982 to 7.2 per cent in 1983 and 6.5 per cent in 1984 with an additional reduction expected in 1985.

The proposed program will cover 18 months, the second half of FY 1982/83 and the whole of 1983/84. Apart from the measures expected as prior action (see section 5 below) at the start of the program, further action might be necessary at the start of the 1983/84 budget. Reviews, which would be a performance criteria, would take place in July/August and November/ December. A visit by a small team

would be carried in May/June to discuss the budget prior to its presentation to Parliament.

1. Development and production policies

The recommended exchange rate action will aid the transfer of domestic resources to the external sector and help in reducing import demand. However, given the agricultural nature of the Kenyan economy, the impact of these measures on production will be felt only in 1984, as the 1983 crops are being, or have already been planted. The return to a more liberal import system will permit a more regularized inflow of imported inputs and capital goods, facilitating production planning. Also important for these objectives is the maintenance of prices at realistic levels. The program will require that the effect of the devaluation be fully passed on to consumers, particularly with regard to energy. Moreover, the bulk of the exchange rate windfall should be passed on to non-traditional exporters, and the export compensation scheme would be eliminated. A proportion of the windfall of traditional exporters will be taxed.

2. Fiscal policies

The program will emphasize the re-emergence of fiscal discipline from the difficulties encountered in the first quarter. The programmed reduction in the overall deficit/GDP ratio will involve revenue measures expected to yield K Sh 1.3 billion on an annual basis, representing the equivalent of 7 per cent of 1981/82 revenues. These measures could include the taxation of a proportion of the exchange rate windfall on traditional exports, and additional duties on imports which should yield about K sh 400 million in the first half of 1983 and K sh 850 million in budget year 1983/84. However, the mission will consider alternative tax measure which the authorities may propose in lieu of the above. The mission will also examine the implementation of revenue measures proposed by FAD technical assistance during the last few years. Taking into account the above measures and the exchange rate action, revenues and grants in 1982/83 are estimated to increase

by some K Sh 3.3 billion to K Sh 19.9 billion (about 19.9 per cent and 19.5 per cent including and excluding grants respectively), reversing the sluggish growth rate recorded in the first quarter. The proposed 'State Corporation Act' for regulating the establishment and monitoring the operations and management of parastatals will be introduced to Parliament before the mid-term review. The program will include a public commitment by the authorities to implement the recommendations of the Working Party on Government Expenditures (the Ndegwa report); their recommendations relating to the budget accounting practices will be implemented as part of the procedures for the 1983 budget. Expenditure will be contained further by the elimination of the export compensation scheme concurrent with the exchange rate change, the phasing out of the current practice of automatic recruitment of graduates of government sponsored schools, and the postponement of stretching of development projects. In addition, the recent fall in international interest rates will provide additional savings. However, there will also be a need to reduce the annual rate of expenditure allocations in the second half of 1982/83 to offset the unexpectedly high rate incurred in the first quarter, including by the strict adherence to the requirement not to undertake expenditures in excess of budgetary appropriations without prior Treasury approval, to keep total outlays to K Sh 23.8 billion, representing a rise of only 14.4 per cent from the previous year. This target takes account of subsidies which will be necessary on a one time basis only in exporting the excess production of beans and maize already purchased (food surpluses of the magnitude recorded this year are not expected to recur) and the impact of the exchange rate action. It also implies a further reduction in real expenditures.

As a result of the above measures, there will be an important reduction in the net bank financing of the budget to about 3.7 per cent of the stock of money

and quasi-money at the start of the fiscal year in 1982/83 and 2.6 per cent in 1983/84 compared to 8.9 per cent in 1981/82. These levels could be further reduced by the emergency aid sought by the authorities.

New revenue measures may be required in 1983/84 to keep the adjustment effort on track to reach an overall deficit equivalent to 3.5 per cent of GDP (4.6 per cent excluding grants). Possible measures could be the following: collection of tax arrears, especially corporate profit taxes; elimination of various exemptions and deductions, such as the reduction of losses carried forward for business and an adjustment of the depreciation allowances for agricultural machinery; changes in the tax rates applied to several goods (beer, spirits, and electricity), from a specific to an ad valorem basis; and improved administration to combat tax evasion, with respect to income and profit taxes, sales and excise taxes, and import and export taxes.

3. Monetary policy

The program will require the continuation of a tight monetary policy, with the stock of money and quasi-money growing by less than 14 per cent in 1983 compared to 20 per cent for nominal GDP in order to bring a downward bias on prices. To accomplish this objective there is the need to attract additional savings into the banking system and to limit the amount of disintermediation which is taking place in favor of nonbank financial institutions. Consequently, the program will call for an upward adjustment in the structure of bank interest rates of 4 percentage points on deposit rates at the start of the program. Presently, time deposit rates range between 10.75 per cent and 12.5 per cent and are 6.0 to 4.3 percentage points negative when measured against consumer prices while savings rates at 10 per cent are even more negative in real terms similarly measured. Depending on the trend of prices in the first half of 1983, there may be grounds for a further increase at the time of the mid-term review, with the aim of making the long-term rates neutral with respect to prices.

The expected improvement in the budget will allow for an adequate increase in credit to the economy in line with the original objectives of the adjustment program. Overall domestic credit is projected to grow by about 15.0 per cent in FY 1982/83 compared with 33 per cent in the previous fiscal year, with private sector credit growing by 17.3 per cent compared to 16.0 per cent, previously. The program will have quarterly ceilings on net domestic assets and net credit to the Government. As in the past, the ceiling on net credit to the Government will be net of the changes in the Cereals and Sugar Finance Corporation's (CSFC) position with the Treasury. Ceilings will be set for March and June of 1983 with reviews, which will be a performance criteria, taking place in July/August and November/December at which time the ceilings for September and December, and March and June will be agreed upon.

4. External policies

The current account deficit of the balance of payments is expected to be reduced from a revised level of 10.2 per cent of GDP (11.4 per cent excluding official grants) in 1981 to 7.9 per cent (8.8 per cent excluding official grants) in 1982, compared to a target of 8.0 per cent (9.2 per cent excluding official grants) in the current program. On the basis of the proposed program, including the exchange rate action, and the foreign assistance which is likely to result from the London conference, the current account and overall deficit are projected to narrow in the next two years to attain a sustainable position in 1985, as had been the target of the current program. Current staff projections indicate that the current account deficit can be reduced to about 7.2 per cent in 1983 (8.3 per cent excluding grants), even after allowing for a further reduction in the volume of imports of 3.3 per cent following a 5 per cent decline in 1982 and a 19.5 per cent fall in 1981. This reduction is consistent with a target for the balance of payments current account deficit of 5.0 per cent of GDP by 1985 (6.0

per cent excluding official grants). The balance of payments for 1983 at present has a financing gap of about US\$100 million, which is expected to be filled as a result of the London Aid Conference.

Given the present lower interest rates in the international markets, Kenya's debt service ratio is now projected to increase only slightly in the next few years. Including the additional borrowing foreseen through 1985, the ratio is expected to rise by only 2 percentage points to 26 per cent. Under the proposed program the contraction of new loans on commercial terms with a maturity of 1-12 years will be limited to SDR 150 million over the next 18 months, compared to SDR 146 million in the current 12-month program. A subceiling for commercial loans with a maturity of 1-5 years will also be established.

The program will contain the usual intentions with respect to the trade and exchange system.

5. Prior actions

The program will include the following measures as prior actions:

- (1) exchange rate depreciation of 20 per cent in foreign currency terms and the elimination of the export compensation schemes;
 - (2) full adjustment of regulated prices to reflect exchange rate action;
 - (3) rationalization of the import system;
 - (4) an initial increase in interest rates of about 4.0 percentage points, with a further review in June 1983;
 - (5) new revenue measures expected to yield K Sh 450 million during the second half (Jan-June) of the present fiscal year and K Sh 950 million on an annual basis;
 - (6) the identification of budgetary programs and allocations which will be reduced; and
 - (7) closing of the resulting gap in the 1983 balance of payments through additional aid resulting from the London Aid Conference or, failing which, through other measures.
- 

6. Proposed phasing and reviews

A return to a more liberal import system is an important element of the adjustment program. However, without adequate initial financing, the Government of Kenya will be unable to finance the expected import demand, even after the exchange rate action. Thus, it is important that Kenya have sufficient resources to support the liberalization. In this context, a large initial drawing from the Fund, which is also supported by the preconditions included in the program, becomes important. Consequently, the following schedule of drawings is proposed for the program:

	In millions of SDRs	As a per cent <hr/> of quota of total	
<u>1983</u>			
January (on approval of program)	30.0	29.0	19.3
April	25.0	24.2	16.1
August	25.0	24.2	16.1
November	25.0	24.2	16.1
Subtotal 1983	105.0	101.4	67.6
<u>1984</u>			
April	25.0	24.2	16.1
July	25.3	24.4	16.3
Total	155.3	150.0	100.0

The drawing in August 1983 would also be subject to a review of the program. Thus, only SDR 55 million (53 per cent of quota or 35 per cent of the amount of the stand-by arrangement) would be scheduled for purchase prior to a general review of the program.

Fiscal, monetary, import, and exchange and interest rate policies will be reviewed in July/August and November/December.

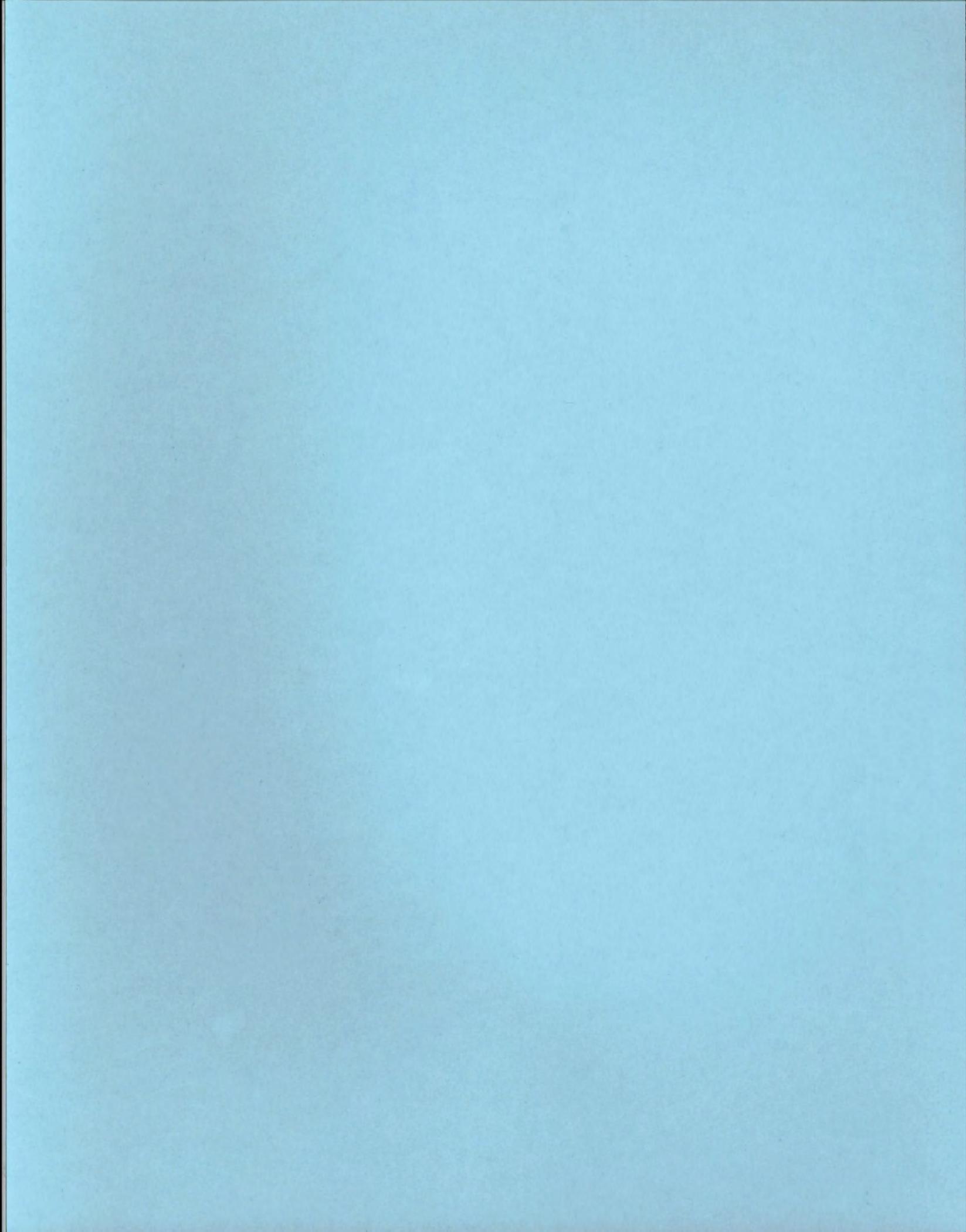
Relations with the Fund 1/

Status:	Article XIV
Date of membership:	February 3, 1964
Quota:	SDR 103.5 million
Fund holdings of currency:	SDR 422.49 million (408.20 per cent of . . . quota)
Of which: oil facility	SDR 2.13 million (2.06 per cent of quota)
compensatory facility	SDR 129.4 million (125.0 per cent of quota)
supplementary	
financing facility	SDR 94.83 million (91.62 per cent of quota)
Holdings of SDRs:	SDR 8.10 million, or 21.9 per cent of net cumulative allocation (SDR 36.99 million)
Trust Fund loan disbursements (first and second periods):	SDR 46.91 million
Direct distribution of profits from gold sales (July 1, 1976- July 31, 1980):	US\$7.61 million
Gold distribution:	41,079.961 fine ounces (four distributions)
Exchange arrangement:	Pegged to the SDR at K Sh 11.95 = SDR 1 (since September 21, 1981)
Intervention currency and rate for the U.S. dollar:	U.S. dollar; K Sh 11.14 = US\$1

1/ As of September 30, 1982.

Kenya: Selected Economic and Financial Indicators, 1981-82

	1981		1982		1983	
	Program	Estimate	Program	Revised program	Proje- ction	Proje- ction
<u>(Annual per cent changes, unless otherwise specified)</u>						
National income and prices						
GDP at constant prices	4.2	4.1	4.0	4.2	4.5	3.0
GDP deflator	12.0	9.7	11.4	15.4	18.8	16.5
Consumer prices	10.0	20.0	8.0	14.0	16.8	14.9
External sector (on the basis of SDRs)						
Exports, f.o.b.	-11.0	-8.0	17.1	11.3	3.2	0.4
Imports, c.i.f.	-6.5	-6.7	1.1	0.4	-7.5	-2.7
Non-oil imports, c.i.f.	3.7	-17.3	5.5	2.1	-10.4	-4.3
Export volume	-1.1	--	6.7	6.0	1.1	-1.3
Import volume	-14.2	-19.5	-4.7	-3.0	-5.0	-3.3
Terms of trade (deterioration -)	-7.5	-19.1	1.8	1.0	4.4	1.2
Nominal effective exchange rate (depreciation -)	--	-14.5	--	...	3.0	...
Real effective exchange rate (depreciation -)	--	- 6.7	--	...	15.0	...
Government budget ^{1/}						
Revenue and grants	18.2 ^{2/}	21.3	13.0	10.1	12.2	19.9
Total expenditure	8.0 ^{2/}	29.7	5.9	4.9	3.3	14.4
Money and credit ^{1/}						
Domestic credit	20.3 ^{2/}	24.2	19.9	25.2	33.0	14.7
Government	37.5 ^{2/}	83.4	34.0	50.3	65.5	7.7
Private sector	15.2 ^{2/}	9.5	15.3	15.3	16.0	17.3
Money and quasi-money (M ₂)	7.0 ^{2/}	7.3	11.0	7.5	9.1	13.7





Office Memorandum *W*

TO : Mr. Jiminez

DATE: November 5, 1982

FROM : W. A. Beveridge *WAB*

SUBJECT : Kenya

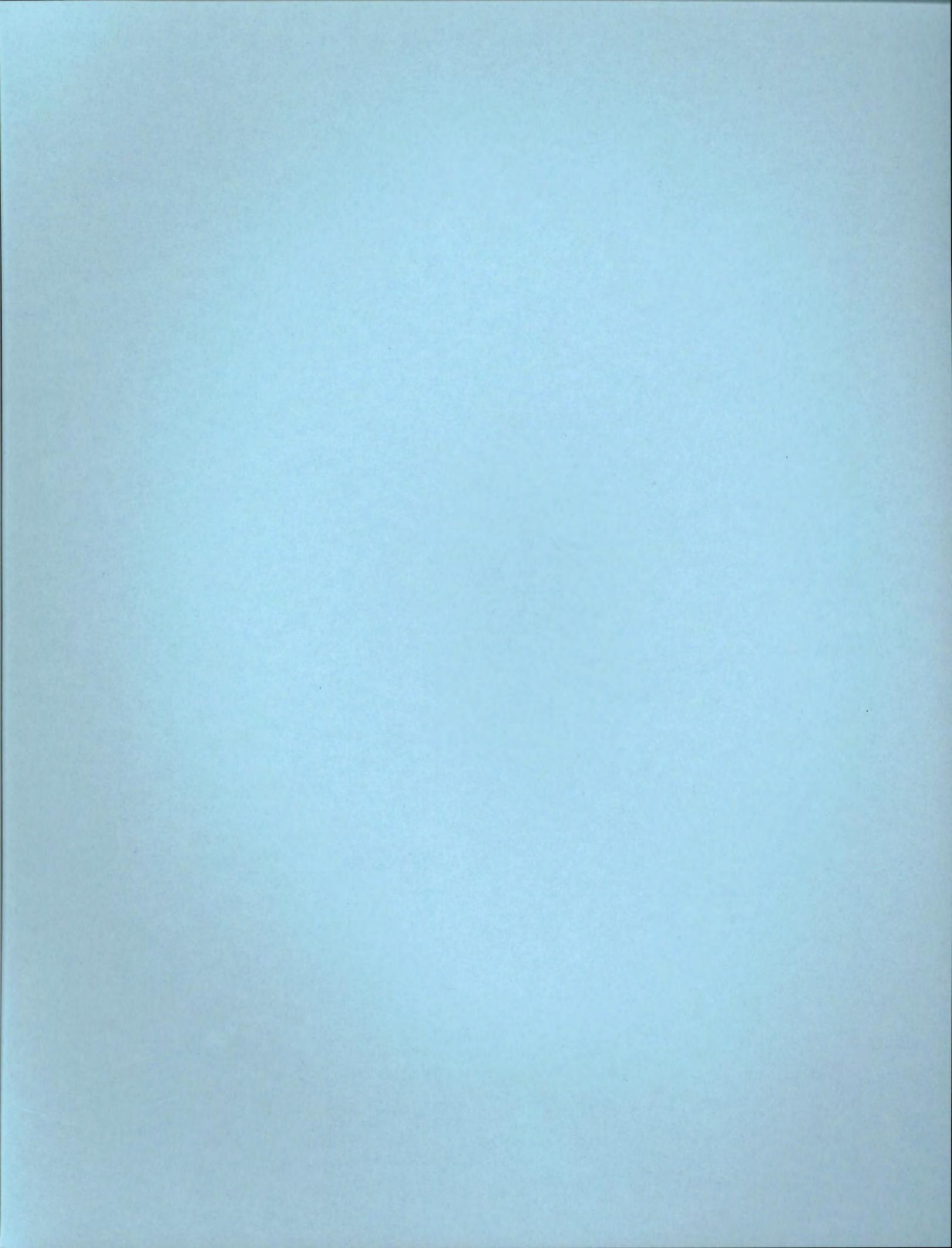
I understand that you do not propose to reflect my concerns (my memorandum dated November 2) in the briefing paper and that you plan now to send the briefing paper to management. Accordingly, please incorporate the attached paragraph in a covering note to management. I suggest that you consult with Mr. Zulu regarding indicating in the covering note the concerns of Mr. Wapenhans on the Kenyan situation.

Please let me see the final version of the briefing paper before it is transmitted.

Attachment

cc: Mr. Zulu
Mr. Finch ✓

ETR (Mr. Beveridge) considers that especially in light of the succession of inoperative programs, insufficient adjustment is being sought and there is undue reliance upon balance of payments financing. The 1983 external position is financeable only on the basis of optimistic assumptions, including additional Euro-dollar financing that is not yet arranged and of US\$100 million of additional donor support that it is hoped would be obtained at a special meeting. In light of the lack of confidence, both at home and abroad, sizable and convincing adjustment efforts at the outset of the program are needed to deter capital flight and to relax the foreign exchange constraint which is now very tight. The program envisions a decline in the ratio of the current account of the balance of payments excluding grants from a projected 8.8 per cent in 1982 to 7.6 per cent in 1984, a very modest rate of adjustment of the period of the program. A further decline of 1.5 percentage points is expected in 1985, a year beyond the program period. In ETR's view, there is need for stronger actions, than proposed in the briefing paper, in the interest rate, budgetary, and perhaps exchange rate areas.





Office Memorandum

TO : Mr. Jiminez

FROM : W. A. Beveridge

SUBJECT : Kenya

DATE: November 2, 1982

After reviewing the revised briefing paper for Kenya, I believe that insufficient adjustment is still being sought and there is undue reliance upon balance of payments financing. In light of the confidence issue, both at home and abroad, which endangers the Kenyan financial position, a sizable and convincing adjustment effort at the outset of the program is needed to deter capital flight, relax the foreign exchange constraint and dampen inflationary tendencies. The program envisions a decline in the ratio of the current account of the balance of payments excluding grants from a projected 8.8 per cent in 1982 to 7.6 per cent in 1984, a very modest rate of adjustment over the period of the program. A further decline of 1.5 per centage points is expected in 1985, a year beyond the program period, for reasons that are not apparent. The 1983 position is tenable only on the basis of \$100 million of additional donor support from the proposed London meeting.

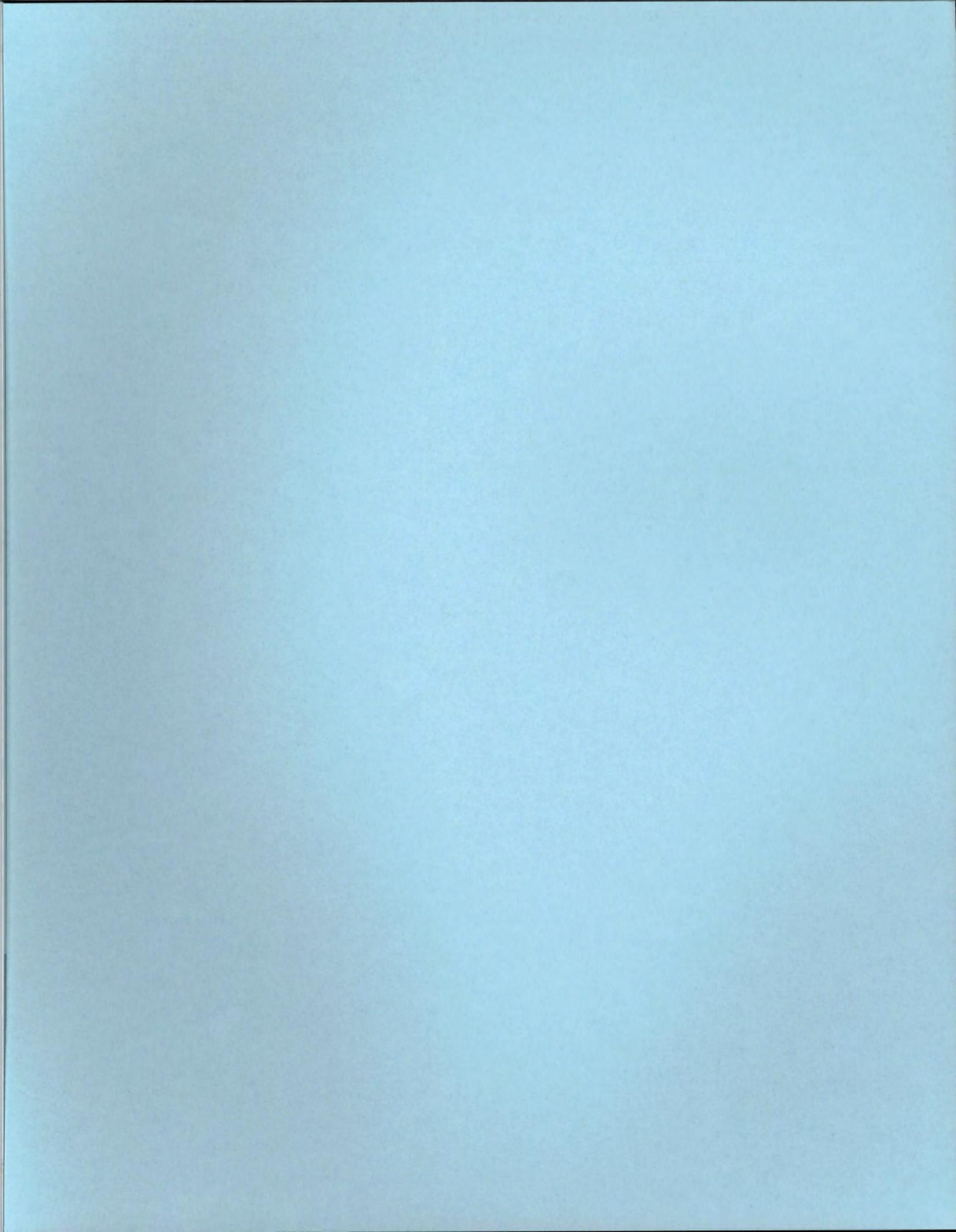
A combination of measures could be used jointly to bolster the initial adjustment effort, some addressed to the government budget and others to relative prices and the overall expenditure level. The briefing paper indicates that exports for 1983 are predetermined by the fact that planting has already occurred; thus reduction in the import level should be the focus, whether through a larger import surcharge or larger exchange rate movement. Greater interest rate liberalization could be used to restrain the overall expenditure level and help the balance of payments situation.

On a particular point, the elimination of the export compensation scheme should be a prior action along with the exchange rate and other action. This scheme is costly and delay in its removal serves no purpose.

As to Fund financing the planned commitment of 150 per cent of quota or 100 per cent on a 12-month basis is still high in light of other recent arrangements.

I have a few other less pressing amendments to the briefing paper.

cc: Mr. Makalou
Mr. Bhatia
Mr. Tait





Office Memorandum

October 13, 1982

To: Managing Director
Deputy Managing Director

From: Julio M. Jiménez *JMJ*

Subject: Kenya--Staff Visit

A mission composed of Messrs. Simpson (AFR) and Doe (FAD), and Miss Simpson (secretary-AFR), and myself visited Nairobi between September 26 and October 6, 1982 to review the impact of recent developments (particularly the coup attempt in August) on the current stand-by arrangement and on Kenya's medium term adjustment effort. The mission also concluded the Article IV consultation discussions began in July. The mission was well received and had friendly and detailed discussions with the authorities, including Mr. Magugu, Minister of Finance, Mr. Ndegwa, Governor of the Central Bank of Kenya, and Messrs. Nachai and Mule, Permanent Secretaries in the Cabinet Office and the Ministry of Finance, respectively. His Excellency, President Moi, requested a meeting with the mission and took this opportunity to stress that the Kenyan Government appreciated the Fund's help and the understanding that it had shown in the past. He added that he hoped close relations would continue. He recognized that the situation now facing Kenya was very difficult, but hoped that in recommending the necessary course of adjustment, the Fund would keep in mind that in part Kenya's problems were caused by forces outside its control and that given the fragility of the economy, particularly after the impact of the coup attempt, the fiber of the nation was now frail and at stake. He stressed to the mission that the Government was committed to seek a solution to Kenya's problems within a western oriented economic framework.

The mission confirmed that the June credit ceilings under the current stand-by arrangement were exceeded. Moreover, recent developments have severely hindered Kenya's adjustment efforts. The balance of payments, which had shown considerable improvement in the first half of the year, is now facing strenuous pressures and reserves have fallen below prudent levels. The coup attempt and subsequent disturbances have caused severe damage on public confidence and created speculation and lowered business activity, especially by nonresidents. Inflation has remained stubbornly high, while the import system launched last year has broken down and import licenses, once more, are being restricted. Speculation against the exchange rate appears to have become widespread.

The Government has given the task of rebuilding a high priority. Yet, the size of the task ahead is testing Kenya's democratic political system. The Government's initiatives are being hindered by the need to create a political consensus, which transcends group distrust. As much as the authorities recognize the need to move forward, the pace of policy implementation is being limited by the need to convince the various political groupings to accept sacrifice at a time in which the coup attempt has made the political

establishment cautious in accepting the difficult solutions being proposed. Therefore, it is likely that negotiating a new stand-by arrangement may require a longer time frame as the authorities seek to create the necessary political consensus and push waivering elements towards making difficult compromises.

The mission's review of the 1982 balance of payments indicates that the improvement now expected in this year will fall short of previous estimates, as a result of a better performance in 1981 than previously assumed (actual statistics are now available) and a further fall in commodity prices (Kenya nonquota market coffee sales are apparently being made at a discount of about 60 per cent from quota market prices, as opposed to the 40 per cent previously assumed), a drop in tourist earnings, and a weakened capital account. Consequently, an improvement in the current account deficit of the balance of payments of about 0.6 percentage points is now projected (from 10.2 per cent of GDP in 1981 to 9.6 per cent in 1982), compared with the previous estimate of 2.5 percentage points (from 11.0 per cent of GDP to 8.5 per cent). Moreover, the overall balance of payments deficit will widen further to SDR 251 million from SDR 200 million, due to delays in some official capital inflows and some private sector capital outflows. Given the low level of foreign reserves (as of the end of September gross foreign assets of the Central Bank totaled SDR 134 million, equivalent to less than four weeks of projected 1982 imports), the authorities have begun to limit the number of import licences approved in order to save foreign exchange for debt service payments. Moreover, following the August events, there appears to have been an unusually large import demand. The authorities have also made a special appeal to their traditional creditors for increased assistance. At least one creditor (the U.S.) has already responded positively. The real effective exchange rate of the Kenya shilling has continued to appreciate, given the strength of the SDR (to which it is pegged) and the higher inflation rate in Kenya than in its trading partners.

A few days before the mission's arrival, the export compensation scheme, which had been suspended in June, was reinstated in a slightly modified version. The rate of compensation has been reduced from 20 per cent to 10 per cent. However, all industries which are able to increase the level of exports from one year to the next will be given a higher compensation payment of 25 per cent on all the additional exports. The authorities explained that they had been unprepared for the uproar which the suspension of the scheme had caused. They pointed out that several nontraditional export industries had closed, alleging that without the compensation scheme they were unprofitable. In view of the other political difficulties being faced, the authorities stressed that they could not allow the level of unemployment to rise at this particular time and, hence, had no alternative but to reinstate the scheme.

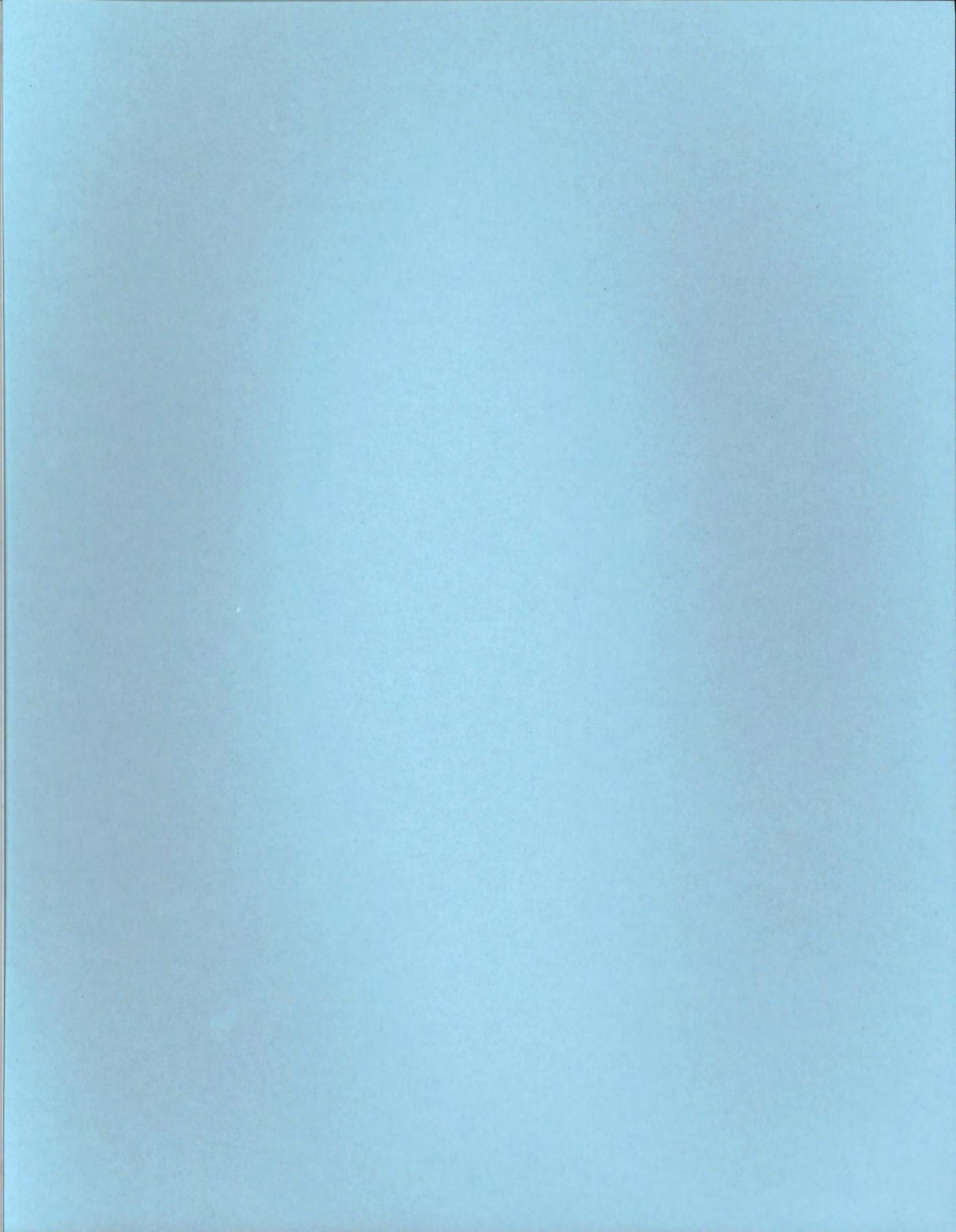
The substantial fiscal adjustment made in fiscal year 1981/82 (July-June), involving a reduction of the budgetary deficit from 11.9 per cent of GDP to 7.9 per cent is in danger of being reversed. In the first quarter of the current fiscal year (July-Sept. 1982), revenues have grown by barely 3 per cent over the first quarter of the previous fiscal year, while expenditures have risen much faster, generating a large demand for

bank credit. Net budgetary credit in the first quarter was some 40 per cent greater than the previous year. As you will recall, the July mission felt that the 1982/83 budget was unrealistic and required further adjustments and refinements. Unfortunately, the difficulties following the coup attempt rendered the adjustments which the authorities were contemplating insufficient. Consequently, further corrective action is needed. The Government had set up a commission to review government expenditures and its report is now available. A selection of the recommendations contained in the report is being made for submission to the Cabinet by the end of October. In addition, the authorities have reviewed and cut the number of development projects to be executed in the current fiscal year. While these cuts are expected to bring the budget to a more realistic position, the Government is also facing additional requirements. Apart from the additional expenditures connected with the export compensation, resources are needed to meet the expected loss which will be incurred by the National Cereals and Produce Board in exporting the excess national production of beans and maize from this year's harvest, which Kenya is unable to store or utilize. There are also pressures for supplementary appropriations in various ministries, particularly Defense. Given that all of the elements which will form part of the revised 1982/83 budget are still being discussed within the Government, the authorities did not have budgetary proposals to discuss with the mission. They indicated that such proposals would be available in early November. In this regard, the mission pointed out the need to continue with the budgetary adjustment began last fiscal year and cautioned against the danger of allowing too much of the present year to go by before appropriate budgetary policies are put into place.

During the mission's visit an article appeared in the London Financial Times stating that the Fund had suspended the current stand-by arrangement with Kenya and highlighted the various difficulties faced by the authorities. The article, which was quickly picked up by the local press, contained detailed figures and information on the stand-by arrangement that the authorities were unhappy to have in the public domain. However, the initial suspicion that the information had come from the mission was overcome when the authorities realized the dateline for the article had been Washington. The Minister of Finance gave a press conference in rebuttal to the article.

The authorities are interested in continued assistance from the Fund to support a new adjustment program. However, they also are aware that before discussions on the new stand-by arrangement can be initiated, they must formulate policies which will focus on the present growing disequilibrium. To speed-up discussions, the authorities proposed that a Kenyan delegation come to Washington before the end of October to begin discussions on the new stand-by arrangement. They selected coming to Washington to avoid press speculation. Assuming that progress is made during their visit, a mission (already in the mission schedule) could visit Nairobi in November to complete the discussions. A briefing paper detailing the mission's negotiating stand for the discussions in Washington will be sent to you shortly for your consideration and approval. Meanwhile, we will wait in issuing the consultation report until after the next contact with the Kenyan authorities, when the timetable of negotiations will be clearer.

cc: CBD, ETR, EXR, FAD, INST, LEG, RES, SEC, TRE, Mr. Carter





Office Memorandum

cc: EA

SEP 23 1982

TO : The Managing Director ✓
 The Deputy Managing Director

FROM : J.B. Zulu and W.A. Beveridge

SUBJECT : Kenya - Briefing Paper

DATE: September 23, 1982

me

Thank you

for

Sept. 24. 82

You commented on this paper in relation to a reference regarding financing of the food crop in 1982/83 as follows:

had we not made some allowance for such greater needs for stock financing in some other cases? Should we not show some--limited--flexibility here?

You are correct. We have adjusted credit ceilings for the temporary financing of crops in a number of cases, occasionally by an automatic formula and at other times through a modification or waiver of the ceiling. Indeed, in the case of Kenya, the June 1982 credit targets were increased to take account of temporarily increased food stocks but not of a permanently increased level of food stocks that the Government wished to hold. The latter is, of course, analogous to increased government expenditure (the proposal for Kenya was approved by the Executive Board on June 9, 1982). We would plan to follow the same procedure when the time comes to negotiate the credit program for 1982/83. As you are aware, the present mission is for fact finding and not to negotiate a financial program.

cc: Mr. Carter
 Mr. Jimenez (On return)



cc: 1) MR KANESA-THASAN
MR LOSER
BLUE FOLDER

SEP 16 1982

2) ETR FILES

INTERNATIONAL MONETARY FUND

September 16, 1982

TO : THE MANAGING DIRECTOR

FROM: WILLIAM B. DALE *WBD* ←

SUBJECT: Kenya - Briefing Paper Review of Stand-by

I consider the attached brief to be sound and appropriate. We shall have to see how the impact of the recent coup attempt will affect the future of the program of adjustment. I recommend approval.

Yes
4-1-9
W
20.2.12



Office Memorandum

MR BEVERIDGE
cc: 1) MA KANESA-TIHASAN
BLUE FOLDER
2) ETR FILES

TO : Mr. Jimenez
FROM : W. A. Beveridge
SUBJECT : Kenya

DATE: September 14, 1982

The revised version of the briefing paper you circulated today is a more accurate reflection of the agreement reached in Toronto with the Kenyan authorities. I have made some further changes in the text which I am attaching. I draw two points particularly to your attention.

1. I do not think it is reasonable to state, or infer, that the current program could be modified if only more time were available. Given the record of non-observance of performance criteria and the implications of the recent coup, I do not see a possibility of a waiver of the broken June ceilings.

2. I think the briefing paper should simply state the facts regarding the non-observance of the June performance criteria. Accordingly, I have deleted references to the breakage as being due to technical factors or matters outside Kenya's control. The mission is authorized, in any event, (p.2) to review the developments which led to the breach of the ceilings.

As to the possibility of ETR participation in the mission, I suggest that you request Mr. Makalou to be in contact with Mr. Palmer as soon as possible.

Attachment





Office Memorandum

SEP 16 1982

TO : Acting Managing Director

DATE: September 16, 1982

FROM : J.B. Zulu *J.B.*

SUBJECT : Kenya

Attached for your approval is the Briefing Paper for Kenya's Review of Stand-By Arrangement mission. This paper has been cleared with:

ETR (Mr. Beveridge)
FAD (Mr. Tait)
LEG (Ms. Lachman)
TRE (Mr. Chandavarkar)

Att.

cc: Managing Director (upon return) ✓
Mr. Carter

INTERNATIONAL MONETARY FUND

KENYA

Briefing Paper - Staff Visit

Prepared by the African Department and the
Exchange and Trade Relations Department

(In consultation with the Fiscal Affairs,
Legal and Treasurer's Departments)

Approved by J.B. Zulu and W.A. Beveridge

September 16, 1982

I. Introduction

On January 8, 1982, the Executive Board approved Kenya's request for a one year stand-by arrangement in an amount of SDR 151.5 million, representing 146.4 per cent of Kenya's quota. Kenya met the performance criteria established for end-January and reached understandings on fiscal, import, exchange rate, and interest rate policies, during a review which was completed by the Executive Board on June 9, 1982. At that time, credit ceilings for end-June 1982 were approved; small upward revisions were made to the indicative targets that had been established earlier to take account of temporary needs. Kenya has drawn SDR 90 million under the arrangement. At the time of the last review, Kenya's request for a purchase of SDR 60.4 million under the decision on compensatory financing of export fluctuations and fluctuations in the cost of cereal imports was also approved, relating to a net shortfall for calendar year 1981. As of August 31, 1982, the Fund holdings of Kenya shillings, excluding those under the oil and compensatory financing facilities reached 282 per cent of quota, while the recent drawing under the compensatory financing facility raised the Fund

holdings of Kenya shillings under the CFF to 125 per cent of quota.

Information available indicates that the credit ceilings for end-June were not observed. In a letter dated August 23, 1982, the Kenyan authorities suggested a waiver of those ceilings and proposed ceilings for end-September to allow the two remaining drawings under the stand-by arrangement to be made. During the Annual Meetings the Kenyan authorities reiterated this request. After discussion, the authorities accepted the staff's view that in the light of the non-observance of the June credit ceilings, the need to revise the 1982/83 budget and the uncertainties for the adjustment program resulting from the recent coup attempt, an immediate fact finding mission would be appropriate. They also accepted the staff's view that it would be unwise to seek a waiver for the June performance criteria. Policy discussions on a new program covering 1983 could take place later, possibly in early November.

Therefore, a mission comprising Messrs. J.M. Jiménez (head-AFR), J. Simpson (AFR), D. Lipton (ETR), L. Doe (FAD) and Miss M. Simpson (secretary-AFR) will visit Nairobi beginning Sept. 27, 1982 for about two weeks. The mission will review the developments which led to the breach of the ceilings at the end of June and update the economic and financial outlook, including the impact of the recent coup attempt. In so doing, the mission will assess how far recent developments have pushed Kenya's medium-term adjustment effort off track and assess the general policy areas which need further adjustment. The mission is not authorized to negotiate a financial program but may provide the Kenyan authorities with its preliminary findings. The mission will also conclude the Article IV consultation discussions initiated by an earlier mission in June-July 1982. 1/

A summary of relations with the Fund is attached.

1/ The three-month deadline for the consultation discussions in the Board will come on October 13. It is planned to issue the consultation report as soon as possible after the mission's return from Nairobi but a postponement of Board discussion beyond October 13 will be needed.

II. Performance under the Current Stand-By Arrangement

Kenya has made great efforts to keep to the adjustment objectives of the current program. Developments prior to the recent coup attempt led the staff to conclude that there was likely to be a reduction in the current account deficit from the equivalent of 11.0 per cent of GDP in 1981 to 8.5 per cent of GDP in 1982, or by 2.5 percentage points, roughly in line with the program's objective of 2.8 percentage points. Moreover, the rate of growth of GDP was also picking up, as programmed, although the rate of inflation remained stubbornly high. As part of the program the authorities had also put into effect an important array of pricing measures: the exchange rate had been devalued by 15 per cent in September 1981; interest rate had been increased by 3 percentage points; producer prices had been reviewed and some increased; and a significant number of controlled prices had been adjusted upwards. Moreover, as required under the stand-by arrangement, Kenya further streamlined the import system, by transferring 20 per cent of items from the restrictive schedules to the schedule of freely importable items in June 1982. These items accounted for about 25 per cent of non-oil imports in 1978, the last year of free import system, and, therefore, represent a significant change. The export compensation scheme was also suspended.

Significant progress was also recorded in the budgetary field. On the basis of the Government's strict adherence to the overall expenditure targets agreed in the program, the overall deficit during FY 1981/82 (July/June) was reduced from 11.9 per cent of GDP to 7.7 per cent of GDP, slightly better than the program's objective of 7.8 per cent. However, partly as a result of a large shortfall in the net inflow of foreign financing, caused both by a reduction in the inflow of foreign resources and larger amortization payments, and unexpected

secondary market transactions of Treasury bills between the nonbank and banking sectors, the credit ceilings established for end-June were exceeded.

During the recent mission, agreement could not be reached on the ceilings for end September, as it became necessary to confirm Kenya's performance under the end of June credit ceilings and there was a need to further modify and adjust the 1982/83 budget. Contacts to finalize these points were to have resumed in early August. However, the coup attempt and the uncertainty which prevailed in its aftermath prevented these discussions to be held on time.

III. Recent Economic Developments

Improved weather conditions in 1981 and 1982 have resulted in a better performance in the agricultural and industrial sectors than had originally been expected, and during the June/July mission it had been estimated that the growth rate of real GDP for 1982 would reach 4.5 per cent compared to 4.1 per cent in 1981 and 4.3 per cent in 1980. However, the inflation rate was projected to remain high, at about 18 per cent compared to 20 per cent in 1981. The continued price pressures reflect the devaluation of the shilling in 1981 and the large increases allowed in many price controlled items, some of which carry important weights in the cost of living index. However, the rate of increase in prices was expected to slacken during 1982 and be at a more manageable pace in 1983, as a result of the more cautious financial policies being followed in 1982 and from the bountiful agricultural output, which would limit the increases in food prices.

The improved performance of the economy, particularly in the agricultural sector, generated a larger demand for domestic credit to finance production and stocks and it proved difficult for the monetary authorities to completely offset

the rise in net budgetary credit equivalent to 14.6 per cent of the stock of money and quasi-money at the start of the fiscal year. In the same period, nonbudgetary credit expanded by 12.2 per cent similarly measured compared with an indicative target in the program of 12.8 per cent. Total credit reached K Sh 21.6 billion, rising by 26.7 per cent during the fiscal year with respect to the stock of money and quasi-money at the start of the fiscal year, compared with a target of K Sh 20.2 billion and a growth rate of 18.8 per cent. Nevertheless, the growth in money and quasi-money at 9.4 per cent was kept well below the growth of current GDP, although somewhat higher than assumed in the program.

Provisional data for fiscal year 1981/82 indicated that total budgetary expenditures were in line with the revised target of K Sh 20.6 billion. Revenues and grants at K Sh 16.5 billion exceeded slightly the revised target of the program and the overall deficit at K Sh 4.1 billion was slightly lower than programmed. Although Kenya's efforts to limit total government expenditures to the targeted level and keep the overall deficit in line with the program were successful, it faced considerable difficulties in attracting the level of net foreign financing expected in the program. At its launching, the stand-by arrangement envisaged net foreign financing of K Sh 2.8 billion. This level was adjusted downward during the first review to K Sh 1.7 billion, but net drawings are now estimated at only K Sh 1.2 billion. Part of this shortfall had been expected to be met by the placing of Treasury bills with the nonbanks. To influence this outturn the monetary authorities had been more rigorous in enforcing the reserve and liquidity requirements of nonbanks. In addition, the interest rate on Treasury bills was progressively increased from about 6.0 per cent at the beginning of the fiscal year to 12.7 per cent at the close of the fiscal year. On

the basis of these efforts and on the indication that the tight expenditure policy had taken hold, the authorities were confident that the performance criteria on the financing of the budget would be observed at the end of June. Unfortunately, due to secondary transactions of Treasury bills between the nonbank and banking sectors in the month of June unexpected by the authorities, there was larger net accumulation of Treasury bills in the banking sector and the credit ceilings were exceeded.

The adjustment of the balance of payments was initially expected to take place as a consequence of a decline in the volume of imports arising from the impact of the devaluation undertaken in 1981 and of the increased tariffs being implemented in conjunction with the reduction of quantitative restrictions. Moreover, a slight improvement in Kenya's terms of trade was expected with some improvement in the prices of coffee and tea, which would allow for an increase in exports in SDR terms. The recent mission confirmed that these assumptions were still valid and that the current account deficit was being reduced as programmed. A reversal in the adjustment of the current account deficit may well be expected as a result of the recent coup attempt. In addition, large pressures may be expected in the capital account. The level of gross international reserves at the end of June 1982 is estimated at about 4-5 weeks of imports of goods and services, a level considered unduly low by the monetary authorities. Net international reserves have been negative for some time. The low level of reserves has in the past tended to hinder the efficient and orderly management of the exchange and trade system. Without additional support, it is likely that the authorities would rely more heavily on quantitative and ad hoc restrictions on imports.

Following the two devaluations of the Kenya shilling, which depreciated the exchange rate by about 20 per cent in terms of the SDR in 1981, the real effective exchange rate of the Kenya shilling appreciated in the first half of 1982, but has remained below its value at the beginning of 1976.

IV. Issues for Discussion

The current program sought to attain a sustainable balance of payments position by 1985 with a further gradual reduction in the budgetary deficit. This objective was expected to be reached with a current account deficit in the balance of payments of about 5 per cent of GDP in 1985. The Government's medium-term policies also sought to increase the annual growth rate of GDP to about 5 per cent in 1983-84. The mission will review the extent to which the recent developments have affected Kenya's medium-term adjustment objectives and discuss with the authorities the necessary additional measures needed to bring the thrust of their policies in line with the objective of a sustainable external position.

1. Development and production policies

The Government's medium term strategy, incorporated into the current stand-by arrangement, aimed at improving the domestic allocation of resources, by promoting export-oriented growth and by making the domestic manufacturing sector more outward looking and competitive. The key policies involved were a depreciation of the exchange rate, a reform of the import system, and the adjustment of regulated prices to realistic levels. The mission will review the extent to which the thrust of Government policy in this area needs strengthening, will stress the importance that the Fund attaches to realistic policies in these fields, and will indicate that such policies will need to be addressed in any subsequent

discussions. In particular, the mission will express concern that since the depreciation of the exchange rate in September 1981, the effective exchange rate has appreciated by about 12 per cent, largely because the Kenya shilling continued to be pegged to the SDR and inflationary pressures were greater in Kenya than in the main trading partners.

The principal producer prices were last reviewed in the second half of 1981. Indications are that these prices still remain adequate, but the mission will review them with the Kenyan authorities in light of production objectives.

In the current program great emphasis has been given to the simplification and liberalization of the import system. As indicated previously, significant progress has been made in this area, most recently with the transfer of 20 per cent of items from the restricted to the nonrestricted schedule. The authorities have indicated that they expect to remove all quantitative restrictions in a period of 5 years beginning with June 1982 by transferring to the nonrestricted category 20 per cent of restricted items per year. This objective has been incorporated into the IBRD's second structural adjustment loan. The mission will ascertain if these policy intentions remain the Government's objective. Other recent developments in the exchange and trade system will also be reviewed.

2. Fiscal policy

In FY 1981/82 the overall budgetary deficit was significantly reduced through a restrictive expenditure policy. The 1982/83 budget as prepared by the authorities called for a further reduction. The adjustment was largely to be carried out by a continued tight expenditure policy, particularly with regard to current expenditure, although some new revenue measures were included.

for such greater needs for stock financing in some other cases? Should we not show some--limited--flexibility here?

- 9 -

The mission will review the most recent budgetary trends, as well as the expected impact on prospective expenditures and revenues of the recent coup attempt to ascertain whether they are consistent with the medium-term adjustment effort. In addition to new expenditure requirements generated by the coup, there are pressures on the Government to relax its tighthold on government expenditure, while revenue yields are also likely negatively affected by the business losses and disruptions arising from the coup.

The mission will seek the authorities' view about the size of the government contribution toward the financing of the food crop in 1982/83 and the offsetting measures in order to hold credit expansion within acceptable limits. The mission will also explore in some detail the realism of the authorities' estimate for supplementaries in 1982/83.

The official projections of expenditure contain no provision for float broadly defined as checks issued by spending ministries but not cashed by the close of the fiscal year on June 30. There are no reliable data on the amount of the float in the preceding years. The Kenyan authorities' view of a realistic forecast for 1982/83 should be sought and the need for a float allowance in future programs should be estimated. If it appears that significant budgetary adjustment will be needed for both revenue and expenditure the mission can explore the possibility of technical assistance in this area.

The mission will emphasize the need to reinforce the monitoring procedures now utilized by the Government, and advise the authorities to extend the monitoring to the financing items, so that the shortfalls in foreign inflows and the impact of the secondary market transactions of Treasury bills can be foreseen in adequate time.

3. Monetary policy

The mission will assess the monetary trends and ascertain, in particular, the reasons for the transactions in Treasury bills at the end of June, will discuss with the authorities their views as to the level of net domestic credit necessary in 1982/83 and the policy measures which they plan to introduce to reach this target.

In the first half of 1982, the rapid growth of domestic prices has resulted in most domestic interest rates becoming negative. The mission will review the inflationary prospects for fiscal year 1982/83 and discuss with the authorities their plans of adjusting interest rates to more realistic lines.

4. External policies

The mission will discuss how recent developments have affected the balance of payments outlook for 1982 and 1983 and the extent to which the objectives of the current account in this area have been affected. In this regard, the mission will discuss with the authorities their plans to further the economy's adjustment and review their efforts in attaining additional assistance on concessional terms.

Kenya's external debt service (including IMF) is estimated at 18 per cent of the exports of goods and services in 1981 compared with 11.2 per cent in 1980. On the basis of contracted debt as of December 31, 1981, the debt service ratio is projected to increase slightly through 1985 and decline thereafter. Because of the level of debt and debt service payments already attained, Kenya must monitor the contraction of additional debt very carefully. The mission will review with the authorities the role they foresee for further foreign borrowing on commercial terms.

Relations with the Fund 1/

Status:	Article XIV
Date of membership:	February 3, 1964
Quota:	SDR 103.5 million
Fund holdings of currency:	SDR 422.48 million (408.19 per cent of quota)
Of which: oil facility	SDR 2.13 million (0.97 per cent of quota)
compensatory facility	SDR 129.4 million (125.0 per cent of quota)
supplementary	
financing facility	SDR 94.83 million (91.62 per cent of quota)
Holdings of SDRs:	SDR 8.10 million, or 21.9 per cent of net cumulative allocation (SDR 36.99 million)
Trust Fund loan disbursements (first and second periods):	SDR 46.91 million
Direct distribution of profits from gold sales (July 1, 1976- July 31, 1980):	US\$7.61 million
Gold distribution:	41,079.961 fine ounces (four distributions)
Exchange arrangement:	Pegged to the SDR at K Sh 11.95 = SDR 1 (since September 21, 1981)
Intervention currency and rate for the U.S. dollar:	U.S. dollar; K Sh 11.03 = US\$1

1/ As of August 31, 1982.

Kenya: Selected Economic and Financial Indicators, 1981-82

	1981		1982		
	Program	Estimate	Program	Revised program	Projection
(Annual per cent changes, unless otherwise specified)					
National income and prices					
GDP at constant prices	4.2	4.1	4.0	4.2	4.2
GDP deflator	12.0	9.7	11.4	15.4	17.1
Consumer prices	10.0	20.0	8.0	14.0	18.0
External sector (on the basis of SDRs)					
Exports, f.o.b.	-11.0	-8.0	17.1	11.3	13.3
Imports, c.i.f.	-6.5	-6.7	1.1	0.4	-1.3
Non-oil imports, c.i.f.	3.7	-17.3	5.5	2.1	2.1
Export volume	-1.1	--	6.7	6.0	8.0
Import volume	-14.2	-19.5	-4.7	-3.0	-3.0
Terms of trade (deterioration -)	-7.5	-19.1	1.8	1.0	4.0
Nominal effective exchange rate (depreciation -)	--	-16.2	--
Real effective exchange rate (depreciation -)	--	-15.4	--
Government budget ^{1/}					
Revenue and grants	18.2 ^{2/}	20.3	13.0	10.1	11.6
Total expenditure	8.0 ^{2/}	25.3	4.0	4.9	4.2
Money and credit ^{1/}					
Domestic credit	22.7 ^{2/}	24.2	19.9	25.2	33.0
Government	37.5 ^{2/}	83.4	34.0	50.3	65.5
Private sector	15.2 ^{2/}	9.5	15.3	15.3	16.0
Money and quasi-money (M ₂)	7.0 ^{2/}	7.3	11.0	7.5	9.2
Velocity (GDP relative to M ₂) ^{3/}	3.20 ^{2/}	3.23	3.45	3.68	3.92
Interest rate (annual rate, one year savings deposit) ^{3/}	... ^{4/}	10.00 ^{5/}	10.00	...	10.00
(In per cent of GDP)					
Central government current account surplus	5.4 ^{2/}	0.6	3.5	3.0	3.2
Central government overall budget deficit	6.0 ^{2/}	11.9	7.5	7.8	7.7
Domestic bank financing	2.5 ^{2/}	3.5	0.7	1.9	4.1
Foreign financing	3.2 ^{2/}	6.1	5.3	3.1	2.3
Gross domestic investment	23.0	24.9	25.0	24.7	24.7
Gross domestic savings	12.5	16.2	16.2	19.1	19.1
Current account deficit ^{6/}	12.6	11.0*	8.0	8.0	8.5
External debt	34.9	39.1	43.7	37.6	40.5
inclusive of use of Fund credit:					
External debt	36.7	43.6	45.5	39.4	43.6
Debt service ratio ^{7/}	13.0	18.0	15.0	14.9	19.0
Interest payments ^{7/}	5.5	8.5	6.1	7.9	9.0
(In millions of SDRs, unless otherwise specified)					
Overall balance of payments ^{8/}	-273.0**	-198.0**	-32.0	-169.0**	-201.0**
Gross official reserves (months of imports)	1.2	1.4	2.0	1.5	1.5
External payments arrears	--	--	--	--	--

^{1/} Fiscal year ending June 30.

^{2/} Refers to stand-by program approved on October 15, 1980 and canceled on January 8, 1982.

^{3/} Level in per cent.

^{4/} The program did not specifically indicate level, only upward direction.

^{5/} Rate introduced in September 1981.

^{6/} Asterisk * reflects severe constraint on foreign exchange availability.

^{7/} In per cent of exports of goods and services.



Mr. FINCH ✓



Office Memorandum

cc: Mr. Basu
Mr. Kaneco-Phasar
Ms. Eken

TO : Acting Managing Director

DATE: July 16, 1982

FROM : Julio M. Jiménez *JMJ*

SUBJECT : Kenya--Article IV Consultations and Review of Stand-By Arrangement

A mission composed of Messrs. Simpson (AFR) and Doe (FAD), Ms. Eken (ETR) and Ms. Coker (secretary-AFR), and myself visited Nairobi between June 27 and July 9 to conduct the Article IV consultation discussions and to carry out the final review of the current stand-by arrangement. The mission was well received and met with the economic and financial authorities, including Mr. Duncan Ndegwa, Governor of the Central Bank of Kenya and Mr. H. Mule, Permanent Secretary, Ministry of Finance.

For the stand-by review the mission was to set credit ceilings for September, the last check point, and review the import policy. The mission found that there were some uncertainties as to the outcome of the 1981/82 budget, particularly the performance under the credit ceilings, and that the 1982/83 budget, as announced required further elaboration specially with regard to more accurately estimating the foreign financing, before discussions on the September credit ceilings could be finalized. With regard to the review of import policy, the mission verified that the authorities had transferred 20 per cent of the items from the restricted categories to the non-restricted one, as required. The imports transferred accounted for 8 per cent of non-oil imports in 1981, a year in which imports were very restricted and about 25 per cent of non-oil imports in 1978, the last year of a relative free import policy. Consequently, in the mission's view, the Kenyan authorities have met the import policy requirements of the current stand-by arrangement.

Largely due to the return of better weather conditions in 1981, real GDP (market prices) expanded by about 4.1 per cent. There are indications that with the continuation of good weather conditions in 1982 and the new producer prices announced in December 1981, the growth rate in agriculture will continue at a high level and that overall GDP should expand by about 4.5 per cent. The restraint on the level of imports called for in the stand-by arrangement has restrained the current expansion, which has also been held back by the decline in real terms of overall government expenditures. Strong inflationary pressures have been evident in the first half of 1982, largely reflecting the large adjustments which took place in administered prices in December 1981 and again in the second quarter of 1982. Price trends were also affected by the exchange rate action taken late in 1981 and by the introduction of higher excise taxes in April 1982. The authorities are confident, that barring a return of bad weather conditions, the economy is poised on its recovery. They also expect that the level of price increases

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recorded in the first half of the year will fall off rapidly in the second half, as the exceedingly good agricultural results are creating the necessary surpluses to maintain price stability.

Revenues, grants and total budgetary expenditures for 1981/82 are in line with the estimates included in the last stand-by review paper discussed by the Board on June 6. The overall deficit is presently estimated at K Sh 4.2 billion, or 7.7 per cent of GDP, slightly better than the program's target of 7.8 per cent, and compared to an overall deficit of 11.1 per cent of GDP in 1980/81. However, there were shortfalls in the expected drawings of foreign loans and amortization payments were larger than previously estimated. Consequently net foreign financing (excluding the Eurocurrency loan captured within the program's credit ceilings) covered only 30 per cent of the overall deficit compared to a target of 40 per cent. The Treasury made considerable effort at the close of the year to stay within the credit ceilings agreed for the program. Actions were taken several months ago to limit the amount of expenditures to the agreed targets and a close monitoring of outlays was carried out. The measures with regard to expenditure proved successful. On the basis of Treasury estimates of bank credit, the Treasury was under the impression that at the close of the year the ceilings had been observed. The mission's review of the data, however, revealed that the data had erroneously classified certain Treasury bill holdings of commercial banks in the non-bank sector and it is the mission's view that the ceiling on net bank credit to the Government was exceeded at the end of June. It is difficult at this time to estimate with accuracy the magnitude of the excess, as there are secondary market transactions for Treasury bills involving the non-bank sector which take place at the end of each month. Consequently, verification of the exact position must wait until the end of July when the balance sheets of commercial banks for June will become available. The export compensation scheme was abolished effective from June 18, 1982, following the recommendations of previous Fund missions.

The review of the 1982/83 budget, as approved by Parliament, showed that the estimate for total recurrent revenues and grants, involving an increase of 16 per cent to K Sh 19.2 billion, was reasonable. With regard to expenditure the mission concluded that the level of recurrent expenditures, which included an increase of only 6 per cent to K Sh 15.1 billion, was unrealistically low and that it included no allowance for supplementary appropriations, as there has been in the past. Development expenditures at K Sh 7.1 billion were optimistically high and not properly coordinated with the expected inflow of foreign financing. Largely because of the need to make allowance for supplementaries, the overall budget deficit at 4.8 per cent of GDP was considered unrealistic. After adjusting for the underestimation in the recurrent budget and the over-ambitious development targets, the mission concluded that the overall deficit could be kept to the equivalent of about 5.0 per cent of expected GDP. This would result in a further

important fiscal adjustment, reducing the overall deficit by about 6 percentage points of GDP over two years. With the adjustment of the development expenditures to a more reasonable level, there is also a need to revise downward the expected foreign financing. The mission estimated net foreign financing to be equivalent to 48 per cent of the overall deficit as opposed to the budgetary target of 61 per cent. After an allowance is made for possible non-bank financing of the budget, net bank financing was estimated at K Sh 1.4 billion or about 7 per cent of the stock of money and quasi-money at the start of the fiscal year, which in the mission's view was a reasonable level. The mission discussed its analysis of the budgetary proposals with the authorities and they agreed that further work on their part was needed with respect to the distribution of expenditures and in more accurately estimating net foreign financing before they could agree on the credit ceilings.

The somewhat higher than projected level of economic activity, particularly in agriculture, where there has been a need to finance crop surpluses, has created pressures for additional bank financing from the private sector. The mission estimated that non-budgetary credit (credit to public entities and private sector) at the end of May was approaching the ceiling levels estimated for the end of June. Consequently, it is likely that as a result of the higher level of credit to the budget and to the nonbudgetary sectors, the ceiling on net domestic credit for the end of June was also exceeded.

Estimates for 1982 indicate that the current account deficit of the balance of payments will fall to about 8.5 per cent of GDP from a revised level of 11 per cent in 1981. Exports are estimated to rise by 13 per cent to SDR 995 million and imports at SDR 1,863 million to remain almost stagnant in SDR terms. The present forecast of the current account deficit is slightly higher than the estimate included in the stand-by paper of 8.2 per cent of GDP. However, given the revised level for 1981, the adjustment involves a reduction of 2.5 percentage points of GDP, or the same level called for in the stand-by arrangement. The review of the capital account for 1982 indicated that the inflow of capital is somewhat smaller than originally estimated. This reflects the shortfall in budgetary development expenditures and some weaknesses in the private sector accounts. Consequently, the overall deficit of the balance of payments is now estimated at SDR 200 million as opposed to an estimate in the stand-by program of SDR 167 million.

Because of the peg of the shilling to the SDR and the recent rise in Kenya's domestic price level there has been an appreciation of the trade weighted real effective exchange rate of the shilling, which has wiped out some of the effects of the depreciation carried out last year. The mission called the attention of the authorities to this deterioration and advised on the need for a more flexible exchange rate

policy to maintain the competitive position of the shilling. Similarly, the mission cautioned against the effect that higher domestic prices were having on the real interest rates.

Because of the uncertainty of the performance under the ceilings for June and the need to revise certain aspects of the 1982/83 budget, an additional contact, probably in August, will be necessary before agreement on credit ceilings for September can be achieved.

cc: Managing Director (o/r)

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ETR ✓

EXR

FAD

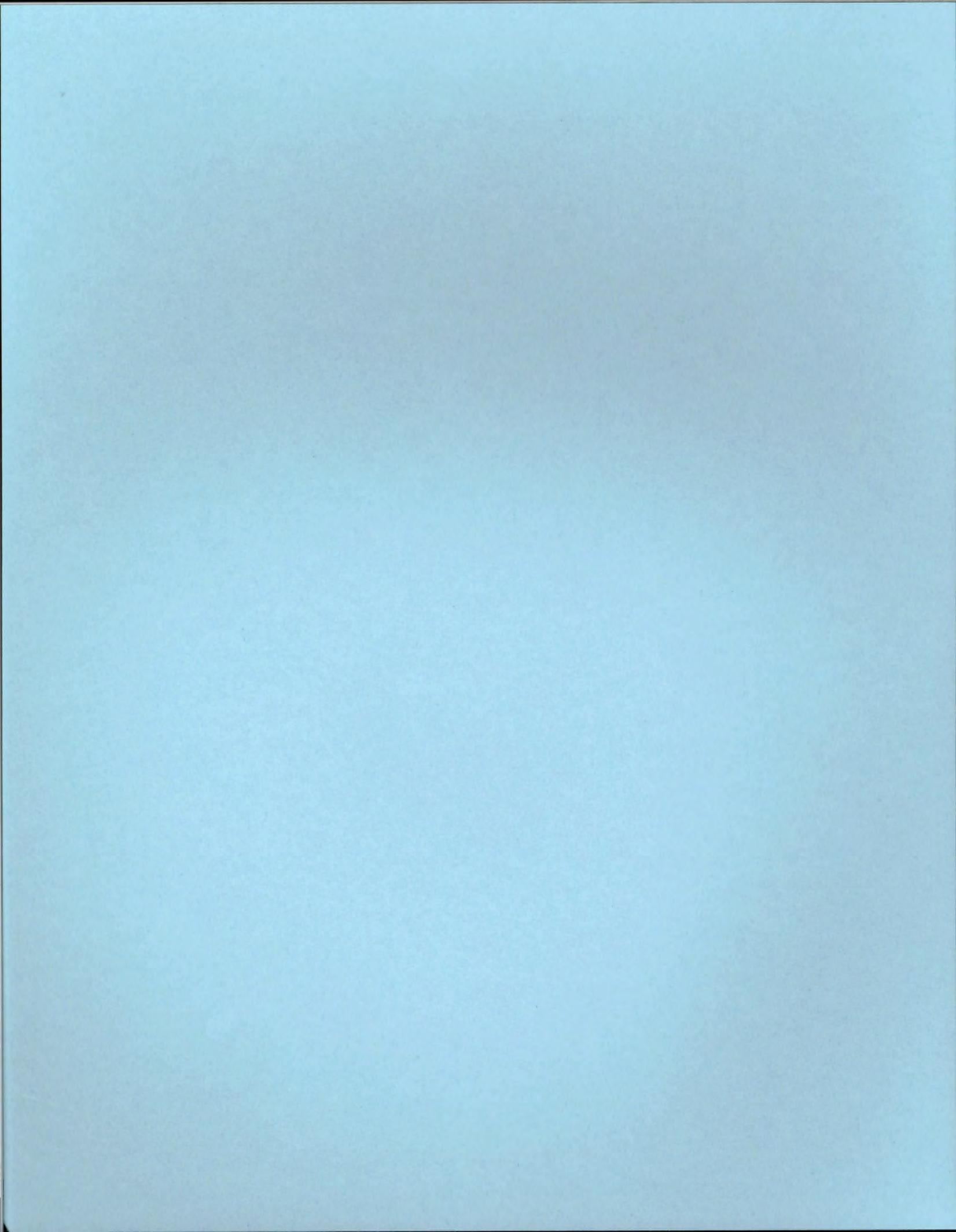
INST

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Mr. Carter



MR LOSER
cc: BLUE FOLDER
✓ ETR FILES
Mr. Beveridge
CONFIDENTIAL

INTERNATIONAL MONETARY FUND

KENYA

Briefing Paper - 1982 Article IV Consultation and Stand-By Review

Prepared by the African Department and the
Exchange and Trade Relations Department

(In consultation with the Fiscal Affairs,
Legal, and Treasurer's Department)

Approved by J.E. Zulu and W.A. Beveridge

June 16, 1982

Approved
W.A. Beveridge
ABH
SAS

I. Introduction

A mission comprising Messrs. J.M. Jiménez (head-AFR), and J. Simpson (AFR), Ms. S. Eken (ETR), Mr. L. Doe (FAD) and Mrs. Y. Coker (secretary-AFR) will visit Nairobi beginning June 27, 1982 for about two weeks to conduct the Article IV consultation discussions, and to review performance under the current stand-by arrangement. The mission's visit will also have the purpose of reaching understandings on import policy and establishing credit ceilings for September 1982.

A summary of relations with the Fund is attached.

II. Performance Under Stand-by Arrangement

On January 8, 1982 the Executive Board approved Kenya's request for a one year stand-by arrangement in an amount equivalent to SDR 151.5 million, representing 146.4 per cent of Kenya's quota of SDR 103.5 million. Of the total, SDR 54.7 million (52.8 per cent of quota) was to be provided from ordinary resources and SDR 96.8 million (93.6 per cent of quota) from supplementary financing. Full use of resources available under the

to contribute to a reduction in excess demand pressures and in line with a continued moderate increase in money and quasi-money. In establishing the ceilings for the credit program for 1982, the mission will take into account the need to slowdown the rate of inflation and will ascertain that the budgetary proposals for the whole of FY 1982/83 are in line with the Government's commitment to further reduce the overall deficit in terms of GDP. The September ceilings will be calculated by applying the seasonal factors to the agreed 1982/83 outturn. They will also take into account the repayment by the Government to the banking system of seasonal loans to build up cereal stocks. In addition, as proceeds from the second SAL by the IBRD are expected to be disbursed before the end of September 1982, the ceilings on total domestic credit and net bank credit to Government for that date will be adjusted downward in line with the receipt of the IBRD resources. With a view to ease government dependence on the banking system, the authorities will be urged to maintain the interest rate paid on Treasury bills at a competitive level. As the Kenyan authorities are likely to want a new stand-by arrangement at the conclusion of the current one, the mission will inform them that the indicative figures for the 1982/83 budget agreed for the September ceiling will be expected to be the basis of the fiscal objective for a future arrangement. At this time, however, the mission will not be in a position to negotiate the details of a future program, given the possible need for other policy adjustments.

The mission will also verify the experience of the new import system. Specifically, the mission will ensure that 20 per cent of items now subject





Office Memorandum

Mr. Finch

1) *A. Kanasa Hasan*

2) MR BEVERIDGE
BLUE FOLDER
ETR FILES



DATE: May 6, 1982

TO : The Managing Director
The Deputy Managing Director
FROM : Wm. C. Hood *W.C.H.*
SUBJECT : Kenya--CFF, Cereal Option

Attached for your approval is the staff paper on Kenya's request for a CF drawing, which has been prepared in conjunction with the African Department and cleared by ETR, Legal and Treasurer's Departments. The CF request, together with the paper reviewing the stand-by arrangement, is expected to be considered by the Board in early June.

Your attention is invited to the following points:

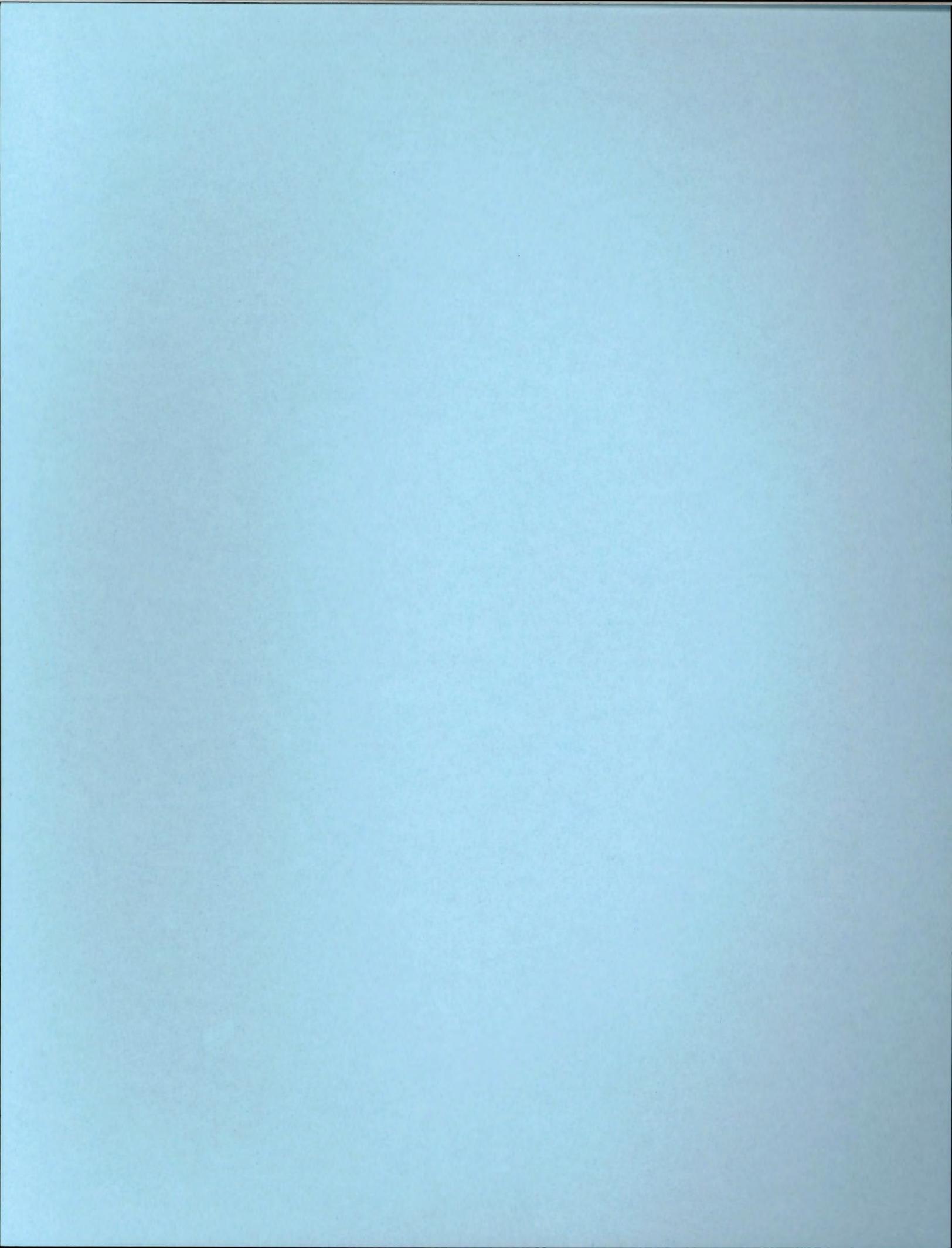
1. The expected request is made under the cereals facility and relates to both an excess in the cost of cereal imports and a shortfall in merchandise exports. Actual data for cereal imports have been used, but the export data for the shortfall year are based on estimates for the last six months. Consequently, there is the possibility of an early repurchase when the entitlement is subsequently recalculated on the basis of actual data.

2. The proposed purchase of SDR 60.4 million would raise Kenya's outstanding CF purchases from 67 per cent to 125 per cent of quota. The required test of cooperation is considered to have been met by the member's satisfactory performance under the current stand-by arrangement, as discussed in the review paper.

3. The excess in cereal import costs was mainly due to the effects of a drought on domestic crops of maize and wheat; the shortfall in merchandise exports was largely caused by lower prices for coffee and a reduced output of tea due to adverse weather. Consequently, both the cereals excess and the export shortfall are believed to be clearly beyond the member's control.

Attachment

cc: Mr. Habermeier
✓ Mr. Finch
Mr. Nicoletopoulos
Mr. Zulu
Mr. N. Carter



MR BEVERIDGE

cc: 1) MR KANESA HASAN
2) ETR FILES
BLUE FOLDER

APR 19 1982

INTERNATIONAL MONETARY FUND

April 19, 1982

TO : THE MANAGING DIRECTOR

FROM: WILLIAM B. DALE

SUBJECT: The Kenya Program and Crop Financing

*Yes
Apr 23.82
W*

This seems to me to be a very reasonable adjustment for a program that is fundamentally on track, and where the authorities are taking very substantial action to overcome the unexpected non-temporary factors that are outside their control. I recommend approval.



Office Memorandum

TO : Managing Director
Deputy Managing Director ✓

FROM : O.B. Makalou and W.A. Beveridge *W.A.*

DATE: April 16, 1982

SUBJECT: The Kenya Program and Crop Financing

As indicated in Mr. Karlstroem's back to office report of April 15, (copy attached), the Kenya program is on track so far in all respects. There are some unforeseen problems which might influence the credit program over the next few months. We feel that there should be no adjustment in the indicative and credit targets for June 1982 as a result of the expected shortfall in external grants and loans. That was not considered as an option by the mission, even though the Kenyan officials tried to argue that case. Instead, the authorities are embarking on a drastic effort to reduce expenditure commitments and are selling additional government paper to the nonbank sector.

However, it seems to us that there is a good case for a minor modification of credit targets to take account of the temporary part of the CSFC crop financing, i.e., that part which will be repaid by end September 1982. The Kenyan officials calculate that some K Sh 220 million out of a total of K Sh 1120 million of CSFC financing in the year to June 1982 is of a seasonal nature. Such an adjustment would mean that total credit expansion (including use of Eurocurrency loans) would be 21 per cent in 1981/82 compared with 20 per cent in the program. Since Kenya classifies this financing as "net lending" by the government (i.e., "above the line") the overall budget deficit would be raised to 8 per cent of GDP instead of the target of 7.5 per cent contained in the program for 1981/82 1/. This compares with 11 per cent in 1980/81.

It has been usual practice to adjust credit programs to take account of unexpected fluctuations in crop financing needs of a temporary or seasonal nature. In some cases adjustable credit ceilings were made part of the original program. In other cases, where the possible need for larger crop financing was not foreseen (as in this case), a waiver of performance criteria was approved by the Board for the excess in the ceiling due to this development. In the Kenyan case the overall need for crop finance in the year to June 1982 is substantially higher than the amount that is identified as being of a purely temporary or seasonal nature. The authorities intend to find domestic nonbank financing for the remaining amount (K Sh 900 million) of crop financing.

1/ Revised data for GDP would reduce the ratio for 1981/82 to 7.8 per cent and 7.4 per cent respectively.

It will be necessary to have a commitment (in the letter of intent) that the K Sh 220 million will be repaid to the Exchequer by end September 1982, even if that would mean shifting part of the CSFC financing from the Exchequer to private nonbank institutions. This would be taken into account explicitly when the September ceilings are negotiated.

Since the program is on track and the review indicates no need for further understandings to be reached on fiscal, exchange rate, interest rate and import policies, we recommend that the indicative target for total credit as of June 30, 1982 be raised by K Sh 220 million to take account of the seasonal crop financing. If you agree we would proceed with the letter of intent and briefing paper relating to the review and the establishment of the credit ceilings for June 1982, as performance criteria.

Att.

cc: Mr. Carter





Office Memorandum

cc: 1) MR. HANSEN
2) LTR FILES
BLUE FOLDER

TO : Managing Director
Deputy Managing Director

FROM : O.B. Makalou and W.A. Beveridge

SUBJECT : The Kenya Program and Crop Financing

DATE: April 16, 1982

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Att.

cc: Mr. Carter





Office Memorandum

TO : Managing Director
Deputy Managing Director

FROM : Bo Karlstroem *BK*

SUBJECT : Kenya--Review of Stand-By Arrangement

DATE: April 15, 1982

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APR 15 1982
EXCHANGE &
TRADE RELATIONS

As indicated in my back-to-office report of March 17, 1982 (attached), a review mission reached understandings with the Kenyan authorities on interest rate, exchange rate, and import reform policies. The credit ceilings for end-January were met. The program is on track as far as the current account adjustment and import policy is concerned; and the staff did not, at this time, see strong reasons for further adjustments in interest and exchange rates after the adjustments in the past year. However, some unforeseen factors relating to a shortfall of foreign assistance and the financing of a large cereal crop had put some doubts on the fiscal outcome for the FY 1981/82 (June-July). A mission from Kenya was supposed to visit Washington early this month to discuss the outstanding issues--in connection with discussions on an SAL with the World Bank. However, the IBRD was not yet ready for these discussions and cancelled the Washington talks. Instead, the Kenyan authorities requested a brief Fund mission to visit Nairobi as soon as possible. Thus, a mission consisting of Messrs. Simpson (AFR), Doe (FAD), and myself visited Nairobi from April 5-7 to finalize the review.

The formal purpose of the discussions was to reach agreement on fiscal policies and to agree on the credit ceilings for end-June 1982. More specifically, the issues that had to be considered were whether the shortfall in foreign aid (both grants and loans) and the financing need of the Cereals and Sugar Finance Corporation (CSFC) could be absorbed through cutbacks in expenditures, new revenue measures, a speeding up of the reimbursement procedures of foreign claims, or in some other way. At the suggestion of the mission, the Kenyan officials had done some further work concerning the shortfall in foreign assistance; they have now concluded that, with an extra effort to speed up the claims procedures, the shortfalls in grants and loans is likely to be K Sh 376 million less than expected a month ago (but still K Sh 680 million below the program projections).

The shortfall in foreign aid will be compensated by further cuts in development expenditure, larger sales of government debt to the nonbank sector (aided by the higher yields on government debt), and possibly by higher revenue collections (so far revenue has been running above the estimates).

On the public expenditure side, the basic strategy is not to start any new development projects unless financing from external sources is firmly secured. Instead, the aim is to support and consolidate only those development projects which are of vital importance to the economy.

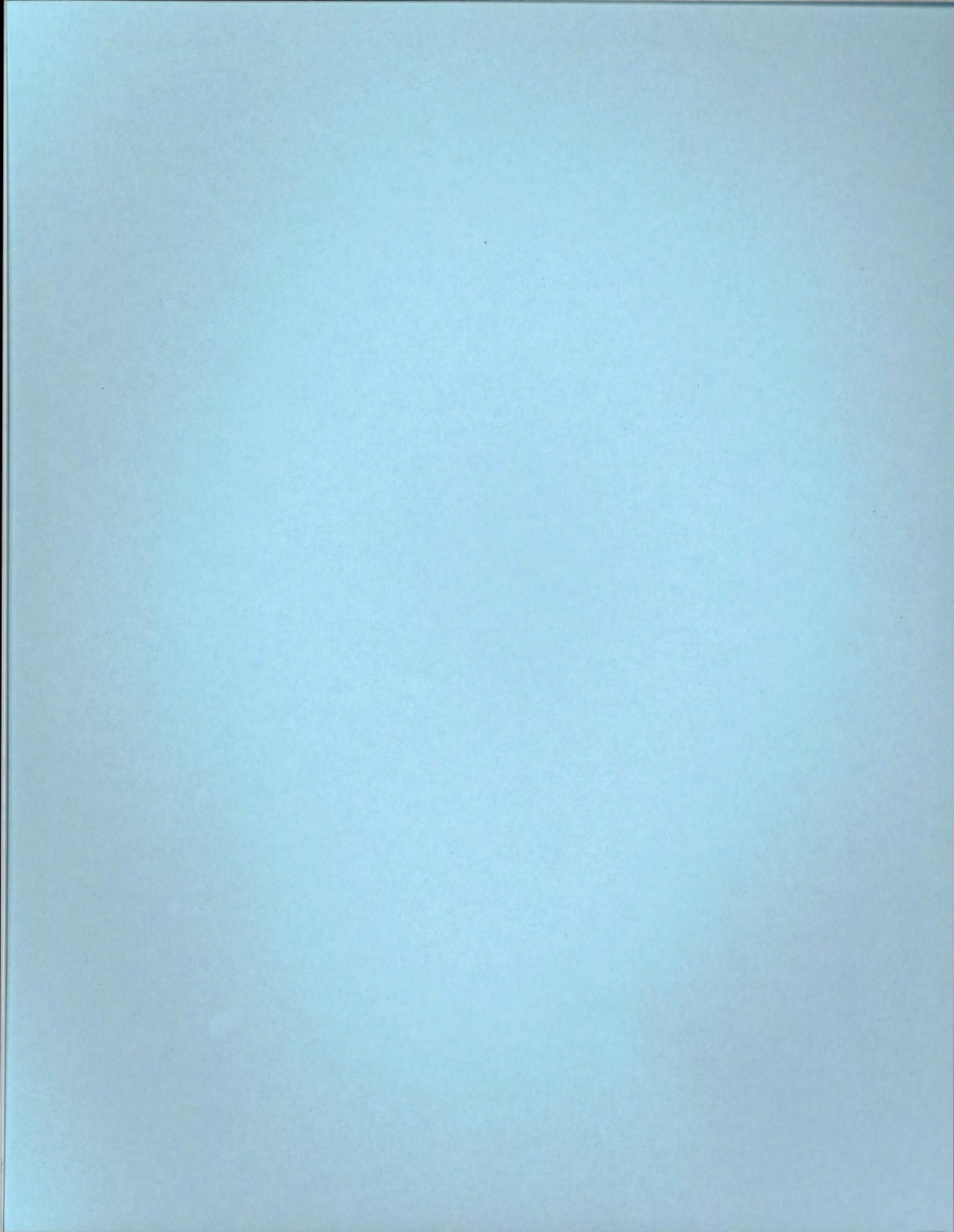
Concerning the financing of the CSFC, the Kenyan authorities explained that, although the total amount to be lent to CSFC was now slightly higher than earlier expected, a large proportion of the total financing (some 65 per cent) would be provided from non-Exchequer sources, by the sale of promissory notes by the CSFC to financial institutions at interest rates significantly higher than those prevailing earlier.

As a result of these policy efforts, the authorities believe that the indicative fiscal and credit targets for the year as a whole might be achieved although at the expense of drastic cuts in development expenditure. They felt that some adjustment in the indicative credit ceilings might be justified because of the large and unexpected financing of the cereal stocks.

The staff responded that an economic case might be made to adjust for the purely seasonal (bridging financing) element of the CSFC lending by the Government, with the proviso that its repayment prior to September 1982 would be explicitly assumed in setting the ceiling for September 1982. The Kenyan officials calculated that out of a total financing need of K Sh 1,120 million of the CSFC, K Sh 220 million was of a purely short-term nature and would be repaid to the Exchequer by end-September 1982. A modification of K Sh 220 million would raise the fiscal deficit for 1981/82 from K Sh 3,952 million to K Sh 4,172 million. In terms of the GDP estimate contained in the stand-by paper this higher deficit would be equivalent to 8.0 per cent compared with a target of 7.5 per cent. In relation to the new and higher GDP estimates, the ratio would be 7.8 per cent. (This compares to a deficit in 1980/81 equivalent to 10.5 per cent of GDP.) Total domestic credit would rise by 21 per cent instead of 20 per cent as in the original program.

I mentioned to the Kenyan officials that I would raise this issue with management and let them know whether an adjustment of K Sh 220 million for purely seasonal crop financing could be accepted. After consulting interested departments we will send you a considered proposal by the staff.

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Mr. Carter





Office Memorandum

cc: Mr. Besenage
Mr. Kareem Hasan
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TO : Acting Managing Director
FROM : J.B. Zulu *JZ*
SUBJECT : Kenya - Review Mission

DATE: April 1, 1982

As indicated in Mr. Karlstroem's back-to-office report (March 17, 1982, attached) the review mission reached understandings on exchange rate, interest rate, and import policies. The credit ceilings for end-January were observed. However, an apparent significant shortfall in foreign aid and an unanticipated lending to the Cereals Board (which is rebuilding stocks after two year of drought) seemed to jeopardize the fiscal target (a reduction in deficit from 10.6 per cent in 1980/81 to 7.5 per cent in 1981/82), and consequently raise the credit ceilings for June beyond the indicative targets set out in the stand-by arrangement paper. These matters have to be resolved in order to conclude the review which is also a precondition for the second drawing under the stand-by arrangement (SDR 30 million) and a drawing (SDR 60 million) under the CFF.

Kenyan officials were supposed to come to Washington on April 2 for discussions of the outstanding issues and to agree on the ceilings for June. The visit to Washington was combined with discussions on a SAL with the World Bank. The Bank now has some internal disagreements about the SAL program and they have called off the discussions with the Kenyan officials. The Permanent Secretary of the Treasury called yesterday and suggested that we settle the outstanding issues under the stand-by review by telephone and cable or, alternatively, that a small mission go to Nairobi for a few days. In the view of the staff, the first alternative is plainly not feasible since the unresolved questions are too complex.

Thus, I propose a brief staff visit of Messrs. Karlstroem (head-
AFR), Simpson (AFR) and Doe (FAD) to spend two or three working days in Nairobi, starting April 5. This staff visit was not anticipated in the current schedule. May I have your approval please.

Attachment

cc: ADM
FAD





Office Memorandum

1) MR. KUNIESA-THASAN
CC: MS. EKEN
B/F
2) ETR FILES

TO : Managing Director
Deputy Managing Director

DATE: March 17, 1982

FROM : B. Karlstrom *BK*

SUBJECT : Kenya - Review of Stand-By Arrangement *BK*

A mission consisting of Mr. Simpson (AFR), Mr. Doe (FAD), Ms. Eken (ETR), Mrs. Heflin (secretary/AFR), and myself visited Nairobi during February 26-March 9, 1982, to review the current stand-by arrangement approved by the Executive Board on January 8, 1982, and to set credit ceilings for June 1982. The review was held to reach understandings on interest rate, exchange rate, import and fiscal policies. The reaching of understandings on these issues was a condition (in addition to the observance of the January 1982 credit ceilings) for the second drawing, of SDR 30 million, under the stand-by arrangement.

The mission verified that the credit ceilings for January were observed. Total domestic credit by the banking system increased at a rate slightly below that projected for the period. While credit to the private sector was practically on target (16 per cent increase from July 1981), the ceiling on credit to central government was met with ample margin to spare. Progress on import policy is being made, and the mission feels that interest rate and exchange rate policies should not be an obstacle to the second drawing. However, uncertainty regarding the financing of cereal stocks and further clarification concerning the amount of foreign grants and loan disbursements (there appears to be a substantial shortfall in foreign assistance) precluded the completion of the fiscal review and the setting of credit ceilings for June.

Furthermore, prior to the mission's arrival a Cabinet reshuffle had replaced, among others, the previous Minister of Finance (also Vice President) Mr. Kibaki. The new Minister of Finance will need to be fully briefed before final agreement in the fiscal area can be reached. Some further work will be done on the Kenyan side and a group headed by the Permanent Secretary of the Treasury will be in Washington in the first week of April.

1. Fiscal policy

Data for the first seven months of FY 1981/82 indicate that both recurrent and development expenditures are running along the lines projected in the stand-by arrangement, as the monitoring and control of expenditure is significantly improved since last year. In this regard, the Fund-sponsored expert who established the fiscal reporting system will return to Nairobi for one month, starting April 4, to help maintain and improve it. Recurrent revenue has performed better than expected and its outlook for the remainder of the fiscal year is in line with our targets.

In contrast with trends in recurrent revenue and expenditure, disbursements of foreign grants and loans are substantially below projections and a shortfall of up to K.Sh. 1.1 billion (SDR 90 million) is tentatively projected for the fiscal year (July-June). ^{1/} As a result of the projected shortfall in external grants, the budget deficit would increase from K.Sh. 3,952 million to K.Sh. 4,248 million, or from 7.5 per cent of GDP to 8.1 per cent of GDP. An adjustment for the shortfall in foreign loans (some K.Sh. 780 million), while not affecting the deficit, would substantially increase the need for domestic financing. Noninflationary domestic financing of this size could hardly be secured. The mission asked for a detailed explanation of the shortfalls (by donors, major projects, etc.). The mission argued that the indicative credit ceilings for June 1982 contained in the stand-by arrangement should be adhered to.

A further increase in the fiscal deficit, not foreseen in the budget, could come from the need to finance a build-up to normal levels of cereal stocks by the Cereals and Sugar Finance Corporation (CSFC). A good harvest after a few years of drought and large imports of maize, warrant the financing of these stocks, which has normally, in the past, been obtained from the Treasury. The mission took the view that the Kenyan authorities should find ways to finance the stock through direct borrowing by the CSFC from nonbank financial intermediaries. The Kenyan officials promised to look into this possibility; they thought that at least some of the financing could be obtained from noninflationary sources.

2. Interest rate policy

In the past two years, there have been a number of interest rate adjustments (the last one in September last year) aimed at keeping lending and deposit rates at a positive level in real terms. Recently, however, the rate of inflation has accelerated from about 11 per cent to an estimated 15-16 per cent in the last quarter of 1981--reflecting the two devaluations of the Kenyan shilling in February and September last year as well as some highly justified increases in administered producer and consumer prices in December 1981. In January 1982, the effective yield on Treasury bills was raised from about 9 per cent to 13 1/2 per cent. The Governor of the Central Bank is concerned about what he considers the current high level of lending rates; however, this view is not shared by the Treasury. Although the present interest rate structure--especially after the recent increase in Treasury bill rates--appears to be adequate, the mission argued that if the rate of inflation remains at present levels, a further upward adjustment will be justified later in the year.

^{1/} The estimate for external grants and loans was made after a consultative group meeting in July 1981 and carefully checked with the IBRD. I am presently in contact with the Bank on this matter.

3. The balance of payments and external policies

The balance of payments outlook for 1982 has now changed substantially after taking into account the lower level of inflows of official capital. While the current account deficit in 1982 is still estimated at below 8 per cent of GDP, or SDR 470 million (compared to a deficit equivalent to 10 per cent of GDP in 1981), a shortfall in net capital inflows of over SDR 120 million from the earlier projections is now foreseen. This will result in an overall balance of payments deficit of about SDR 130 million, as opposed to the near equilibrium projected in the program.

a. Exchange rate policy

After the two devaluations in 1981, the Kenya shilling has become substantially more competitive. However, the higher rate of inflation, if maintained, may well necessitate a further adjustment later in the year. The staff mission took the position that the exchange rate question should be discussed in the context of import liberalization and the abolition of the export compensation scheme (which the Kenyan authorities were unwilling to consider at present). It was agreed that these interrelated questions would be discussed at the time of the next review mission in June (which will also be an Article IV consultation).

b. Import policy

Action so far in the area of import policy can be characterized mainly as a rationalization of a previously arbitrary and inefficient import system. The scope for discretionary decisions and personal interference has been significantly reduced as priorities have been clearly spelled out, along with the new import schedules published in October last year. Imports under Schedule I (no quotas) are processed without delays. The loosening up of the support system is presently constrained by very low foreign exchange reserves. However, the authorities are firmly committed to move 20 per cent of import items from the restricted to the unrestricted list by the end of June (as provided for in the letter of intent). Work has progressed well to identify the items to be shifted. As the items are shifted (probably at the time of the appraisal of the budget in mid-June) tariffs will be adjusted. In this area, therefore, the mission feels that satisfactory progress is being made.

The unresolved issues under fiscal policy need to be clarified further, both on our part (whether to modify, and by how much, for the shortfall in foreign assistance) and on the part of the Kenyan authorities who will provide a detailed account of the reasons for the shortfall. After this information has been obtained, the relevant Departments will be consulted and we will make a proposal to you regarding the future of the program. I should, however, stress that the principal features of the program, including the adjustment in the current account, remain intact.

I hope, therefore, that we will be able to find a solution by the time a group of officials (headed by the Permanent Secretary of the Treasury) arrives in Washington in early April and thus finish the review discussions. The visit of the Kenyan officials to Washington also entails discussions of a second SAL with the IBRD.

The staff has compiled the data concerning a possible drawing under the CFF (a maximum of SDR 60 million which would bring Kenya's use under the CFF to 125 per cent of quota). It is planned to proceed with the CFF request at the same time as the Board paper on the review mission.

cc: CBD
ETR
EXR
FAD
INST
LEG
RES
SEC
TRE

Mr. Carter



KIT
BIF
✓ ETR FILES

WAB
EAM.

INTERNATIONAL MONETARY FUND

FEB 19 1982

Feb. 17, 1982

TO : THE MANAGING DIRECTOR

FROM: WILLIAM B. DALE *WBD* ←

SUBJECT: Kenya - Briefing for Review of Stand-by Mission

I feel this is a satisfactory brief. I recommend approval.

Approved

*W
Feb. 19. 82*



Office Memorandum

TO : Managing Director
Deputy Managing Director

FROM : J.B. Zulu *J.B. Zulu*

SUBJECT : Kenya

DATE: February 17, 1982

Attached for your approval is a briefing paper for the Kenya - Review of Stand-By Arrangement mission. This paper has been cleared with:

ETR - Mr. Beveridge
FAD - Ms. Kelly
LEG - Mr. Silard (by Mr. Surr)
TRE - Mr. Chandavarkar

Att.

cc: Mr. Carter

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

KENYA

Briefing Paper - Review of Stand-By Arrangement

Prepared by the African Department

(In consultation with the Exchange and Trade Relations,
Fiscal Affairs, Legal, and Treasurer's Departments)

Approved by J.B. Zulu and W.A. Beveridge

February 17, 1982

I. Introduction

On January 8, 1982 the Executive Board approved Kenya's request for a one-year stand-by arrangement; the amount was SDR 151.5 million or 146.4 per cent of quota, including SDR 96.8 million, 93.6 per cent of quota, from supplementary financing. Full use of drawings available under the stand-by arrangement would bring Fund holdings of Kenya's currency (excluding those under the oil and compensatory facilities) to 351.9 per cent of quota at the end of the program period (November 30, 1982) after taking into account scheduled repurchases. Following the Executive Board's approval of the program, Kenya drew SDR 60 million on January 4, 1982. At the end of January 1982, Fund holdings of Kenya's currency stood at 252.8 per cent of quota.

In compliance with a performance clause in the stand-by arrangement, a review, with the purpose of reaching understandings on fiscal, import, exchange rate, and interest rate policies, is to be held before April 1, 1982. At that time credit ceilings for June 1982 are to be established. Accordingly, a mission comprising Mr. Karlstroem (head-AFR), Mr. Simpson (AFR), Mr. Doe (FAD), Ms. Eken (ETR), and Ms. Heflin (secretary-AFR) will

visit Nairobi beginning February 26, 1982 for a period of about 10 days to hold the review discussions. The next purchase (SDR 30 million) is contingent on the completion of this review and the observance of the monetary performance criteria for January 1982.

II. Recent Economic Developments

In line with the objectives of the medium-term development program, the Government has taken a series of measures to stimulate production and to improve the domestic allocation of resources. To promote export-oriented output and competitiveness in the domestic manufacturing sector, export prices and imported input costs in domestic currency were increased to more realistic levels through two successive devaluations of the Kenya shilling in February and September 1981, amounting to about 20 per cent in terms of the SDR. Furthermore, the gradual elimination of excessive protection enjoyed by large sectors of the economy was initiated by the introduction of new and more rational import tariff schedules in November 1981, and will continue until quantitative restrictions are eventually replaced by tariffs.

Increases in producer prices for cereals and dairy products in December 1981 were matched by corresponding increases in consumer prices for a number of foodstuffs. In the energy field, the Government has taken measures to increase domestic energy production and to reduce consumption, particularly of imported fuel. To this end, the domestic price of petroleum products was raised by 19 per cent last December, following a previous upward adjustment in July. Finally, interest rates quoted by commercial

banks were increased in September 1981 (for the second time in 18 months) by 1 percentage point on lending operations and 2 percentage points on deposit liabilities. The new maximum deposit rates (11 per cent) and lending rate (14 per cent) are in line with that of other financial intermediaries at home and close to those in competing capital markets abroad.

The program's fiscal policy, aimed at reducing the overall deficit to 7.5 per cent of GDP in FY 1981/82 (July-June), relies mainly on expenditure restraints; the objective is to reduce total public expenditure to 39 per cent of GDP from 43 per cent of GDP in FY 1980/81. To curb the growth in recurrent expenditure, strict government orders limit recruitment into the civil service and abstain from granting general salary increases, while other outlays, mainly in defense and education, are substantially reduced. In the development budget, a list of projects with a high domestic cost component has been drawn up; these projects are either being cut from the 1981/82 budget or postponed to the next fiscal year. Moreover, issues against "token provisions" 1/ are disallowed. To prevent deviations from targets during the implementation of the program, and to control the rate of spending, specific amounts for quarterly allotments are set for both recurrent and development expenditure. Finally and very importantly, a reporting system, devised with the help of Fund technical assistance, enables the Kenyan officials and Fund staff to follow the pace of revenue and expenditure on a monthly basis.

1/ These provisions have no budgetary appropriation other than a token K Sh 200, but they enable the spending ministry to incur an unspecified amount of expenditure which correspondingly increases the initial budgetary appropriations.

III. Scope of the Review

1. Fiscal policy

This should include the
country

Preliminary data for the period July 1981-January 1982 indicate that the actual overall cash deficit of the Central Government was substantially lower than the amount projected in the program. The outcome was mainly based on a successful constraint of total expenditure which was about 10 per cent below the program target for the period; recurrent revenue was slightly higher than anticipated. Although placement of government debt with nonbank financial intermediaries and drawings of foreign loans were running some K Sh 700 million short of planned, the better than anticipated performance of total expenditure appears to have kept bank financing of the deficit some K Sh 700 million (12 per cent) below the ceiling on net bank credit to Government for the end of January.

Monetary data for the 12-month period ended January 1982 show that total domestic credit by the banking system increased ⁷ by 21 per cent, a rate below that projected for the period (24 per cent). The outturn was due to the moderate growth in credit to Government; credit to the private sector (19 per cent) was on target.

At the time of the forthcoming review, the mission will be able to assess the accuracy of the preliminary data for July-January. It will also be in a position to assess the likely fiscal developments in the remainder of the fiscal year. Specifically, the mission will look into the overall expenditure performance, and will assess the effectiveness of constraints on employment in the civil service and public wage and salary increases; targeted reductions in defense and education outlays will also be discussed.

yes

yes

If the review discussions indicate--contrary to developments so far-- that the fiscal targets for the year as a whole may not be reached the mission will advocate further measures to be taken as a condition for further drawings under the stand-by. The mission will argue for an early removal of the export compensation scheme. After the recent devaluation of the Kenya shilling, the retention of this scheme is not economically justified as it represents no appreciable incentive to exporters, while it continues to drain an estimated 2 per cent of total budget revenue. The mission will also review other revenue measures discussed in some detail during the negotiation of the stand-by and measures to ensure that the expenditure targets are realized.

2. Monetary policy

Maximum interest rates quoted by commercial banks have been increased twice during the last year and a half. However, due to the increase in certain controlled consumer foodstuff prices in December 1981 and anticipated further increases in the near future related to higher official prices for farm products, the rate of inflation may well accelerate. The mission will assess, as part of the review of economic policies, if a further adjustment in interest rates is necessary at this time or in the near future. A conclusion on interest rate policy will depend not only on the rate of inflation, but also on the pace of sales of government debt to the nonbank sector, the demand for private sector credit, and the movement of private capital in the balance of payments.

3. External policies

The mission will review Kenya's external position and make an up-to-date projection of the balance of payments for 1982 and determine whether the projected current account deficit is viable in light of revised estimates of export receipts and capital inflows.

The envisaged import liberalization will be discussed in detail and the progress will be assessed. During the period June-October 1981 the Central Bank has taken a rather liberal approach to import policy, as the value of licenses approved during this period was over 45 per cent higher than that for the corresponding period of 1980. In contrast, for the six months preceding the program period (January-June 1981) approvals by the Bank were running 9 per cent below those of the corresponding period of 1980. The import system is presently being monitored through monthly reports on the value of approval of licenses by the Ministry of Commerce and the Central Bank.

The new import schedules put into effect on November 10, 1981, represent a first important step toward the gradual replacement of quantitative restrictions with higher tariffs. Further progress is envisaged later in the fiscal year when 20 per cent of items, the importation of which is now restricted, will be allowed to be freely imported. 1/ The pace of

1/ For items in import Schedule I, licenses are automatically provided and foreign exchange readily supplied; under Schedule IIA importers need to be authorized; under Schedule IIB quotas are specific to each item.

import liberalization depends to a great extent on the availability of foreign exchange. Thus the mission will discuss with the Kenyan authorities which categories of imports are to be liberalized before the end of the fiscal year, with a view to expediting the transfer and easing its supervision. In addition, as part of the import policy review, the mission will ascertain that there are no delays in providing licenses or foreign exchange for items in Schedule I, and that quotas for Schedule IIA are gradually widened.

Following the two successive devaluations of the Kenya shilling in 1981, it is estimated that in real terms, its trade-weighted value as at the end of November 1981 was about one-third lower than two years earlier. The mission will review with the authorities the impact of the exchange rate depreciation on export volume and the demand for imports. In light of this review and the progress in the import liberalization process, the mission will assess the adequacy of the value of the exchange rate.

At the time of the program negotiations balance of payments projections were worked out on the assumption that US\$65 million would be available under the IBRD structural adjustment loan (SAL) within FY 1981/82 and that the Government would raise loans abroad up to US\$160 million on commercial terms. According to information obtained from the World Bank, disbursements from the SAL will take place as envisaged in the program. The mission will review the likelihood of realizing the projected level of foreign loan disbursements. In the event of a shortfall the impact on the balance of payments and the budget will be assessed.

4. Performance criteria

yes

Present indications are that the January performance criteria were observed. If further examination indicates that this is not the case, the mission will inform the authorities that a waiver would not be possible for other than purely technical reasons of a type that would be readily accepted by Management and the Executive Board. If the mission can confirm that the performance criteria have been observed, it will remind the authorities that this is not a sufficient condition for proceeding with the next purchase. The mission will review the adequacy of fiscal, import, exchange rate, and interest rate policies and indicate, on an ad referendum basis, what additional measures, if any, would need to be implemented in order to comply with the original program. These measures will need to be taken before the review paper is submitted to the Executive Board and thus before the next purchase can take place.

As to the establishment of performance criteria for June 1982, the mission may vary the present indicative ceiling of credit to Government if foreign or domestic nonbank financing appear to be less than originally programmed. In the latter case the mission will insist that the authorities raise interest rates on government paper to maximize domestic nonbank financing or that the export compensation scheme be abolished immediately thus reducing the budget deficit and the need for bank borrowing. The mission will in any case establish the ceiling on total credit as a performance criterion at a level consistent with the present indicative target.

5. Possible use of compensatory financing facility

The Kenyan authorities have expressed their intention to request a purchase under the compensatory financing facility. At the end of January the maximum amount available to Kenya under the facility was SDR 60.4 million. The Commodities Division is at present trying to determine Kenya's actual entitlement on the basis of both an export shortfall and an excess of cereal imports in 1981. The mission will collect latest data needed for the calculations. The compensatory financing facility paper would be presented to the Board at the same time as the review paper.

1981



Office Memorandum

TO : Managing Director ✓
Deputy Managing Director

DATE: December 8, 1981

FROM : J.B. Zulu *JR*

SUBJECT : Kenya--Modification of Stand-By Arrangement

The attached Board paper on the Kenyan program has been revised following the staff visit last week to Nairobi. The changes are relatively minor. As explained in Mr. Karlstroem's memorandum (attached), the modifications to the program that you suggested were successfully agreed upon.

Please note that the combination of resources from ordinary and supplementary resources (second sentence on page 1) may be changed pending discussions later today with LEG and TRE Departments.

May I please have your approval of the Board paper? If possible, we will try to issue the paper tomorrow so as to be able to have a Board meeting on December 21 or 23.

The paper has been cleared by:

- FAD (Mr. Yandle)
- ETR (Mr. Beveridge)
- LEG (Mr. Surr)
- TRE (Mr. Chandavarkar)

Attachment

cc: Mr. Carter

INTERNATIONAL MONETARY FUND

B/F
Mr. Beveridge
5-100

December 7, 1981

TO : THE MANAGING DIRECTOR

FROM: WILLIAM B. DALE *WBD* ←

SUBJECT: Kenya - Modification of Stand-by
(back-to-office)

yes | pretty much as
 expected. There may
 will be doubt, however,
 whether the new stand-by
 can be processed and
 approved by the Board
 during ~~September~~ December.
 This needs
 some additional
 time to study
 Dec. 8. 1981

WBD
mb

Center: MD wants
4 weeks for Board
to study this.



Office Memorandum

LEC 7 1981

TO : Managing Director ✓
Deputy Managing Director

DATE: December 7, 1981

FROM : B. Karlstroem *BK*

SUBJECT : Kenya--Modification of Stand-By Arrangement

1. As agreed in a meeting on November 25, I went to Nairobi, together with Mr. Simpson (desk economist for Kenya), for three days in order to change the arrangement from a second year of a two-year stand-by into a new one-year stand-by arrangement. I explained the context in which this change would take place (comparability with other countries, etc.) and the Kenyan officials accepted the proposal after some hesitation. The staff visit was clearly justified: first, to dispel any misunderstandings concerning the change in the format of the arrangement; second to stress to Vice President Kibaki your concern about the fiscal performance; third, to agree on the modifications mentioned below; fourth, to check on the implementation of the fiscal monitoring system; and fifth, to collect remaining data for a possible CFF transaction.

2. Apart from the change in the format of the arrangement, we have agreed on two minor changes of substance:

a. In our preliminary earlier agreement, the first checkpoint for which credit ceilings would be determined was December 31, 1981. In view of the delay in processing the program, the Board discussion is now likely to take place just before the Christmas recess, i.e., only a week before the first checkpoint. In view of this awkward timing, we agreed to shift the first credit ceilings to end-January 1982. The second drawing under the new program will thus be contingent on performance at end-January and the reaching of understandings on exchange rate, interest rates, fiscal and import policy (the last two most importantly). The review to discuss these issues will be held in late February/early March with Board discussion before April 1. Thus, the second purchase will take place toward the end of March 1982.

b. We agreed to phase the purchases over a longer period. Instead of having the last purchase (SDR 61.5 million) based on June 1982 performance criteria plus a review of import policy, that purchase will now be SDR 30 million, with the remaining SDR 31.5 million to be purchased on observance of September 1982 credit ceilings (to be determined in the June/July review mission).

3. Fiscal developments in the period July-October are on track. Total expenditure is marginally below the targets we have worked out with the officials; similarly, revenue is slightly below targets; thus the deficit is under control. The monitoring of fiscal data has improved significantly as a result of the monthly reporting system set up with Fund technical assistance; and, as far as the mission could judge, the expenditure control mechanisms have been substantially improved.

December 7, 1981

4. In a discussion with Vice President Kibaki, I stressed your concern about the fiscal situation in view of the poor performance last year. I also used this opportunity to stress the need for further fiscal measures in order to ensure that fiscal developments remain on track. In this connection, I argued specifically for the early abolition of the export compensation scheme.

5. The Kenyan officials felt strongly that since the economic policy underlying the program is focused on fiscal year 1981/82 (June/July), the policy period which underlies the program should be June 1981-September 1982, rather than a 12-month period starting September or December 1981; they felt that such a starting point would be artificial (as it would differ from the fiscal year); moreover, in some areas data would not be available. However, the stand-by arrangement will, of course, be for 12 months beginning the date of Board approval (tentatively set for December 21, 1981). The last purchase, based on September 1982 performance criteria, will become available in November 1982.

6. The mission also collected further information concerning a possible CFF purchase. Although eligibility has still to be determined by the Commodities Division of the Research Department, it seems possible that Kenya might qualify for a CFF drawing but it is not possible to get a CFF paper out in time for consideration by the Board on December 21. The Kenyan authorities are anxious to have the Board meeting on the stand-by arrangement as early as possible.

7. The revised paper will be sent to you shortly.

cc: ETR (Mr. Beveridge)
FAD (Mr. Tanzi)
LEG (Mr. Surr)
TRE (Mr. Chandavarkar)
Mr. Carter

INTERNATIONAL MONETARY FUND

December 8, 1981

TO : THE MANAGING DIRECTOR

FROM: WILLIAM B. DALE

WBD ←

SUBJECT: Kenya - Modification of Stand-by

As you noted on the back-to-office report, the ~~stand-by~~ require some ^{time for} study by E.D's. Please see the credit program on p. 15 - this could be a point of contention.

INTERNATIONAL MONETARY FUND

Dec. 9/81

Yes

a few additions (p.8 & 25)

And give EDs 4 weeks to look at this very contentious program which comes after a catastrophic 1st year

p.8

In view of the poor performance under the 1st year of the program it was essential that effective measures

before the Board considered any further assistance to Kenya.

p. 25

It is clear that Fund assistance will depend on the effective continuous adherence to these policies.

*you
a few
additions (p. 8 - 25)
And give EDs
4 weeks to
look at this
contentious program
which comes after
a catastrophic
1st year.*

*WBD
Dec. 9.81*

in reaching the targets contained in the financial program for that year, and as a result bank credit to the Government exceeded the program ceilings in June 1981. The main reason for the unexpectedly large budget deficit in 1980/81 was substantial expenditure overruns, partly due to inefficient expenditure controls. A significant general salary increase in the civil service was also a contributing factor. The authorities are very much aware of the need to tighten the fiscal policy stance and, specifically, to improve the system of expenditure controls. Although a reduction in the expenditure/GDP ratio of the size implied in the program will be difficult to achieve, data for the first four months of 1981/82 indicate that total public expenditure has developed as planned. The staff welcomes the assurance that, if these policies are not adequate to contain the fiscal deficit within the target limit, further fiscal measures will be introduced. The nature of these measures has been discussed with the authorities. Provision has also been made for a review, before April 1, 1982, for the purpose of reaching understandings, inter alia, on fiscal policies. The staff feels that these arrangements should help to ensure that the planned reduction in the deficit will be achieved. It also notes the intention of the authorities to reduce further the overall deficit in terms of GDP in the fiscal year starting July 1, 1982.

The planned reduction in domestic credit expansion during 1981/82 is entirely the result of the projected smaller demand for bank credit by the Government. Private sector credit is expected to rise somewhat more rapidly than during 1980/81. To encourage financial savings and improve the allocation of financial resources, the maximum interest rates quoted by commercial

*It is clear that the...
+ bank...
in the...
cost...
adherence...
these pol*



Office Memorandum

MR FINCH

mo

U

TO : Mr. Beveridge

FROM : S. Kanesa-Thasan

SUBJECT : Kenya - Financial Program

DATE: November 27, 1981

A huf m

I am surprised that the memo to the Managing Director of November 25 contains the following statement "As noted in our previous memo of November 23, prior action (not explicitly required in the briefing papers) has been taken on the exchange rate on interest rates and on import policies." The reference to previous briefs is not correct, because such actions were called for explicitly in the brief to the last mission dated August 28, 1981.

cc: ✓ Mr. Finch
Mr. Zulu



INTERNATIONAL MONETARY FUND

Mr. Zulu
Mr. Beveridge

mb
n
wb *hr*

This paper is perfectly clear.
(I think that we should use the same
methods in similar cases.) I
still have a doubt on the "front
loading" aspect. We said in the
last Board meeting that when imple-
mentation was faulty we had to
resort to:

- preconditions (done in this case)
- and to backloading. Here we
have done a heavy frontloading.

JdeL 11/25/81



Office Memorandum

NOV 25 1981

M. Zulu
W.A. Beveridge
... of ...
... think ...

TO : Managing Director
Deputy Managing Director

DATE: November 25, 1981

FROM : J.B. Zulu and W.A. Beveridge *WAB*

SUBJECT : Kenya--Financial Program

1. This is in response to your comments on our note of November 23. Attached is a table and a chart showing the fiscal and current account deficits as percentages of GDP (as you requested). The deviation on the fiscal side was quite substantial in 1980/81, while the external adjustment is largely on track.

2. Your question as to what the credit ceilings for 1981/82 would be if fiscal policy in 1980/81 had been on track is somewhat difficult to answer. A two-year projection of the credit ceilings was not made in the original design of the program because of a large number of uncertainties relating, inter alia, to the flow of external assistance (IBRD loans, etc.). However, in the discussions with the Kenyan authorities, it was indicated that the fiscal deficit for 1981/82 should be of the order of 6 per cent of GDP, i.e., about the same as originally intended for 1980/81 and well below the average for the three years preceding the program (8.3 per cent).

3. It is clearly appropriate to focus on the fiscal performance in 1980/81; it was inadequate even after allowing for exogenous factors. The fiscal weakness has been highlighted in several briefing papers. The position taken in the briefs and in the negotiations has been that if the Kenyan authorities were prepared to take action not only to reduce substantially the fiscal imbalance but also to act on exchange rates and interest rates, as well as on import policies, we would have a defensible program for the second year of the stand-by arrangement. As noted in our previous memorandum of November 23, prior action (not explicitly required in the briefing papers) has been taken on the exchange rate, on interest rates, and on import policies. In addition, we have set up a monitoring system to help the authorities ensure that the fiscal deficit will be reduced to 7.5 per cent of GDP.

4. Regarding attaching performance clauses to government expenditure, we feel that the necessary data to fulfill the requirements of accuracy and verifiability would not be forthcoming. Experience in the two other cases (Chile and Zaire) where a similar approach was attempted, indicates that the information on expenditures simply "disappeared" in the course of the program year. The fiscal monitoring system in Kenya was established to aid officials in implementing budget policies and the attachment of a performance clause to government expenditure as derived through this system would, in our judgment, place too great a strain on a newly functioning system, possibly resulting in its "disappearance" while involving the Fund in unproductive arguments regarding the classification and timing of government transactions. Performance ceilings on expenditures could easily be met by the accumulation of payments arrears. While the same argument can be made with regard to credit ceilings, it has more force in the case of expenditure ceilings in that the policy options

available to the authorities to meet expenditure ceilings are more limited than in the case of credit ceilings. Imposition of an expenditure ceiling might well result in an accumulation of arrears.

We are greatly concerned about implementation of expenditure policies. We will impress your concerns again on the authorities and will monitor the data, to be received monthly from Nairobi, with great care. Expenditure trends and policies will be a focal point of the February review mission.

We would therefore advise against the use of binding ceilings on government expenditure.

**
P. 10
5. We feel that in view of the significant actions already taken, the program is viable and should be supported by SDR 151 million (146 per cent of quota). You raised a question about the SDR 60 million to be drawn upon Board approval. Such an amount representing 40 per cent of the total purchases would be in line with the guidelines on phasing. Moreover, this amount is also justified so as to provide the authorities with foreign exchange in the context of the import liberalization they have now announced.

6. If your concerns about this program are not resolved, a possible alternative might be to cancel the present two-year arrangement and have the program, as now negotiated, support a one-year stand-by arrangement. This one-year arrangement would go beyond the present fiscal year (July 1-1981-June 30, 1982) and the amount would be the same as now proposed with SDR 60 million available upon Board approval. The letter of intent has been signed, on the assumption that we were going into the second year of the program. The letter, as well as the paper for the Board, will need some changes and modifications in case you decide in favor of cancellation. If you consider this alternative approach preferable, we would plan for Mr. Karlstroem and Mr. Simpson (both AFR Dept.) to go to Nairobi for a few days on an urgent basis.

7. This memorandum has been cleared with FAD.

Attachments

cc: Mr. Finch
LEG
TRE
FAD
Mr. Carter

** This guideline is not a prescription. The advantage of backloading in the case of a bad performing country is to keep it under firmer control.

Table 1. Kenya: Overall Fiscal Deficit
(In per cent of GDP)

	<u>Fiscal year 1980/81</u>		<u>Fiscal year 1981/82</u>	
	Original program	Actual	Original program	Program for 2nd. year
Overall fiscal deficit	5.9	10.6	(6.0) <u>1/</u>	7.5

Table 2. Kenya: Current Account Deficit of the Balance of Payments
(In per cent of GDP)

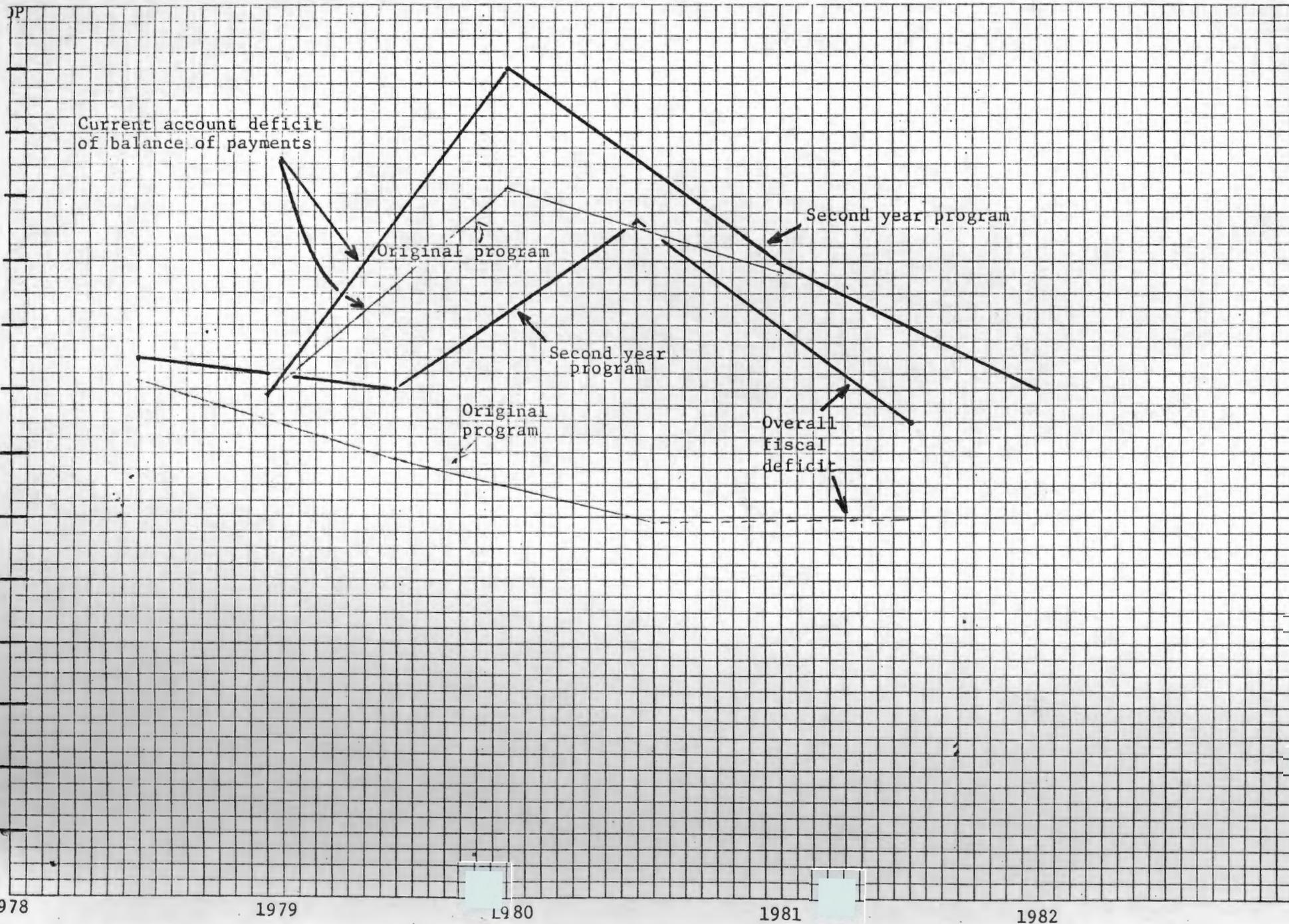
	<u>1980</u>		<u>1981</u>		<u>1982</u>	
	Original program	Actual	Original program	Revised projection	Original program	2nd year program
Current account deficit of the balance of payments	11.2	13.0	9.7	10.0	...	8.0

Sources: EBS/80/215; Economic Survey 1980; and staff estimates.

1/ This figure was not explicitly contained in the Board paper, but a deficit of this order of magnitude was mentioned in our discussions with Kenyan officials.

cent

Chart 1. Kenya: Overall Fiscal Deficit and Current Account Deficit of the Balance of Payments





Office Memorandum

TO : Managing Director
Deputy Managing Director

FROM : J.B. Zulu and W.A. Beveridge

SUBJECT : Kenya--Financial Program



DATE: November 23, 1981

You have raised substantive matters in relation to this program and we are replying in some detail.

1. Fiscal policy

We have been deeply concerned throughout the negotiation for the second year of the program, which have been going on since June, about the shortcomings of fiscal policy, specifically expenditure policy. There have been serious efforts to curb government expenditures while negotiations proceeded to complement a sizable exchange rate change (20 per cent in 1981), a liberalization of the import system and a significant increase in interest rates (which are now positive in real terms). The Government presented its budget in June 1981 indicating a reduction in the overall deficit for 1981/82, as a percentage of GDP to 5.5 per cent compared with the outcome of 10.6 per cent in 1980/81. In our judgment this was not a realistic projection and after considerable further discussion and additional measures, we concluded that the deficit could reasonably be held to 7.5 per cent of GDP, including allowance for supplementary expenditures. We do not regard the fiscal position as unsustainable but we do expect a further reduction in the size of the deficit in 1982/83; the authorities have committed themselves to do this in the letter of intent. Balance of payments projections indicate reductions in the current account from 13 per cent of GDP in 1980 to 10 per cent in 1981 and 8 per cent in 1982. The projections suggest a small overall external surplus in 1982.

A major problem is to have the necessary implementation of policies so as to restrain the budget deficit in 1981/82 to 7.5 per cent of GDP. We did not opt for the attachment of performance criteria to government expenditures for two reasons. First, fiscal data are not sufficiently precise for their unambiguous use in connection with binding ceilings. Second, use of such criteria on government expenditure would be quite exceptional in Fund practice and in our opinion, could not be regarded as a macro variable in the sense used in the Guidelines on Conditionality.

Rather, we embarked on another course. With Fund technical assistance, the authorities have established a system whereby they monitor fiscal developments each month. These data are reported to us promptly, and by this means we know that fiscal trends are on track in the July-September period and specifically that expenditures are running below estimates. Further, a specific list of expenditure projects has been identified which provides the basis for cutbacks in outlays or for postponements into 1982/83. The authorities have undertaken to introduce further fiscal action by the end of 1981, if budgetary developments are not satisfactory.

*Final
9/20/81
Credit*

MB

MB

MB

MB

MB

1

To support this monitoring and control, a review as a performance clause will take place in late January 1982 to focus on economic policies and specifically on fiscal policy. The purchase from the Fund, scheduled after the initial one, will be governed not only by the December 1981 performance criteria but also by the satisfactory completion of the February review. If fiscal, or other developments are not proceeding as programmed, we will insist on further substantive measures, including termination of the export compensation scheme.

In our judgment, this procedure provides adequate assurances to the Fund and does not carry with it the disadvantages of applying performance clauses to specific aspects of government operations.

2. Amount of arrangement

Regarding the amounts to be purchased, the total amount of the arrangement (over two years) is SDR 241.5 million (233.3 per cent of quota), of which SDR 90 million has been purchased. The last purchase under the first year's program (SDR 30 million) was not effected since the credit ceilings were exceeded in June 1981. In the briefing paper of August 28 and back-to-office report of September 22, it was stated that if we could reach agreement on a viable program for 1981/82, the backlog of SDR 30 million would be included in the second year's purchases. This is in line with current policy and it has been the basis underlying our negotiations with the Kenyan authorities.

You will notice from the attached table (which will be incorporated into the paper) that the phasing for the second year has been backloaded to a degree, as compared with the original phasing. SDR 30 million has been held back until after June 1982 and the last purchase of SDR 61.5 million could only be purchased after observation of the June 1982 performance criteria which will be set in the February 1982 review and after the transfer of 20 per cent of import items to the "free" list.

Since the time the briefing paper was approved, ETR has been having discussions with area departments on these phasing matters as well as a range of current conditionality problems. An internal paper is at present under discussion with area departments and Mr. Finch has indicated that he hopes sufficient consensus could be reached within the staff for this paper to be sent to you by early December.

There are strong grounds for going ahead on the Kenyan case without prejudice to the outcome of the internal review. These are:

- a. in our judgment, the second year program is viable and incorporates adequate safeguards for the Fund.

b. our negotiations with the Kenyans have been based on the availability of the SDR 30 million of interrupted purchases.

c. the Kenyan decision to go ahead with import liberalization in the face of deteriorating terms of trade and internal bureaucratic disputes over import policy was predicated on the availability of foreign exchange from the Fund; and

d. the present phasing for the second year of the program involves stretching out of an additional SDR 30 million of purchases until the end of the second year of the program.

Attachment

cc: Mr. Finch
LEG
TRE
FAD
Mr. Carter

Table 1. Kenya: Schedule of Purchases under Stand-By Program

(In millions of SDRs)

By end of period		Original Phasing for First-Year Program <u>1/</u>	Actual Drawings During First- Year Program	Proposed Phasing for Second- Year Program <u>1/</u>	Total Draw- ings Under Program
1980	October	30	30		30
	November	30	--		--
	December	--	30		30
1981	January	--	--		--
	February	30	--		--
	March	--	30		30
	April	--	--		--
	May	--	--		--
	June	--	--		--
	July	--	--		--
	August	30	--		--
	September	--			--
	October	--			--
	November	(30) <u>2/</u>			--
	December	--		60 <u>3/</u>	60
1982	January	--		--	--
	February	(30)		--	30
	March	--		30	--
	April	--		--	--
	May	(30) <u>2/</u>		--	--
	June	--		--	--
	July	--		--	--
	August	(31.5) <u>2/</u>		61.5	61.5
	Total	<u>241.5</u>	<u>90</u>	<u>151.5</u>	<u>241.5</u>

Sources: Phasing in the stand-by arrangement; and data provided by the Treasurer's Department.

1/ Assuming a lag of around six weeks for reporting observance of quarterly ceilings. Phasing of purchases for the second year of the stand-by arrangement had not been legally specified in the stand-by arrangement.

2/ Indicative.

3/ Upon approval of second-year program.





Office Memorandum

TO : Mr. Karlstroem

DATE: September 24, 1981

FROM : S. Kanesa-Thasan

SUBJECT : Kenya - Second Year Program

My principal reactions to your debrief on the Kenya mission are as follows:

(a) The action taken on the exchange and interest rates is an important step forward. I would suggest that we urge the Kenyan delegation to eliminate the export subsidy and to increase somewhat the export tax on traditional exports. Both measures were proposed by the staff on earlier occasions. I think that there is substantial justification for such measures, not least given the large remaining fiscal gap (see below).

(b) Although you mention that the budget deficit will be contained within 7 per cent of GDP in 1981/82, I seriously doubt this being attainable without immediate additional measures of the kind referred to in (a) above. Since the Kenyans themselves intend to contain the deficit within the proposed level, the staff should point out to them that unless appropriate measures are taken now we would soon have a problem with performance criteria not being observed.

(c) As for import policy, you state that the mission has "moved toward a workable compromise." In view of the importance attached in the program to this area and the very specific instructions from the management (memorandum to Managing Director of August 28) I would like to know how you plan to formulate the action to be taken in this area. As mentioned to you prior to your departure to Kenya, we may have problems if we focus exclusively on the number of items to be shifted to the less restricted classification.

(d) I understand from Mr. Silard that a formal waiver of June performance criteria can be avoided, when we reach agreement on the second year program.

cc: Mr. Zulu
Mr. Beveridge
Mr. Zervoudakis

Margaret
6-208A

INTERNATIONAL MONETARY FUND

Sept. 22, 1981

TO : THE MANAGING DIRECTOR

SEP 23 1981

FROM: WILLIAM B. DALE *WBD*

SUBJECT: Kenya - Program Negotiations (back-to-office)

This report, in my view, contains good news. I think Mr. Karlstrom and his colleagues have done a good negotiating job which, on the face of it, appears an effective one

(W. Dale
N. Karlstrom)
I would like to visit, before any waiver, or getting the final situation covered

JL
Sept. 24. 81.



Office Memorandum

1981/22

TO : Managing Director
Deputy Managing Director

FROM : Bo Karlstroem *BK*

SUBJECT : Kenya--Program Negotiations

DATE: September 22, 1981

A mission comprising of Mr. J. Jimenez (AFR), Ms. M. Kelly (FAD), Messrs. J. Simpson (AFR), E. Zervoudakis (ETR), Mrs. B. Livsey-Coates (AFR-Secretary), and myself visited Nairobi from September 4 to 15, 1981, to negotiate a financial program for the second year of the current stand-by. The total arrangement is for SDR 241.5 million (233.3 per cent of Kenya's quota). Of this amount, SDR 90 million has been purchased.

The discussions took place against the background of a weak performance--particularly on the fiscal front--during the first year of the program, and a critical Board discussion at the end of August of the Article IV consultation discussions with Kenya. The Board discussion supported the major points of the mission's brief, in particular the need for strong fiscal adjustment, a depreciation of the Kenya Shilling (preferably as a prior action), a need for a further rise in interest rates, and a move toward a more market-oriented import policy.

The discussions in Nairobi were constructive and we made substantial progress, especially on two of the most sensitive issues, the exchange rate and interest rates. The authorities requested additional time to review the fiscal and monetary data, but basic agreement has been reached on the fiscal target for 1981/82 (June-July). The most protracted discussions related to the exchange rate question. After several meetings with the Vice-President, who is also the Minister of Finance, the Governor of the Central Bank and senior officials, agreement was reached and a depreciation of 15 per cent (in foreign currency terms) was announced last Friday. A further two percentage point increase in deposit interest rates and an increase of one percentage point in other rates was also announced at the same time. Interest rates have now been raised by five percentage points in the past year and a half. Despite the scarcity of foreign exchange (at K Sh 2.4 billion, reserves are well below what the authorities consider a safe minimum), I believe we have moved towards a workable compromise in import policy.

The main issue that is still not entirely settled is that of fiscal policy. My strong impression is that the authorities have accepted, in principal, the mission's proposal to reduce the budget deficit from the equivalent of 11 per cent of GDP in 1980/81 to around 7 per cent in 1981/82. However, to achieve this adjustment may well require further fiscal action, not only through improved expenditure controls (where progress is being made, in part with IMF technical assistance) but possibly also through further revenue measures; a list of possible measures was prepared by the mission and given to the Kenyan officials. They felt that revenue measures in the course of the fiscal year were politically very difficult to take, but they would study the mission's proposals. The mission also prepared and discussed

.../...

with the Kenyan officials a memorandum on fiscal policy, listing what kind of budgetary information which the staff would need to monitor the program. The issues in this memorandum were agreed with the Kenyan officials.

The proposed fiscal adjustment and the credit ceilings for December 1981 are presently being studied by the Kenyan authorities (credit ceilings for June 1982 will be set at the time of the review mission in February 1982). In view of the measures already taken, I feel that we might show some flexibility in setting the December 1981 ceilings by allowing a slight "margin of error" in forecasting budget and credit developments during the first half of the fiscal year.

To bolster gross reserves in the short run, and thus permit a gradual, albeit slow, movement to a more rational import policy, the Kenya Government is raising a \$100 million Eurodollar loan (which would justify being accommodated under the external debt ceiling); it will also rely heavily on the remaining IMF drawings (totalling SDR 151.5 million over the next 12 months) and a second structural adjustment loan from the IBRD, which is now being negotiated. In the medium term, the exchange rate measure, together with the other parts of the financial program described above, should strengthen the underlying balance of payments position, ease the foreign exchange reserve constraint, and permit further improvements in the import system.

The discussions will resume at the time of the Annual Meetings. The outstanding issues relate to the possible need for further fiscal measures, the December credit ceilings, and the treatment of the export compensation scheme (the mission argued for its abolition at the time of the depreciation but we have not had any news on this front). There is, in my opinion, a good likelihood that these remaining issues will be settled and that a letter of intent will be signed. On the basis of the financial program for 1981/82 we would then request a waiver for the June 1981 credit ceilings which were exceeded.

cc: CBD
ETR
FAD
INST
LEG
EXR
RES
SEC
TRE
Mr. Watson

cc: Mr. Kanasa - Kasar

INTERNATIONAL MONETARY FUND

AUG 31 1981

N. Zuber

Aug. 31, 1981

TO : THE MANAGING DIRECTOR

FROM: WILLIAM B. DALE

SUBJECT: Kenya - Second year
of Stand-by.

I believe the
prop is appropriate
and in accordance
with the Board's
discussion. I
recommend approval.



*See v. 2
jr
See v. 2 - 81*



Office Memorandum

TO : Acting Managing Director

DATE: August 28, 1981

FROM : J.B. Zulu

SUBJECT : Kenya--Negotiations of Second Year Program

As indicated in Mr. Karlstroem's back-to-office report (July 27, 1981) the discussions held with the Kenyan authorities between June 18 to 26 were inconclusive, as there was uncertainty on the final outturn of the 1980/81 budget and, therefore, agreement on budgetary policies for 1981/82 could not be concluded. Moreover, the authorities were not prepared at that time to commit themselves on the import and exchange rate policies which were proposed by the mission. The authorities requested that discussions continue in early September. Following Governor Ndegwa's recent visit to the Fund, the timing of the start of the mission (already approved) for September 4, 1981 was confirmed. The Governor expressed the view during his visit that the Kenyan authorities were not against exchange rate action, but were concerned with the timing and magnitude of any recommendation in this field. The Acting Managing Director responded that action in this area was urgently needed, especially as the export compensation scheme was not functioning as intended. He stressed that the agreed measures should begin to be implemented prior to the consideration of the program by the Executive Board.

The mission will continue to be guided by the briefing paper dated June 10, 1981 which set the guidelines for the last mission. However, in certain areas developments have been somewhat different than anticipated in that brief and, therefore, certain adjustments are proposed with respect to the program. The principal issues requiring adjustment are the following:

1. Financial developments and policies

According to recently received information, the ceilings on both total domestic credit and net credit to the Government were exceeded at the end of June (earlier ceilings had been observed). The principal source of the rapid credit expansion was an unexpectedly large budgetary deficit. At the time of the June mission, fiscal data for 1980/81 were incomplete and there was not full appreciation of the extent of the deterioration of the budgetary situation. The mission had estimated the overall deficit for the 12 months to June 1981 at K Sh 3.5 billion, equivalent to 7.5 per cent of GDP compared to a program target of 5.0 per cent. The June brief authorized the mission to accept a budgetary deficit for 1981/82 no larger than 5.0 per cent of GDP.

However, the overall fiscal deficit in 1980/81 widened further to K Sh 5.1 billion or about 11 to 12 per cent of GDP mainly as a result of large expenditure overruns. Even allowing for the impact, mostly through revenue loss, of developments outside the control of the authorities, the figures reveal that there has been a serious deterioration in the underlying

X axis by the discussion in the Board in Aug 31

budget situation, which the authorities readily admit. According to the budget for 1981/82 presented to the Government in June, the deficit will be limited to about 5 to 6 per cent of GDP. However, the staff is convinced that the budget estimates are unrealistic in that expenditures are considerably underestimated. The mission will urge that the Government takes specific measures to make the budget estimate of the deficit credible. Given the size of the budget gap in 1980/81, it would indeed be unlikely that the authorities will be able to lower the deficit ratio to their declared level of 5 to 6 per cent, unless there were substantial expenditures of a nonrecurring nature incurred in 1980/81. The mission will examine the 1980/81 budget results closely and provide, in any event, for a minimum reduction of 4 per cent in the deficit/GDP ratio in 1981/82. This implies a deficit in 1981/82 of no more than 7 to 8 per cent of GDP. For this purpose, it would be necessary to take further measures restricting expenditure growth and tax/price increases (for example in the petroleum area). For such an adjustment to be effected, clearly actions have to be taken as early as possible in the current fiscal year; in any case, they would have to be in place before the Executive Board discusses the program. Also, as indicated in the previous brief, the mission will seek assurances on additional specific measures to be implemented in the course of the financial year, if it were to become apparent that the overall deficit is likely to exceed the program target. These measures will be agreed in an appropriate form. Given the authorities' expectations in foreign borrowing (including Eurocurrency and the effect of the proposed depreciation) and nonbank financing, which the staff considers reasonable, the bank financing required for the proposed deficit could be accommodated within the projected 19 per cent increase in the banking system's net domestic assets, without crowding out the private sector. Eurocurrency borrowing beyond the level assumed in the program will need to be covered within the credit ceilings.

The mission will also press for further action in regard to interest rates, especially on deposits to be in place prior to Board discussion of the program.

2. Exchange rate

In the 12 months to May 1981, the real effective exchange rate depreciated by 7 per cent, mostly as a result of the 5 per cent change in February, but also as a result of the strengthening of the dollar which has continued in recent months. In its previous brief, the mission had been authorized to request, as a preferred solution, a depreciation of 10-20 per cent in conjunction with the abolition of the export compensation scheme at this time. Given the previously mentioned trends in the real effective exchange rate and the strong political resistance to abolish the export compensation scheme at this time, if necessary the mission will accept the continuation of the export compensation scheme and a depreciation in the lower half of the previously authorized range. The mission will require that exchange rate action be taken prior to the Executive Board's consideration of the program.

also future flexibility, as mentioned in this morning's Board meeting.

Try and limit the loss to the possible to pay
yes

I had understood that we must at a sign of further step should be taken in the year of the Board members

3. Import system

yes | Sufficient technical progress has been made by the authorities to start the implementation of the new import system involving a shift from quantitative restrictions to import tariffs. The mission will insist that a substantial part of the program be in place prior to the Executive Board's consideration of the program and that there be prior agreement on a schedule for the full implementation of the import program. The early implementation of the new import system will also boost revenue collections.

4. Review of the program

The June briefing paper called for a review of the program prior to the end of December at which time progress in implementing external and budgetary policies would be assessed and the credit ceilings for the remainder of the program set. It is now proposed that a review be carried out in February, when full data for calendar year 1981 will be available. Under this procedure, the last two drawings under the stand-by arrangement (totaling SDR 61.5 million) would be purchased only after the review was undertaken and the credit ceilings for the remainder of the program (March and June) agreed.

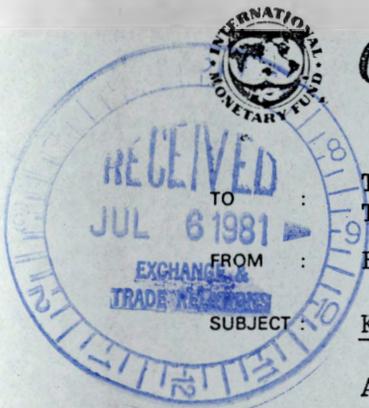
This note has been cleared with Messrs. Beveridge (FAD), Kanesa-
Thasan (ETR), and Surr (LEG).

cc: Managing Director (on return)
Mr. Beveridge
Mr. Kanesa-Thasan
Mr. Surr
Mr. Watson



Office Memorandum

cc: Mr. Hockney
Mr. Kanasc. Masar
Mr. Zervoudakis



TO : The Managing Director (on return)
The Deputy Managing Director

DATE: July 2, 1981

FROM : Bo Karlstroem

SUBJECT : Kenya: Standby Negotiations

A mission consisting of Mr. Jimenez (AFR), Ms. Kelly (FAD), Mr. Zervoudakis (ETR), and myself visited Nairobi, June 18-26, 1981 to negotiate a program for the second year (beginning July 1) of our standby arrangement with Kenya. Under the first year of the program SDR 90 million (out of a total SDR 241.5 million) has been purchased. The last purchase under the first year program (on the basis of June 1981 performance criteria) would be available in mid-August.

The mission had very useful discussion with all the relevant officials. I saw the Governor of the Central Bank, Mr. Ndegwa, on several occasions, discussing in particular the exchange rate question with him. I also had a long meeting with the Vice President, the Hon. M. Kibaki who took time out from the OAU conference which coincided with our stay in Nairobi.

Financial policies in 1980/81 (year ending June 30) have not been stabilizing and have deviated substantially from the program; moreover, the implementation of the medium-term adjustment policies is lagging. According to the mission's calculations, the budget is likely to be at least twice as large as assumed in the program (equivalent to some 10-12 per cent of GDP instead of 5-6 per cent), and as a result, the ceiling on credit to the Government is likely to be broken by a significant margin. It is possible that the ceiling on overall domestic credit will also be exceeded due to the estimated sharp increase in government credit. However, the Kenyan officials were optimistic about the outcome of the 1980/81 budget (for which data are not yet available) hoping for large revenue gains towards the end of the fiscal year (offsetting some of the substantial arrears on the expenditure side) and thus a smaller fiscal deficit. In the meantime, the budget for 1981/82 has been published, showing total expenditure 4-5 per cent lower than that estimated by the staff for 1980/81; this together with some taxation measures would bring the deficit back to about 5-6 per cent of GDP. Although this would seem to be an acceptable basis for a financial program, the mission felt that in view of the large discrepancy between the staff's and the Kenyan officials' estimates of the outcome of the 1980/81 budget, particularly relating to the expenditure level, it could not, at this stage, judge whether the new budget proposals are realistic; it would therefore be unwise to negotiate a financial program based on such uncertain premises. We would again run the risk of presenting a program to the Board which, although attractive on paper, would not be implemented.

Moreover, there is a review provision in the letter of intent concerning Kenya's import policy; this calls for reaching understanding before entering into the second year program. This review clause was included to ensure that the gradual move from the highly restrictive import license system towards a tariff protection would finally get started. It is doubtful, in the mission's judgment, that any progress has been made in this field--apart from the technical preparations of new and more rational import schedules. The political consensus seems to be lacking when it comes to implementing the new system; this is partly, but not entirely, a reflection of continued low levels of reserves which does not permit too much experimentation with the import system at this point.

Thus, on the basis of the uncertainty concerning fiscal and import policy, I decided that the best course of action would be to wait with further discussions until the monetary and fiscal situation in 1980/81 is clearly documented, while indicating to the Kenyan authorities what actions would be expected (in fiscal, credit, import and exchange rate areas) for a convincing program for the second year. A draft letter of intent was left with Kenyan officials as a basis for further discussions. They suggested that discussions be resumed in early September.

The medium-term program of adjustment published last year and to a large extent underlying the standby program has not been implemented as intended. A few measures have been taken: the exchange rate was depreciated by 5 per cent in February this year, interest rates were raised by 2 percentage points in June, and the budget introduced a number of tariff increases--the latter as part of the switch towards tariff production but not significant enough to allow a relaxation of quantitative restrictions.

The economic situation in Kenya, although not acutely serious as yet, will deteriorate rapidly if further adjustment measures including a further depreciation are not taken soon. The balance of payments situation is very weak; terms of trade have declined substantially and are not likely to improve over the foreseeable future; the growth in export volumes is fairly slow, foreign exchange reserves are low (about two months of imports) and declining, and the Governor mentioned that a large portion of the reserves are already "tagged" for imports that have already entered Kenya (no formal payments arrears have yet developed). There is a definite risk that the gradual movement towards a more open and efficient import system (which the Kenyan authorities have publicly endorsed at the Cabinet level) will be delayed for fear of further loss of reserves. In this situation, we did not discourage suggestions that the Government go ahead with a proposed Euro-currency loan; however, some officials were hesitant to borrow abroad at present high interest rates. The debt service ratio is presently about 12 per cent and is likely to rise over the next few years as a previous Euro-currency loan begins to fall due; however, there is no risk at present, of an unmanageable foreign debt burden.

The external current account deficit may decline slightly from 12 per cent of GDP in 1980 to about 10 per cent in 1982. However, the need for balance of payments export remains large, and the Kenyan authorities are

counting on Fund resources as a major source of this financing. Moreover, the IBRD is presently negotiating a second structural adjustment loan. The Vice President stressed that if these sources of finance are not available in time, the intended shift in the import system can not take place, and economic growth will have to be curtailed.

A consultative group meeting is planned for July 28-29 in Paris. In our statement for that meeting we will stress that discussions for a 1981/82 program have started and that we expect to conclude an agreement soon. It is important--both to Kenya and the Fund--to ensure that confidence is not negatively effected by the interrupted negotiations.

cc. Mr. Watson

CBD
ETR
EXR
FAD
INST
LEG
RES
SEC
TRE



MR KANESA-THASAN
CC: 'BLUE FOLDER
ETR FILES

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

KENYA

Briefing Paper - Use of Fund Resources:
Negotiation of the Second Year Program

Prepared by the African Department and the
Exchange and Trade Relations Department

(In consultation with the Fiscal Affairs,
Legal, and Treasurer's Departments)

Approved by J.B. Zulu and S. Kanesa-Thasan

June , 1981

I. Introduction

As indicated in the briefing paper for the 1981 Article IV consultation with Kenya held in April, a mission was to return to Nairobi in June to negotiate the financial program for the second year of the current stand-by arrangement. Accordingly, a mission comprising Messrs. Karlstroem (head-AFR), J. Jimenez (AFR), Ms. M. Kelly (FAD), Mr. E. Zervoudakis (ETR), and Miss O. Kanchanadul (secretary-AFR) will visit Nairobi beginning June 18, 1981 for a period of about ten days. Mr. Kanesa-Thasan (ETR) will participate in some of the discussions.

On October 15, 1980 the Executive Board approved Kenya's request for a two year stand-by arrangement for an amount equivalent to SDR 241.5 (233.3 per cent of present quota), including SDR 184.4 million (178.4 per cent of present quota) from the supplementary facility. Full use of the drawings available under the stand-by arrangement would bring Fund holdings of Kenya currency to 409.3 per cent of quota by August 30, 1982, after taking account of scheduled repurchases. Kenya has drawn SDR 90 million under the arrangement; SDR 151.5 million remain to be utilized. The mission will discuss with the authorities

the possibility of reapportioning the resources under the arrangement in order to reflect Kenya's new quota.

A summary of relations with the Fund is attached.

II. Recent Economic Developments

Since 1978 Kenya has faced difficult economic and financial problems. Rising prices for imported energy coincided with a major reduction in export prices, particularly for coffee. Economic growth has stagnated, while domestic price increases have accelerated. As a result of the intensification of import and payment restrictions and an increased inflow of short term capital, following the requirement that certain imports be financed by mandatory 90-100 day suppliers' credit, the balance of payments was temporarily in surplus in 1979. However, the underlying balance of payments situation remains weak and the heavy reliance on import restrictions is hindering the efficient allocation of domestic resources. Moreover, fiscal policy has tended to be generally lax and to undermine the Government's demand management policies. Although some progress was made in fiscal year 1979/80 (July/June) in reducing the central government's overall deficit, particularly the domestically financed portion, it remained high at about 5 per cent of GDP.

In 1980 Kenya's economic and financial situation worsened partly as a result of drought conditions and also reflecting the world recession. The Kenyan authorities recognized that the unfavorable situation required wide-ranging reforms, designed to improve the economic performance in the medium term. Consequently, in 1980 the Government launched an economic program aimed at correcting long-term

structural problems while, at the same time, limiting the impact of the expected short-term economic disturbances. The Government proposed a program in mid-1980 to establish an export-oriented policy, which would raise export earnings, reduce non-essential imports, while promoting the efficiency of domestic industries through a reduction in external protection. The Government also proposed to utilize monetary and fiscal policies to limit domestic demand and the foreseen medium-term balance of payments deficits. To this end, the Government set targets for the balance of payments and budgetary deficits and domestic bank credit expansion. The Fund supported these objectives through a two-year stand-by arrangement.

Of major importance to Kenya's medium-term development strategy was the governmental decision to replace quantitative restrictions and related import licensing by tariffs. The Government sought in this process to reduce the excessive protection which had been given to industry in the first decade of independence and to rationalize the protective system. Apart from reducing quantitative restrictions, the Government would aim at establishing a coherent tariff structure which would promote these objectives in the industrial sector while, through the use of an import surcharge in conjunction with an export compensation scheme, provide the equivalent of an estimated 10-15 per cent depreciation of the exchange rate. The new policy would attempt to make Kenyan industry outward-looking and competitive in order to aid in the improvement of the balance of payments and to generate additional economic development.

The proposed package was only partially implemented in 1980. Initially required for the introduction of the new policy stance was a thorough review of

the import system and the establishment of new and comprehensive import schedules. The work on these elements was delayed and only recently have the new import schedules been finalized. Pending their introduction, the import system was managed on an ad hoc basis, in order to limit speculation by importers and minimize the loss of foreign exchange. Administrative interferences created a shortage of raw materials and spare parts, further negatively affecting the productive sectors. Moreover, from the experience so far, it appears that the export compensation scheme is not working satisfactorily. The volume of exports has not responded despite an increase in the premium from 10 to 20 per cent, and the range of goods being processed under the scheme has hardly been extended, even though that was an important part of the new policy. This lack of response is partly due to payment delays to exporters and other bureaucratic inefficiencies. The balance of payments came under increasing pressure in 1980, the current account deficit is estimated to have risen to the equivalent of 12 per cent of GDP in calendar 1980 against 8 per cent in 1979. Despite SDR 132 million of longer-term balance of payment support obtained during the year, including the final disbursement of SDR 76 million of a Eurocurrency loan and SDR 56 million from a structural adjustment loan from the World Bank, the overall balance of payments deficit in 1980 reached SDR 143 million, or 3 per cent of GDP. At the end of the year, gross foreign assets of the Central Bank had fallen to SDR 376 million, equivalent to about 10 weeks of 1980 estimated imports. A further decline was recorded in the first quarter of 1981. Debt service on external public debt, which was 7.8 per cent of export earnings in 1980, has grown rapidly but remains manageable and is expected to reach 11.5 per cent in 1981.

The overall expansion of the banking system's net domestic assets rose by 13 per cent in 1980, compared to 8 per cent in calendar year 1979. During 1980 credit to the private sector recorded a growth of 20 per cent, compared to less than 10 per cent in 1979. The bulk of the credit expansion occurred in the first half of the year with the annual growth in the second half falling to about 14 per cent, as commercial banks increasingly faced liquidity problems, with many failing to meet the liquidity ratio at the end of the year. In 1980 money and quasi-money increased by less than 3 per cent, compared to almost 14 per cent in 1979. Although banks have improved their liquidity in 1981, private sector credit has stagnated, while net credit to the Government has grown rapidly.

The improvement which was recorded in the budget in FY 1979/80 was reversed in FY 1980/81. Revised estimates for the 1980/81 fiscal year now indicate that the overall deficit grew markedly and could reach the equivalent of 7.5 per cent of GDP, with central bank financing equivalent to 5.2 per cent of the stock of money and quasi-money at the beginning of the fiscal year. The worsening fiscal situation resulted mainly from smaller revenue collections than earlier estimated, in part reflecting the greater than expected reliance on import restrictions and the unanticipated slowdown of the economy; more importantly, total expenditures, chiefly on the recurrent budget have exceeded the fiscal projections. The higher growth of recurrent expenditures reflects substantial salary increases ranging from 23 per cent to 30 per cent, approved in November 1980, larger imports of food grains, and an increase in defense spending. All of these increases were on a greater scale than had been programmed.

On February 3, 1981 the Kenyan authorities notified the Fund that effective on that date the rate for the Kenyan shilling was changed to SDR 1 = K Sh 10.15,

representing a depreciation of about 5 per cent from the previous rate which had been in effect since October 27, 1975. Excluding the effects of the import surcharge and export compensation scheme, the real effective exchange rate of the Kenya shilling depreciated by 4.4 per cent in the 12 months ending February 1981. The recent strengthening of the U.S. dollar has resulted in a further small depreciation.

III. Performance Under the First Year Program

The ceilings on net domestic bank credit and net bank credit to the Government were specified as bands in the first year program, with the lower limits constituting reference points for consultation with the Managing Director and the upper limits the performance criteria. All performance criteria have been observed and Kenya has made purchases under the stand-by arrangement totaling SDR 90 million. However, the lower limit on net credit to the Government was exceeded in September and December and the lower limit on net domestic credit was also exceeded in December. Budgetary trends indicate that it is unlikely that the authorities will be able to meet the performance criteria for the end of June on net credit to the Government. Because of the expected larger expansion of Government credit it is possible that the ceiling on net domestic credit will also be exceeded in June. Although it is recognized that certain unexpected factors, such as food imports, played a role in this outturn, it appears that the main cause has been inadequate expenditure controls which have swollen overall government expenditures.

The authorities faced important delays in implementing the medium term strategy. In part this apparent inaction is explained by the Government's need to build the consensus required in Kenya's democratic political system prior to embarking on a changed policy course. Not only have some government departments

provided dissenting views, but Parliament exerts a strong voice, where varying opinions must be contended with, some of which are rallying to defend the many interests which will suffer by the import and industrial reform. Consequently, there have been delays in the implementation of the new import regime and tariff structure. The increasing short-term financial disequilibrium and the lost time in implementing the medium-term strategy point to the need for the firm action in order to reverse the trends of the past few years.

IV. Proposed Program for Second Year of Stand-By Arrangement

Continued balance of payments and budgetary pressures are expected in the medium-term. In 1981 the current account is expected to narrow slightly to about 10 per cent of GDP. Export growth is estimated to fall somewhat, and a large deceleration in the growth of imports is projected, partly as a result of a smaller increase in the price of energy imports. The overall balance of payments financing need for 1981 is now estimated at SDR 257 million, slightly less than the SDR 282 million for 1980. Longer term balance of payments financing of between SDR 62 million to SDR 133 million is being negotiated in a structural adjustment loan from the World Bank, the EEC STABEX facility, and Eurocurrency borrowing, leaving an unfinanced gap of between SDR 125 million to SDR 200 million. During the year purchases from the Fund under the current stand-by arrangement could provide SDR 90 million. The mission will investigate a possible drawing by Kenya under the CFF/Food Facility.

In light of the continued balance of payments problems of Kenya, the limited progress made so far in implementing relevant measures under the stand-by arrangement and the fact that an amount equal to almost 150 per cent of Kenya's

quota will be available to Kenya during the balance period of the stand-by arrangement, the second year program will need to include specific measures to be in place in regard to the budget, import policy and other external sector policies, before the Board discussion of the program. The mission will impress on the authorities that it would be necessary for the management in recommending for Board approval such a program to say that sufficient steps have been taken to bring the program broadly back on track.

The financial program for 1980/81 was based on policies which implied a reduction in the overall fiscal deficit to about 5.0 per cent of GDP while the upper limit of the ceiling on bank credit to Government contained in the program was consistent with an overall deficit of 6 per cent of GDP. As already outlined, fiscal performance in 1980/81 has been considerably worse than programmed and the overall deficit is likely to amount to 7.5 per cent of GDP. For 1981/82, the mission will reiterate the recommendation, made during the consultation mission in April 1981, that the budgetary deficit should be no more than 5 per cent of GDP. If the mission's forecasts indicate a weaker fiscal outlook, agreement will need to be reached on rephrasing of expenditures in 1981/82, since the authorities are unlikely to be willing to contemplate further revenue measures immediately after the budget (the budget will be presented in mid-June). The mission will seek assurances on specific measures to be implemented by the end of 1981, if it were to become apparent in the next few months, that the overall deficit is likely to exceed the program limits. These measures will be agreed in an appropriate form.

Because the resulting bank financing required will still be large, the mission will emphasize the need to coordinate monetary and fiscal policies more closely,

giving a more prominent role to interest rates. In this regard, the mission will press for a significant increase in interest rates. Such a policy would reduce the present negative real rates on bank deposits and promote financial savings. It will also help to reverse the present disintermediation toward nonbank financial intermediaries. Higher lending rates would also foster the authorities' goal of making enterprises use available capital more efficiently, while making government debt instruments more competitive in the nonbank sector.

The problem of the appropriate set of export incentives remains of crucial importance. The actions taken so far--the expansion of the export compensation scheme and the 5 per cent depreciation in February 1981--do not appear to be sufficient in terms of generating higher export growth. The Treasury, at the time of the recent depreciation, was arguing for an exchange rate change of 15-20 per cent. They also feel that the export compensation scheme has proved to be an ineffective tool. The mission will support the views held by the Treasury. The mission will assess the operation of the system of export subsidy and import surcharge that was adopted in late 1980 as a substitute for exchange rate action, and in light of its conclusions and other criteria, propose that adequate adjustments be made. A preferred solution would be to depreciate further--either gradually, or in one step--by some 10-20 per cent and to abolish the export compensation scheme. A more flexible exchange rate policy should be accepted with less resistance than in the past, in view of the fact that the recent depreciation was carried out smoothly and with no adverse political effects. The mission will suggest that the windfall profits arising from the devaluation should be shared between the producers of traditional exports and the Government by the use of export taxes. Because of budgetary considerations, the mission

will suggest that the tariff surcharge should only be reduced gradually, pending the introduction of a new tariff structure.

As part of the review, in June 1981 Kenya is required to reach understandings with the Fund on its import policy. The program will need to include progress in replacing quantitative import restrictions with tariff adjustments. In this context, the mission will assess the significance of the revised import schedules which had been prepared by the authorities. As performance criteria the mission will also set quarterly ceilings on net government credit and total domestic credit, taking into account the use by the Government of the counterpart of foreign loans and Fund drawings. If the Kenyan authorities feel strongly that the program should continue to be formulated in terms of a band (with the upper limit being the performance criteria) the second-year program will follow the same format. The ceiling on net government credit will be consistent with a significant reduction in the ratio of the overall deficit to GDP, while the net domestic credit will take into account the expected overall balance of payments deficit and the growth in liquidity. A ceiling on foreign borrowing with maturities of up to 12 years will be negotiated.

Credit ceilings will be set only for September and December 1981. A review clause will be included in the program and a mission will return prior to the end of December to review the progress made in implementing the import system and to set credit ceilings for the remainder of the program period.

Relations with the Fund 1/

Status:	Article XIV
Date of membership:	February 3, 1964
Quota:	SDR 103.5 million
Fund holdings of currency at end-May (as per cent of quota):	SDR 282.53 million ^a (272.97 per cent of quota)
Of which: oil facility	SDR 11.06 million (10.68 per cent of quota)
compensatory facility	SDR 69.0 million (66.67 per cent of quota)
extended facility	SDR 5.33 million (5.14 per cent of quota)
supplementary financing facility	SDR 50.10 million (48.41 per cent of quota)
Holdings of SDRs at end-May:	SDR 20.6 million, or 55.7 per cent of net cumulative allocation (SDR 36.99 million)
Trust Fund Loan Disbursements (First and second periods):	SDR 46.91 million
Direct distribution of profits from gold sales (July 1, 1976-July 31, 1980):	US\$7.61 million
Gold distribution:	41,079.961 fine ounces
Exchange arrangement:	Pegged to the SDR at K Sh 10.15 = SDR 1 (February 3, 1981)
Intervention currency and rate for the U.S. dollar:	U.S. dollar; K Sh 8.47 = US\$1
Last consultation (Article IV):	April 1981. Papers to be issued.

1/ As of April 30, 1981.

ATTACHMENT IIKenya - Economic and Financial Ratios

	1979	1980	1981	1982
	(In per cent of GDP)			
Current account deficit	7.9	11.6	10.5	10.1
Fixed investment	23.5	18.2	20.0	21.0
Domestic savings	15.5	7.4	9.4	8.9
Central Government deficit <u>1/</u>	7.0	5.1	7.5	6.0
External debt	23.2	26.4	29.6	30.9
External debt service (including debt to Fund)	1.7 (2.5)	2.3 (2.6)	3.2 (3.6)	3.6 (4.1)
	(In per cent)			
Oil imports/total imports (c.i.f.) <u>2/</u>	23.8	25.4	27.5	28.6
External debt service/exports of goods and services <u>3/</u> (including Fund)	6.4 (9.1)	7.8 (8.6)	10.3 (11.7)	11.5 (13.4)
Use of resources under program/Quota	--	57.1	85.7	87.1

1/ Fiscal year 1978/79 through 1981/82.

2/ Customs data.

3/ Based on debt outstanding in 1979.



Office Memorandum

BLUE FOLDER

mb
A



TO : Mr. Karlstroem

FROM : S. Kanesa-Thasan

SUBJECT : Kenya - Brief

DATE: June 8, 1981

The two year stand-by arrangement approved last year was for an amount that was nearly the maximum then available under Fund policy--350 per cent of their quota. It was justified on the ground that the Government would implement measures to effect structural change in the economy (as indeed outlined in the Government's Sessional Paper 4 of 1980), as well as measures to reduce the short-term imbalances.

It is clear from the briefing paper that Kenya has fallen far short of the stand-by program in implementing the relevant policies. This failure was largely responsible for the continued pressures on the balance of payments although exogenous developments did also contribute.

Given this experience, a credible program for the second year would need to provide for specific measures to be taken as part of the budget for 1981/82 before Board discussion. I would suggest that the last section of the brief be reformulated to reflect this need.

The areas for action were already identified by your last mission. Obviously, budgetary revenue and expenditure measures will be needed to reduce the deficit. The last program aimed at lowering the deficit/GDP ratio to 5 per cent in 1980/81 and your last mission had discussed the same target ratio for 1981/82. I would suggest that this target ratio be maintained.

As for the import system, understandings in regard to which are to be arrived at by the review mission, there are two aspects to be considered: (a) changes in the system of industrial protection to eliminate the anti-export bias in the economy; (b) changes in the systems of import control to make it more responsive to and consistent with (a) and other objectives. In regard to (a) it would seem reasonable to require some specific action to replace quantitative restrictions on imports by tariffs, along with a restructuring of import tariffs; your April mission had already pressed for it. As for (b), the recent reclassification of import licensing categories leaves some questions as to whether it is a step in the direction of import liberalization and how its application could serve the objective (a). The mission will need to assess the significance of the new import system in this context, and also verify whether it will still involve exchange quotas.

It is apparent that the "proxy approach" of export subsidies and import surcharges has not worked as intended. Given this experience it would seem that direct exchange rate action is required, as indeed your last mission had pressed for, and as is apparently also already the judgment of the Finance Ministry. It would be necessary for the mission to assess what de facto effect the proxy approach has had on the exchange rate in comparison with the equivalence of "a 10 per cent depreciation plus a tax on traditional exports" as described in the program. Based on such an evaluation and other relevant criteria, action on the exchange rate would need to be determined. 1/

1/ It is possible that the exchange reform in Uganda, if successful, will also prod the Kenyan authorities in the direction of an exchange depreciation.

It would be important to verify with the World Bank their current views on increasing incentives to exports, including traditional exports, and on rationalization of industrial protection, especially since they are working on a new structural adjustment loan for Kenya. This could also be reflected in the brief.

Interest rates

Your last mission had already urged a significant increase in interest rates.

Balance of payments outlook

The brief indicates target current account deficit/GDP ratios of 10.5 per cent and 10.1 per cent for 1981 and 1982. It would be necessary for the mission to review Kenya's medium-term balance of payments to determine an appropriate economic strategy. Is an external current account deficit ratio to GDP of 10 per cent sustainable for long?

Further purchases from Fund

It is likely that June performance criteria will be exceeded, especially on credit to government. In that event, for Kenya to make the next purchase it would be necessary not only to agree on the second year's program but also to ^{waive} the June criteria, on the basis of specific actions being taken which would bring the program back on track.

I am not in favor of augmenting the stand-by because the amount available during the second year is already near 150 per cent of Kenya's quota.

cc: Mr. Beveridge
Mr. Zervoudakis



Office Memorandum

cc: J. Karasa - Thasar

ETR
FILES ✓

TO : Managing Director
Deputy Managing Director
FROM : B. Karlstroem

DATE April 21, 1981

SUBJECT Article IV Consultation and Review of Stand-By Arrangement

A mission consisting of Mr. J.M. Jimenez (AFR), Ms. M.R. Kelly (FAD), Mr. E.J. Zervoudakis (ETR), Ms. M. Duane (secretary-AFR), and myself spent two weeks, starting April 2, in Nairobi to conduct the Article IV consultation and to review performance under the current two-year stand-by program with Kenya (a total of SDR 241.5 million or 178.4 per cent of Kenya's quota, of which SDR 90 million has been drawn). Mr. S.A. Silard (LEG) joined the mission for the second week. Mr. Kiingi, Executive Director for Kenya, participated in some of the meetings.

The discussions went smoothly; talks were held with the Ministries of Finance, Planning, Commerce, Industry and Agriculture, and with the Central Bank. The mission had several discussions with the Governor of the Central Bank, Mr. Ndegwa, and at the end of the mission I had a long and very useful discussion with the Vice President and Minister of Finance, the Honorable Mwai Kibaki.

The Kenyan economy is going through a difficult period with slow economic growth (about 2 per cent in 1980 and not much more expected for 1981), a large fiscal imbalance, and a structurally weak balance of payments where prices for traditional exports are weak and the growth in nontraditional exports has stagnated. Unless policies (especially on import protection, export orientation and in the fiscal area) are changed soon, the medium-term outlook is serious, particularly in view of the rapid increase in population (nearly 4 per cent a year). It has been calculated that a growth rate of 6 per cent per annum will be necessary over the next year to absorb the growth in the potential labor force.

The balance of payments situation is weak and will require substantial support for the next few years. The reasons for the weakness are partly those mentioned above (weak export prices and a slow growth in nontraditional exports) but the situation has been aggravated by emergency food imports and the increase in oil prices (the latter factor being less important than in many other developing countries). The deficit in the current account of the balance of payments was equivalent to 12 per cent of GDP in 1980, and a similar deficit is expected in 1981. This deficit has been restrained by fairly tight import licensing. The overall external deficit (before balance of payments financing) in 1980 was SDR 290 million, of which the Fund provided SDR 56 million (net), and a further SDR 56 million was provided from a structural adjustment loan from the IBRD. In addition, Kenya drew the remaining US\$100 million (SDR 77 million) under a Euro-currency loan. Gross official reserves dropped by SDR 107 million in 1980, and at end March they stood at SDR 365 million, equivalent to less than 10 weeks of imports. The outlook for 1981 is for a continued large current account deficit, and further substantial balance of payments assistance (in addition to that from the Fund) will be needed in order to maintain the present level of gross

reserves. Consideration is being given to another Eurocurrency loan, and a second structural adjustment loan will be negotiated.

The Kenyan authorities are conscious of the constraint on growth implied in the weak balance of payments position and are attempting to reorient their policy toward a more export-oriented growth. The mission discussed at length these policies which have so far not been implemented with any forcefulness. An extension of the export compensation scheme and the imposition of an import surcharge last year, and a devaluation of 5 per cent in February this year were steps in that direction. However, these measures are unlikely to solve the problems at hand. The mission argued for the replacement of the export compensation scheme (which Kenyan officials admit does not operate well) by a further and larger devaluation, possibly combined with increased taxation of the major traditional export crops, and as the fiscal situation permits, the import surcharge should be reduced and ultimately be eliminated. Both the Vice-President and the Governor seemed positive to the suggestion (without making any commitments) and there was general agreement that the exchange instrument would be used more flexibly in the future.

An important reason for the anti-export bias of the Kenyan economy is the complex and highly protective import system that has developed out of the infant industry protection in the 1960s. This has led to a cost permissive, inefficient industrial sector primarily oriented towards the domestic market. A major reform is now being undertaken to improve the import system by gradually moving away from quotas to tariffs. It has taken a long time to reach some consensus on how to implement the policy and will probably take further time before substantial changes can be seen. However, the Ministries of Finance and Planning are optimistic that some progress will be made soon.

Performance under the stand-by program went fairly well up until the early part of 1981. However, fiscal policy has weakened in the course of the year, and the move towards a more open import policy has been seriously delayed. The overall budget deficit for 1980/81 estimated at the equivalent of 5.9 per cent of GDP in the program (negotiated in August 1980), is now estimated at 8.6 per cent. The principal reason for the deviation is an excess of expenditures, which mainly reflects salary increases, larger food imports, and a general lack of expenditure control. The Treasury has now issued a strongly worded instruction to Ministries to keep their expenditures within the appropriated amounts. In addition, FAD is providing assistance on the monitoring and control of expenditure, but this assistance is unlikely to have much impact in the current fiscal year. It seems likely that the government borrowing ceiling for June 1981 will be exceeded; however, at present, there was no request from Kenyan officials to consider a waiver. Total credit, however, is more likely to be below the ceiling.

At the request of the Kenyan officials, the mission provided several tentative alternative scenarios to lower the 1981/82 fiscal deficit to about 5 per cent of GDP and to reduce its domestic financing. The mission also recommended that the fiscal measures be complemented with a further depreciation of

the shilling, the rapid implementation of an import regime based on tariffs and not quantitative restrictions, and a significant increase in interest rates. These issues were discussed with the Permanent Secretary of the Treasury and also with the Vice-President.

The negotiations for the second year of the stand-by arrangement will be held in late June. A Consultative Group Meeting is planned for the latter part of July, by which time the IBRD documentation will be ready; the Fund has been asked to report on the status of the stand-by arrangement.

cc: CBD
ETR ✓
FAD
INST
LEG
OER
RES
SEC
TRE
Mr. Watson

INTERNATIONAL MONETARY FUND

KENYA

Paper - 1981 Article IV Consultation and Stand-by Review

Prepared by the African Department and the Exchange
and Trade Relations Department

(In consultation with the Fiscal Affairs, Legal, and
Treasurer's Departments)

Approved by J.B. Zulu and S. Kanesa-Thanan

March 19, 1981

I. Introduction

A mission comprising Messrs. B. Karlstroem (head-AFR), J. Jimenez (AFR), Ms. M. Kelly (FAD), Mr. E. Zervoudakis (ETR), and Miss M. Duane (secretary-AFR) will visit Nairobi beginning April 2, 1981 for about two weeks to conduct the Article IV Consultation discussions and to review progress under the stand-by arrangement currently in effect for Kenya. Mr. Silard (LEG) will join the mission for the last week. The mission will also discuss with the authorities the general outline of the program for the second year of the stand-by arrangement (July 1, 1981-June 30, 1982), but will not at this time negotiate it, in order to provide the Kenyan authorities with the necessary time to incorporate the mission's suggestions into the 1981/82 budget (July/June). A mission is expected to return to Nairobi in June for the actual negotiations.

A summary of relations with the Fund is attached.

II. Performance Under Stand-by Arrangement

On October 15, 1980 the Executive Board approved Kenya's request for a two-year stand-by arrangement for an amount equivalent to SDR 241.5 million (233.3 per cent of quota), including SDR 184.4 million (178.4 per cent of quota) from the supplementary financing facility. Full use of

The drawings available under the stand-by arrangement would bring Fund holdings of Kenya's currency after taking account of repurchases, to 4404.1 per cent of quota by August 30, 1982. Kenya's last drawing under the stand-by arrangement was made on March 11, 1981.

The ceilings on net domestic credit and net credit to the government were specified as bands, with the lower limits constituting reference points for consultation with the Managing Director and the upper limits the performance criteria. All the performance criteria have been observed, but the lower limit on net credit to the government was exceeded in September and December, and the lower limit on net domestic credit was also exceeded in December.

In letters to the Managing Director dated November 20, 1980 and February 23, 1981, and during the visit of Mr. B. Karlstroem to Nairobi (February 4-6, 1981) the Kenyan authorities explained the exceeding of the lower limit on net credit to the government in September and December as caused by a larger than expected carry-over of excess expenditures from the 1979/80 fiscal year, a shortfall from projected revenues, and higher than budgeted expenditures in certain areas, such as for wage adjustments and food imports. The large increase of net credit to the government was in turn the reason why the lower band on the net domestic assets had been exceeded.

III. Recent Economic Developments

Over the last several years the rising prices for imported energy have become a heavy charge on Kenya's balance of payments. On occasions the burden has been offset by temporary higher prices for major exports, particularly coffee, although since 1978 the prices of major exports have

also tended to be weak. The welcome relief provided on these occasions has tended to remove the urgency in adjusting the balance of payments to the higher and rising energy costs. A generally lax fiscal policy has tended to undermine the Government's demand management policies, while a heavy reliance on import restrictions has hindered the efficient allocation of domestic resources. More recently the world recession has had a major negative impact on the economy.

In 1979 Kenya's real growth rate fell to about 3 per cent, while inflation decelerated and the balance of payments was temporarily in surplus. The latter resulted from the intensification of import and payments restrictions, which led to a reduction in imports and also resulted in an increased inflow of short-term capital, following the requirement that certain imports be financed by mandatory 90-180-day suppliers' credit. This temporary improvement diverted the authorities' attention from finding more permanent solutions to the balance of payments problem. However, during 1979/80 (July/June) some progress was made in reducing the Central Government's overall deficit, particularly the domestically financed portion, and the overall credit expansion was kept at only 8 per cent, with private sector credit rising by nearly 10 per cent. Nevertheless, the Central Government's overall deficit in fiscal year 1979/80 was still equivalent to about 6 per cent of GDP.

The favorable 1979 balance of payments outturn led to the early dismantling of some aspects of the restrictive system. In November 1979 the term and amount of the import deposits were significantly reduced and Letters of No Objection (LNOs) were abolished in July 1980, making goods competing with domestic production easier to import. At the same time,

the export subsidy was increased from 10 per cent to 20 per cent and was further extended to include all nontraditional exports. The authorities originally planned to transfer the rebate payment mechanism from customs to the Central Bank, which would have involved a multiple currency practice; however, this intention was never effected--mainly it seems, because of resistance from the Central Bank.

The temporary nature of Kenya's favorable balance of payments position became increasingly obvious as 1980 progressed. For the year as a whole an overall balance of payments deficit of about SDR 300 million, or about 6.6 per cent of GDP, is estimated. The authorities reacted by suspending virtually all import licenses for about two and a half months at the end of the year. Nevertheless, even though exports are projected to have risen by about 15 per cent in 1980, the growth of imports is estimated at over twice that rate. In line with the Fund programs the current account deficit in 1980 is estimated at the equivalent of 15 per cent of GDP compared to 11 per cent in 1979, while the net capital inflow was substantially reduced. At the end of 1980, gross official reserves of the Central Bank were equivalent to SDR 385 million, or about two and a half months of 1980 estimated imports.

The weakening of the balance of payments came at a time when income growth slowed further and inflation accelerated. Present estimates indicate a real GDP expansion in 1980 of about 2 per cent (compared to 3 per cent in 1979) and an inflation rate of about 15 per cent (10 per cent in 1979).

In the second half of CY 1980 the government's financial position deteriorated, with further weakening expected in the remainder of the fiscal year, reversing the progress made in 1979. Revised estimates for

the 1980/81 fiscal year now indicate that the overall deficit could reach the equivalent of 7.5 per cent of GDP, compared to a target in the present stand-by arrangement of about 5.2 per cent. The deviation from the program results from smaller revenue collections than earlier estimated and larger total expenditures, chiefly recurrent expenditures, as development outlays will be below earlier estimates. The higher growth of recurrent expenditure reflects substantial salary increases ranging between 23 per cent to 30 per cent, approved in November, and larger-than-expected imports of food grains.

In 1980 money and quasi-money increased by less than 3 per cent, compared to almost 14 per cent in 1979. The overall expansion of the banking system's net domestic assets rose from about 8 per cent in 1979 to 13 per cent in 1980, roughly in line with the Fund program. During 1980 credit to the private sector accelerated substantially, recording a growth of over 20 per cent for the year as a whole compared to less than 10 per cent in 1979. The bulk of the credit expansion occurred in the first half of the year, with the annual growth in the second half falling to about 14 per cent, as commercial banks increasingly faced liquidity problems, with many failing to meet the liquidity ratio at the end of the year. Reflecting the government's deteriorating financial position, net credit to the government grew by twice as much in the second half of 1980 as in the second half of 1979.

Early in 1981, the government reclassified and restructured the import schedules, reducing the number from five to three. The exact method of allocating foreign exchange to the more restricted schedules is not clear.

On October 27, 1975 the Kenya shilling was pegged to the SDR at a rate of SDR 1 = K Sh 9.66. On February 3, 1981 the Kenyan authorities notified the Fund that effective on that date the rate was changed to SDR 1 = K Sh 10.15.

IV. Topics for Discussion

The mission will review economic and financial trends in 1980 and prospects, for 1981 with particular emphasis on their implications to the current stand-by arrangement. In this regard, the mission will review with the authorities the factors behind the exceeding of the lower limit on net credit to the government and net domestic assets of the banking system in December 1980, and discuss the prospects for the observance of the ceilings for June 30, 1981. Special attention will be given to fiscal developments, particularly expenditure policies. A recent FAD mission reported a lack of control of government expenditures and a breakdown in the accounting system, which makes the monitoring of expenditures extremely difficult. At the request of the Kenyan authorities, the FAD member of the mission will stay for about ten days after the end of the mission to provide technical assistance on public expenditure forecasting. The mission will discuss with the authorities the measures they intend to take in fiscal year 1981/82 to reduce the overall deficit to a more manageable level. In this regard, the Government's ability to increase its nonbank financing will be reviewed, as the Government's large recourse to bank credit in the second half of 1980 has reduced the credit available to the private sector. At the present time, without measures to reduce net government credit, a loosening of private sector credit could lead to the nonobservance of the overall credit ceiling; therefore the mission will stress the need for

a better coordination of fiscal and monetary policies and will discuss the authorities' plans in this area. The mission will also argue the case for higher interest rates to reflect the shortage of liquidity presently facing the banks and the private sector.

The mission will review developments in the real economy in 1980. The drought and continued border difficulties with neighboring countries will be assessed in terms of their impact on economic growth and on the balance of payments. The mission discuss with the authorities the supply-oriented measures which they intend to implement in 1981 to promote a more efficient utilization of domestic resources, specifically with regard to agricultural expansion, industrial rationalization, and the growth of nontraditional exports. For this purpose the mission will seek the authorities' views on the role of exchange rate policy within the overall policy thrust. Greater flexibility in the exchange rate than in the past seem justified in view of the large current account deficits projected for the next few years.

The mission will assess the balance of payments prospects for 1981 and 1982 giving special emphasis to the authorities' policies to constrain the deficit within their financing capability for the period until the supply-oriented measures to be implemented take hold. In this regard, the authorities' energy policies will be discussed, particularly their plans to increase the use of indigeneous energy sources.

The mission will review the progress which has been made in revising the regime of import restrictions in view of the authorities' commitment to replace, over time, existing quantitative restrictions. In this connection, the mission will examine closely the recently implemented import

reclassification measures. The mission will obtain the authorities' timetable for meeting the program's objective and will press for the replacement of quantitative restrictions with tariff increases as recommended by FAD missions.

The mission will also examine the possibility of Kenya making an additional purchase under the CFF.

V. Tentative Framework for the Second Year Program

The mission will discuss, on a tentative basis, the program for the second year of the present stand-by arrangement (beginning July 1, 1981). These discussions will form the basis for the negotiations in June, by which time the budget will have been presented. At this stage the mission will advise, particularly, on the overall stance of fiscal policy in 1981/82; the aim should be to reduce the government's overall deficit and its borrowing from the banking system primarily through more realistic expenditure forecasting and a more effective control of outlays. The mission will also suggest speedier progress in reforming the import system, with a view to reaching the understanding, which is a performance criteria for the second year. The mission will investigate the adequacy of producer prices and argue for a more flexible role for interest rates and the exchange rate.

The format of the program will be similar to that of the first year, with ceilings on the net domestic assets of the banking system, net credit to the government, and on new foreign borrowing.

Attachments

Relations with the Fund 1/

Status:	Article XIV
Date of membership:	February 3, 1964
Quota:	SDR 103.5 million
Fund holdings of currency (as per cent of quota):	SDR 254.08 million (245.49 per cent of quota)
Of which: oil facility	SDR 12.61 million (12.18 per cent of quota)
compensatory facility	SDR 69.0 million (66.67 per cent of quota)
extended facility	SDR 5.33 million (5.14 per cent of quota)
supplementary financing facility	SDR 33.74 million (32.60 per cent of quota)
Holdings of SDRs:	SDR 23.44 million, or 68.16 per cent of net cumulative allocation (SDR 36.99 million)
Trust Fund Loan Disbursements (First and second periods)	SDR 46.73 million
Direct distribution of profits from gold sales: (July 1, 1976- July 31, 1980)	US\$7.61 million
Gold distribution (four distributions)	41,079.961 fine ounces
Exchange arrangement:	Pegged to the SDR at K Sh 10.15 = SDR 1 (February 3, 1981)
Intervention currency and rate for the U.S. dollar (January 30, 1981):	U.S. dollar; K Sh 7.73 = US\$1
Last consultation (Article IV):	May 8-23 and June 19-30, 1980 discussed by the Board October 15, 1980

1/ As of February 28, 1981.

Kenya - Economic and Financial Ratios

	1979	1980	1981	1982
	(In per cent of GDP)			
Current account deficit	10.6	14.8	14.0	13.3
Fixed investment	23.5	24.0	24.0	24.0
Domestic savings	15.5	13.0	14.0	14.7
Central Government deficit <u>1/</u>	7.9	6.4	7.1	5.2
External debt	25.4	29.5	34.1	36.5
External debt service	3.0	3.4	3.7	3.9
	(In per cent)			
Oil imports/total imports (c.i.f.)	22.1	24.2	26.2	25.9
External debt service/exports of goods and services <u>2/</u>	10.0	10.9	13.0	15.0
Use of resources under program/Quota	--	57.1	85.7	87.1

1/ Fiscal year 1978/79 through 1981/82.

2/ Based on debt outstanding in 1979.



Office Memorandum

TO : Mr. Karlstroem

DATE: September 4, 1980

FROM : S. Kanesa-Thanan *etc.*

SUBJECT : Kenya - Comments on Letter of Intent

(a) Credit ceilings. I have no difficulty with the band approach. However, one may argue that the differences between the lower and upper limits appear to be rather large--especially in terms of increments.

Also, there is an asymmetry in the formulation of the credit ceilings. They seem to apply throughout the first half year, but only for the terminal date in the second half.

(b) Multiple currency practice. The export compensation scheme and the import surcharge are described as temporary measures in the consultation report (Page 12). This was the basis on which the multiple currency practice is being approved. The letter of intent should also refer to the temporary nature of the schemes.

(c) The credit ceilings are specified on a half yearly basis. How are purchases from the Fund phased?





Office Memorandum



Mr. Finch
Mr. Kausen-Thor
Mr. Gylfason
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TO : Managing Director
Deputy Managing Director *SA*
FROM : B. Karlstroem *BK*
SUBJECT : Kenya--Negotiations on Use of Fund Resources

DATE: September 3, 1980

A mission consisting of Mr. R. Stillson (AFR), Ms. M. Kelly (FAD), Miss S. Symons (secretary-ETR), and myself visited Nairobi from August 19 to 27 to conclude discussions of a two-year stand-by arrangement to begin July 1, 1980. The arrangement covers all four credit tranches and the total amount involved is SDR 241.50 million (350 per cent of Kenya's quota) of which SDR 189.75 million (275 per cent of quota) is provided from SFF resources. A draft Letter of Intent was agreed with the Kenyan authorities; as soon as I have received comments from the departments concerned I will send the Letter for your approval.

The discussions, which followed those in May and June, were very thorough and characterized by a great degree of seriousness on the part of the Kenyan authorities. Most of the negotiations were held with the new Permanent Secretary to the Treasury, Mr. Mule (who for many years was Permanent Secretary in the Ministry of Planning) and other staff in the Treasury. The mission also had discussions with the Vice-President and Minister of Finance, Mr. Mwai Kibaki, and the Governor of the central bank, Mr. Duncan Ndegwa.

The substance of the program is essentially the same as what was previously discussed (see back to office report dated July 7, 1980), i.e., the arrangement supports a medium-term program of import reform (moving away from quantitative controls) and growth of the nontraditional export sector, together with a short-term financial policy program designed to limit the balance of payments deficits in the next few years. The stand-by is designed to assist Kenya in its external financing until the medium term measures begin to strengthen the balance of payments.

The performance criteria relate to total domestic credit and, as a sub-ceiling, bank credit to the central government. The magnitude of the fiscal deficit (5 per cent of GNP in 1980/81 compared to 6.8 per cent in 1979/80) and the pace of total credit expansion (19.5 per cent during fiscal year 1980/81) as discussed in June still remain the policy targets. However, the Kenyan authorities felt that some more flexibility was needed in setting the ceilings. In particular, they argued that it was extremely difficult to predict the fiscal impact of the import surcharge and of the broadening of the export compensation scheme. These measures will raise both revenue and expenditure by large amounts, and a relatively small margin of error in forecasting the fiscal outturn could easily jeopardize the ceiling on government bank borrowing.

It was therefore agreed, subject to your approval, that we would use the concept of a "band", where the lower point would be the policy target and the upper point would be the ceiling in the traditional sense. The Government will undertake to consult with the Managing Director of the Fund if and when the lower point of the band is exceeded, with a view to determining what measures will be necessary to avoid reaching or exceeding the upper ceiling constituting the performance criteria. In this way we have preserved the policy targets which were earlier

discussed, while providing for some flexibility which the Kenyan authorities wanted. These arrangements are specified in the Letter of Intent.

For total domestic credit, the policy aim is to limit credit growth to 19.5 per cent during fiscal year 1980/81 (the rise in nominal GDP is estimated around 18-20 per cent); the ceiling (upper point of the band) is 23 per cent. Credit to government in 1980/81 is expected to be no higher than K Sh 678 million as a policy target, but the ceiling is set at K Sh 1,000 million. There are always extremely sharp seasonal fluctuations in the cash flow of the central government budget, and the program provides for a higher borrowing limit in the course of the year than at the end. Due to the expected balance of payments deficit, the growth in money supply in the course of 1980/81 is only 4 per cent.

Apart from the financial program which should help limit the external deficit in the short run, the stand-by arrangement is based on, and is in support of, a medium term policy designed to gradually liberalize imports, increase competition from abroad and spur the growth of nontraditional exports. The change in import policy--away from quantitative restrictions--is likely to raise imports and thus widen the external deficit over the next few years. A deficit (after taking into account bilateral aid flows) of some K Sh 2 billion (SDR 220 million) is expected for 1980, and forecasts show a similar deficit for 1981. Official forecasts show a reduction of the deficit in 1982 and the aim is to reach equilibrium in 1983. The proposed standby arrangement, will finance approximately half of these deficits. Further assistance is provided by the IBRD through a structural adjustment loan of US\$70 million; a second such loan is tentatively planned for 1981. Even then, Kenya will need to reduce its reserves, which are presently equivalent to about 3 months' imports, and perhaps also draw the remainder (\$100 million) of a Eurocurrency loan contracted a year ago.

In our discussions on the budget, especially on the seasonality of the central government's bank borrowing, it became clear that there is a need for improved forecasting, monitoring and cash management of the budget. The Permanent Secretary of the Treasury expressed a wish to use some technical assistance from the Fund in this area. A written request will be sent to the FAD in the near future.

cc: CBD
ETR ✓
FAD
INST
LEG
RES
SEC
TRE
Mr. Mohammed
Mr. Watson



Office Memorandum

Sent copy to
Division Mgr. 7/23

JUL 22 1980

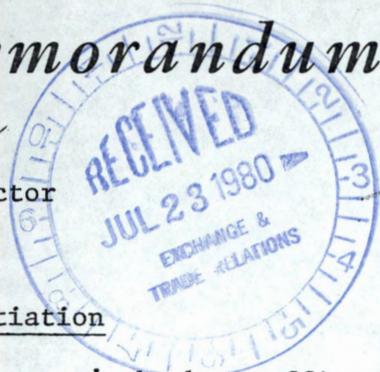
ETR

A. Bhatia

TO : Managing Director ✓
Deputy Managing Director

FROM : Rattan J. Bhatia

SUBJECT : Kenya--Stand-By Negotiation



DATE: July 21, 1980

As indicated in Mr. Karlstroem's back-to-office report (July 7) a draft letter of intent for a two-year stand-by arrangement was left with the Kenyan authorities in late June. The arrangement is for a total of SDR 241.50 million (350 per cent of Kenya's quota) of which SDR 189.75 million is provided from SFF resources. The Kenyan authorities indicated that they wanted some further time to consider the proposed program. In particular, the new Permanent Secretary in the Treasury, Mr. Mule, who had taken office only one day before the mission started, wanted some time to study the proposed letter of intent. We have now received a cable from the authorities proposing substantive changes in the letter which had already reflected the 1980/81 budget proposals announced in mid-June. Their main concern now appears to be that the budget projections are very uncertain and that the credit ceilings should contain larger safety margins than have been provided for in the draft letter of intent.

The proposed changes are too complex to be resolved by phone or cable. I would, therefore, propose that a staff team consisting of Messrs. Karlstroem, Stillson, Ms. Kelly and a secretary return to Nairobi for about one week, beginning August 20 to finalize the letter of intent. The principal issues which would need to be discussed and the suggested lines to be taken by the mission are as follows:

1. Financial policies

To provide for margins of error in forecasting, the Kenyan authorities now propose that the full year ceiling for net credit to the Central Government be raised by 9 per cent from K. Sh. 2,970 million to K. Sh. 3,245 million. The authorities are also proposing that private sector credit be allowed to rise more rapidly during the year than assumed in the program. Net total domestic credit would rise by 23 per cent instead of 18 per cent. In addition, they are suggesting different seasonal patterns for the ceilings.

If we assume that the extra credit to the government were to materialize as a result of a larger budget deficit, that deficit would be equivalent to 5.7 per cent of GNP, compared to a deficit of 4.7 per cent in the preliminary program. For 1979/80 (year ending June 30) we estimate the deficit to have been about 6 per cent of GNP; the figure for the preceding year was about 9 per cent. Thus, the significant adjustment which took place last year in the public sector accounts would be at least maintained, even allowing for the extra margin.

However, the Kenya proposals for private sector credit and total credit seem more problematic. The program controls total credit through a ceiling on the net domestic assets of Central Bank and a constraint on reductions in the liquidity and cash ratios of commercial banks. Total domestic credit in

fiscal year 1979/80 is estimated to have increased by about 16 per cent. The Kenya proposal is for an increase in the ceiling on Central Bank net domestic assets which implies an acceleration to 23 per cent in the fiscal year 1980/81; this accelerated credit expansion would exacerbate a weakening in the balance of payments which has resulted from the increase in oil prices and is expected to worsen due to an expected decline in coffee prices. Even the ceiling agreed to in the letter of intent implies some acceleration in total credit but that seemed justified by the need to rebuild stocks and to finance a reasonable growth in economic activity. The mission will argue that 18 per cent increase in private sector credit (which also is the current Central Bank guideline for the commercial banks) be maintained.

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) You but you might accept 1 or 2 percentage points more as a very last resort.

2. External debt

The new Kenya proposals contain a modification in the paragraph on external debt which indicates that the authorities might plan some further borrowing abroad to finance military purchases. The mission would try to agree on a figure for the intended borrowing in the light of its repercussions on Kenya's debt profile. Although we do not have the latest comprehensive figures on Kenya's external debt (we will get these data from the IBRD before the mission leaves), there is reason to believe that already contracted debt is likely to have raised the debt/service ratio from 9 per cent in 1978 to some 12 per cent in 1980; assuming no further commercial borrowing abroad, the debt service ratio is likely to rise substantially in 1981 when repayments of a Eurodollar loan will begin. Depending on our analysis of the debt situation after we have received the IBRD data, the staff mission might argue for more forceful adjustment in financial policies.

3. Export compensation scheme

As explained in the back-to-office report, an existing export compensation scheme is being extended and administered in such a way as to make it a multiple currency practice. The new administration of the system is most likely an improvement over the earlier one in the sense that it may invite less corruption and is likely to result in fewer and shorter payments delays. We would not argue that the introduction of a multiple currency practice should be an obstacle to reaching agreement on the program. The letter of intent will call for a review of the application of the export compensation scheme after the first year, but not a requirement to reach understandings.

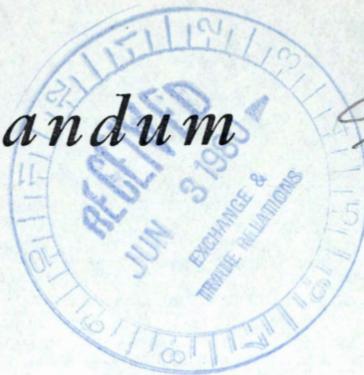
In the past, we have normally asked that the letters include a phrase showing the intention on the part of the authorities to run a multiple currency scheme only as a temporary measure. The Kenyan authorities do not see their new system as temporary and would not be prepared to say so. However, since the Kenyan authorities will not devalue, we regard the scheme as a beneficial measure to increase exports and an important part of their medium-term measures. Therefore, we would accept the multiple currency practice.

cc: ETR
LEG
Mr. Watson





Office Memorandum



ETR

cc: P. Karasa Karasa

TO : Acting Managing Director

DATE: June 2, 1980

FROM : B. Karlstroem

SUBJECT : Kenya--Article IV Consultation and Review Mission

A mission consisting of Mr. Stillson (AFR), Ms. Kelly (FAD), Messrs. Eglin (AFR) and Gylfason (ETR), Miss Simpson (secretary-AFR), and myself visited Nairobi during the period May 8-23 to conduct Article IV consultation discussions, to review the existing stand-by arrangement, and to negotiate, ad referendum, a program that would be supported by Fund resources during the second year of the existing stand-by arrangement (beginning July 1, 1979). Kenya did not draw under the arrangement in 1979 when the balance of payments was showing an unexpected surplus. The ceiling on government borrowing was substantially exceeded in late 1979 and early 1980. However, there was no need to renegotiate this ceiling as foreign exchange reserves continued to increase. The Kenyan authorities expect the balance of payments to weaken sharply during the remainder of 1980 and in 1981, and they expressed the desire to have a program with the Fund for the fiscal year 1980/81. The mission started discussions on a program but discussions were hampered by lateness in the preparation of the 1980/81 budget. The Kenyan authorities requested that discussions be continued and hopefully completed in the latter part of June by which time the new budget will have been presented.

The mission was well received. Discussions were held with officials in the Treasury, the Ministry of Planning, and other government departments, as well as with the Central Bank.

The balance of payments showed an unexpected surplus in 1979, and foreign exchange reserves have continued to rise in the first four months of 1980 to a level corresponding to 4 1/2 months' imports. The surplus has been largely due to temporary factors, including restrictions on trade credit and an import deposit scheme (both of which were substantially eased in November 1979), and sluggish demand for imports as growth has been lagging. However, forecasts show a sharp deterioration in the external accounts during the remainder of 1980 and in 1981. This expected weakening in the balance of payments will be the result of a rapid rise in imports from the depressed levels during the past year and a reversal of short term capital flows after the relaxation of trade credit restrictions. Looking beyond the immediate future to a situation where rapid growth is resumed, there is a fundamental inconsistency between rapid growth and high employment on the one hand, and external equilibrium on the other. This dilemma was clearly analyzed in the latest Development Plan. In particular, the Kenyan authorities are concerned about the stagnation over the past several years in nontraditional exports and the constraint that this will exert on future growth. A recently published policy paper (Sessional Paper No. 4, 1980), approved by the Cabinet in early May, discusses various ways to strengthen export competition and efficiency in the manufacturing and nontraditional agricultural sectors of the economy. A policy of switching from quantitative restrictions towards tariffs will be initiated in the forthcoming budget. Moreover, the mission was informally told that the existing export compensation scheme will be broadened to cover all nontraditional goods, and that the subsidy will be raised from 10 to 20 per cent

(also that the system may be administered through the exchange system); at the same time an import surcharge will be introduced. The economic effects of these measures will be similar to a devaluation with a tax on traditional exports. It appears that a devaluation is not regarded as politically acceptable. The budgetary effect of the export compensation scheme and the import surcharge is likely to be positive, i.e., revenue will rise more than expenditure.

The central government budget has been a source of concern over the past few years. Large increases in certain expenditures, such as military and education, together with a relatively slow growth in revenue, raised the overall budget deficit from 4.7 per cent of GDP in 1976/77 to 8.5 per cent in 1978/79. This caused some strains, particularly in 1978/79, on the banking system which had to absorb an unusually large amount of government debt. The 1979/80 budget, as far as can be judged from preliminary estimates, is showing a smaller overall deficit than in the preceding year (some 5 1/2 to 6 1/2 per cent of GDP) and there may not be a need for the Government to borrow from the banking system over the fiscal year as a whole. This somewhat surprising outcome is the result of higher than expected revenue, low expenditure on the development budget, and exceptionally large financing from external sources other than traditional project aid (which is apparently less than expected).

The mission discussed some of the basic weaknesses in the fiscal area, including the need for more effective expenditure control, for tax measures to raise the elasticity of the tax system and to improve development project implementation. The Kenyan authorities are working on revenue measures, largely on the basis of a recent report by a FAD team.

The growth in credit and money supply over the past year has been fairly moderate. Total domestic credit grew at a rate of 10 1/2 per cent in the 12 months to March 1980, and money supply grew at a rate of close to 14 per cent over the same period. This is well in line with the growth in economic activity (including price increases). The commercial banks are very liquid at present, and normal interest rates have hardly been raised over the past five years. Thus, the moderate growth in credit to the private sector over the past year reflects solely a slow growth in demand for credit.

As mentioned above, the Kenyan authorities expressed the wish to agree with the Fund on a financial program for 1980/81 so as to enable Kenya to draw on Fund resources when the balance of payments need arises. Negotiations on a program will be held in June after the budget has been presented. The Kenyan representatives said they would prefer a new two-year arrangement, starting July 1, 1980 and to suspend the present arrangement. The rationale for this would be that the policies discussed in the Sessional Paper will be implemented over the next few years. Since the policy perspective, as well as the adjustment period is likely to be longer than one year, a new two year arrangement might be more appropriate.

At the request of the Kenyan authorities the mission prepared a tentative financial program for 1980/81 which might serve as a starting point for the discussion in late June.

cc: Managing Director (on return)
CBS, ETR, FAD, INST, LEG, RES, SEC, TRE, Mr. Watson

COPY FOR BLUG FOLDER

~~Am. Kanesa - Thasan~~

CONTAINS CONFIDENTIAL
INFORMATION

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INTERNATIONAL MONETARY FUND

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KENYA

Briefing Paper - 1980 Article IV Consultation and
Stand-by Review

Prepared by the African Department and the
Exchange and Trade Relations Department

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(In consultation with the Fiscal Affairs, Legal, and
Treasurer's Departments)

Approved by Oumar B. Makalou and S. Kanesa-Thasan *ST*

May 1, 1980

I. Introduction

A mission comprising Messrs. B. Karlstroem (head-AFR) and R. Stillson (AFR), Ms. M. Kelly (FAD), Messrs. T. Gylfason (ETR) and R. Eglin (AFR), and Miss. M. Simpson (secretary-AFR) will visit Nairobi beginning May 8, 1980 for about two weeks to conduct Article IV consultation discussions and to review progress under the stand-by arrangement currently in effect with Kenya. As part of the review, the mission will negotiate a financial program for the second year of the stand-by arrangement (July 1, 1980-June 30, 1981).

A summary of relations with the Fund is attached.

On August 20, 1979, the Executive Board approved Kenya's request for a two-year stand-by arrangement through the fourth credit tranche for an amount equivalent to SDR 122.475 million including SDR 70.73 million of supplementary financing. Full use of the drawings available under the stand-by arrangement would bring Fund holdings of Kenyan currency to 364 per cent of quota by June 30, 1981, of which 127 per cent is under special facilities. Kenya has not yet requested any drawings under the stand-by arrangement,

which called for reviews before December 31, 1979 and June 30, 1980, of the progress made in implementing the stabilization program.

II. Recent Economic Developments and Performance Under the Financial Program

The balance of payments in Kenya has exhibited several sharp reversals in the past six years. After a large deficit in 1974/75, the balance of payments improved to a surplus in 1976/77, stimulated by the sharp increase in coffee prices; in 1978, the balance of payments again deteriorated to a large deficit caused by the reversal in coffee prices and an overly expansionary demand management policy; in 1979 the balance of payments moved into surplus, primarily because of a temporary increase in restrictions on imports and a large short-term capital inflow.

Concealed by these cyclical swings is a tendency toward a weaker balance of payments position in the medium term. Thus, there has been an increase in the level of protection, an increasing export dependence on coffee and tea, and a decrease in the real exports of the manufacturing sector (primarily due to the loss of the Tanzanian market). The increasing export dependence on coffee and tea, combined with a continued terms of trade deterioration (declining coffee prices and rising oil prices), indicates that the balance of payments may become a constraint on Kenya's medium-term growth. Apart from the balance of payments constraint, the prospects for growth in the medium-term appear good; the investment rate has been maintained at over 20 per cent of GDP over the last seven years

and the incremental capital output ratio has dropped slightly as investment has emphasized agriculture in this time period more than in the period before 1973.

The external accounts in 1979 were unexpectedly favorable due to a number of temporary factors, mainly the introduction in December 1978 of an import deposit scheme and of new regulations regarding trade credit. At that time inventories were high due to the surge in imports in the last half of 1978; the combination of the high level of inventories and the expectation that the restrictions would be eased within the year resulted in a sharp drop in imports. In 1979, imports were K Sh 1.9 billion less than in 1978, a drop of about 13 per cent in nominal terms and of almost 30 per cent in real terms. This occurred despite price rises of about 25 per cent for oil imports (resulting in a 20 per cent increase in oil payments). The change in regulations regarding trade credit required longer terms for trade credit and resulted in a net inflow of short-term capital of about K Sh 1.0 billion. Thus, although exports stagnated due to a relatively poor coffee crop, the overall balance of payments turned around from a deficit of K Sh 1.6 billion in 1978 to a surplus of K Sh 1.4 billion in 1979. Gross official international reserves increased from the equivalent of about 2.2 months' imports to about 4.5 months' imports at the end of 1979.

The growth of the economy slowed in 1979 to about 2-3 per cent in real terms, partly due to the relatively poor coffee and maize crops. Increases in the prices of energy and other imports, as well as the imposition of the import restrictions, may have contributed to the slowdown; also, the

relatively slow pace of economic growth reduced the demand for imports. Inflation accelerated slightly in 1979 with the overall average Nairobi consumer price index (CPI) increasing by 12.1 per cent during the year, in large part due to the 23 per cent increase in the fuel component of the index.

The fiscal position presents some problems. Revenue buoyancy is low, there has been a lack of control over public expenditure, and budgetary outturns in the past few years have been much more expansionary than planned in the annual budgets. In the fiscal year 1978/79 (July-June), the overall government deficit increased to K Sh 2.3 billion (about 6 per cent of GDP) with a very high level of domestic bank financing of this deficit (of K Sh 1.3 billion). The 1979/80 budget was designed to cut the bank financing of the deficit very sharply, to less than K Sh 400 million, through large increases in external and domestic nonbank financing. However, the 1979/80 fiscal outturn appears to be substantially more expansionary than budgeted, in part because of the subsidies on increased food imports which are expected to result from the relatively bad agricultural year, cost increases in defense imports, and shortfalls in both foreign concessionary financing and domestic nonbank financing of the budget. As a result, at end-December 1979, bank financing of the government deficit was well in excess of the ceiling on bank finance of the government deficit for end-December 1979 contained in the program of the stand-by arrangement.

Monetary developments in 1979 reflected the large balance of payments surplus and the relatively large bank financing of the budget. Overall net domestic credit during 1979 increased by 12.7 per cent, with private sector credit increasing by 14.4 per cent. From June-December, 1979, credit to the government from the banking system increased by 15.6 per cent whereas private sector credit increased by 10.1 per cent. Money plus quasi-money increased by 14.6 per cent, or about the same as the increase in nominal GDP. By December 31, 1979, the net domestic assets of the Central Bank were slightly under the ceiling amount contained in the program of the stand-by arrangement for that date.

In 1980 the staff and the Kenyan authorities expect another reversal in the balance of payments. This is due in part to the increase in oil payments and in part to increases in food imports necessitated by the failure of the short rains in November-December 1979. Also, other imports are expected to rise in 1980 because of restocking. Finally, there is likely to be a substantial short-term capital outflow as trade credit terms are shortened after the lifting of restrictions on the terms of these credits. Export performance will depend mostly on the weather and coffee and tea prices. Current projections are for a slight rise in world prices for coffee and tea; if the rains are normal, exports would increase by about 12 per cent, or substantially less than the expected increase in imports.

On March 25, 1980, the Executive Board of the World Bank agreed to a US\$70 million Structural Adjustment Credit to Kenya. This was the first of

such credits granted by the World Bank and will be disbursed in two installments during the current fiscal year. In a Letter of Intent to the World Bank the Kenya Government outlined various policy measures designed to (a) revise the Government's investment program, (b) improve external debt management, (c) rationalize industrial protection, (d) promote exports, and (e) review interest rate policy. The Letter also specifies certain specific policy actions to be taken during the next fiscal year, including (a) a limit on the utilization of external loans through the fiscal year 1980/81, and the contracting of such loans through July, 1980, (b) a prohibition against issuing new Letters of No Objection privileges, (an administrative device to restrict imports), and (c) the issuing of guidelines by September 1980 to replace quantitative import restrictions with tariffs (the rationalization of the protective system is to be completed by December 1983). It is expected that the Kenyan authorities will request a second structural adjustment loan in 1981, and the implementation of these measures will have a bearing on negotiations for the second loan.

The Fund stand-by arrangement approved by the Executive Board in August 1979 called for a review of progress under the stabilization program before December 31, 1979, and, as part of that review, a review of exchange rate policy. The Kenyan authorities indicated that they would not need to draw on the stand-by arrangement in the first half of 1980, and that there was uncertainty concerning the likely outturn of the budget in the second half of FY 1979/80; therefore, they decided that ceilings in the program of the stand-by arrangement should not be adjusted at that time. In preparation for the exchange rate policy review, a paper was prepared on medium-term

external policy measures and sent to the Kenyan authorities in November 1979. The paper argued for a devaluation of the shilling of at least 15 per cent; however, the Kenyan authorities did not feel that such a measure was needed at that time. They expressed interest in the possibility of changing their exchange arrangement from a peg to the SDR to a "managed float", using as a guideline a peg to a currency basket more representative of Kenya's trade mix. They requested a paper from the staff on the technical aspects of devising and managing such a basket. The paper was prepared and sent to the authorities in March 1980.

III. Topics for Discussion

The mission will review economic and financial developments and prospects for 1980, particularly in the context of the stand-by program. The discussions will focus on: (1) fiscal policy, including measures to better control the growth of bank credit to the Government; (2) the outlook for the balance of payments, in particular the likely effect in 1980 and 1981 of the relaxation of restrictions on imports and trade credit; (3) the exchange and trade system, in particular the possible establishment and management of a currency basket, and the planned reform of Kenya's system of industrial protection; and (4) monetary policy and interest rate policy. The mission will negotiate, ad referendum, performance criteria for FY 1980/81 with respect to bank credit to the Government, net domestic assets of the Central Bank of Kenya, and new external borrowing on nonconcessional terms.

1. Fiscal policy

The fiscal deficit has been a major contributor to economic imbalance in recent years. The overall deficit has steadily increased in real terms and as a per cent of GDP, from 4.7 per cent in 1976/77 to an estimated 7.3 per cent in 1979/80. In the current fiscal year the deficit is expected to increase by K Sh 829 million over the deficit in FY 1978/79. The mission will review in detail the reasons for the expansionary fiscal outcome, including the impact of the drought and of cost escalations in defense expenditure.

A technical assistance mission from the Fiscal Affairs Department visited Kenya in March 1980 to assist the authorities in devising tax policies which would improve the low buoyancy of the tax system. A list of measures was suggested which could have a short-term impact of as much as K Sh 400 million and a much greater long-term impact. The mission will discuss with the authorities implementation of these measures, including the operations of parastatal enterprises. A special commission was established in 1978 for a review of these enterprises. In this connection the mission will review producer price policy and the effects of this policy on agricultural production, consumption and the budget.

Difficulties in obtaining domestic nonbank financing and delays in obtaining reimbursements on externally aided projects were important reasons for the sharp increase in bank financing of the Government in FY 1979/80. The mission will discuss the reasons for these problems and measures to overcome them. The mission will also discuss the overall external debt policy of

the Kenyan authorities, particularly in regard to the accumulation of guaranteed suppliers' credits by the parastatal corporations. The debt service ratio has increased from 5 per cent in 1977 to an estimated 11.2 per cent in 1979, and is expected to increase to about 16 per cent in the mid-1980s.

2. Exchange and trade system

The mission will discuss with the Kenyan authorities their plan for reform of the exchange and trade system, particularly the planned reduction in industrial protection, and any changes in the exchange arrangement or level of the exchange rate. A flexible exchange rate policy would be a useful complement to the fiscal adjustment and to the changes in import policy. As one mechanism to facilitate exchange rate flexibility, the mission will encourage the authorities to consider pegging the shilling to a currency basket representing Kenya's trade mix. However, if the authorities continue to be opposed to a devaluation the mission will not require a change in the exchange rate, or a change in the exchange arrangement, as a condition for agreeing on a financial program for 1980/81.

In November 1979, the Kenyan authorities reduced the time period for the required advance import deposits from six months to three months and reduced the amount of the deposit for most commodities from 100 per cent to 50 per cent of the c.i.f. value. Automobiles and textiles retained the prior level and term of required deposit, and thus still represent a multiple currency practice. Kenya has maintained restrictions on remittances of dividends

(to 10 per cent of capital and reserves) and of rental income. The mission will argue for elimination of the remainder of the advance import deposit scheme during the second year of the stand-by arrangement and will urge the authorities to eliminate the remaining exchange restrictions during this period. However, given the relatively limited impact of the remaining parts of this scheme, the mission will not require action as a condition of the program.

3. Interest rate policy

Interest rates in Kenya have been fixed by regulation at substantially negative real rates since 1976. This has caused a large diversion of deposits and credit to nonbank financial institutions, the interest rates of which are not controlled. The Kenyan authorities are reviewing interest rate policy and two studies have been made, one commissioned by the UNDP and another prepared by an advisor in the Ministry of Finance. Both studies recommended increasing interest rates, extending the jurisdiction of central bank control of interest rates to nonbank financial institutions, implementing a more flexible and market-oriented interest rate policy, and specific measures to enforce a larger flow of finance to agriculture. These are policies which previous Fund missions have recommended to the authorities; the mission will urge that quick action be taken to increase the level of interest rates on private sector loans and on government obligations.

4. Elements of the financial program for FY 1980/81

The program will target for an overall deficit of less than the potential drawings under the stand-by arrangement (K Sh 1,183 million) such that gross

reserves in June 1981 would not be reduced below the level of December 1979. The drawings under the stand-by arrangement will be phased so as to match the likely need for balance of payments assistance over FY 1980/81.

A major part of the adjustment effort will have to be in the budget. The fiscal target for the program will provide for a substantial reduction in the overall deficit in real terms and to about 6 per cent of GDP. This will require a tight control of expenditures, which should be budgeted not to increase in real terms, as well as increases in revenues through discretionary tax increases and measures to increase the efficiency of tax administration. Also, measures must be taken to ensure that the relatively large shortfall in nonbank domestic financing does not reoccur in FY 1980/81.

The program will set a ceiling on the level of domestic bank financing of government fiscal operations consistent with the target for the overall government deficit in FY 1980/81. The ceiling will take into account the fact that the Government obtains banking system resources indirectly from deposits of the CSFC with the Treasury, that use by the Government of the counterpart of the Eurodollar loan has a similar domestic monetary impact to that of bank financing of the government deficit, and that there is usually a large float of uncashed government checks at the end of the fiscal year. The mission will agree with the authorities on ways in which these considerations can be taken into account in the definition or the magnitude of the ceiling.

The program will set a ceiling on the expansion of net domestic assets of the Central Bank consistent with the ceiling on bank finance of the

Government, the targeted change in net foreign assets and a moderate expansion, of about 15 per cent, in private commercial bank credit. In 1979 the inflow of net foreign assets has helped commercial banks maintain excess liquid assets and cash equal to 4-5 per cent of deposits throughout the year. The release of advance import deposits in the first half of 1980 (estimated at about K Sh 300 million or about 2.5 per cent of deposits) will further increase commercial bank liquidity. Therefore, in order to help implement the credit policy, the mission will argue that there should be an increase in minimum cash and liquidity ratios of commercial banks.

The program will include a commitment by the Government that no new external commercial bank loans will be contracted by the Government during FY 1980/81 and a commitment to improve the reporting and control of external debt guaranteed by the Government.

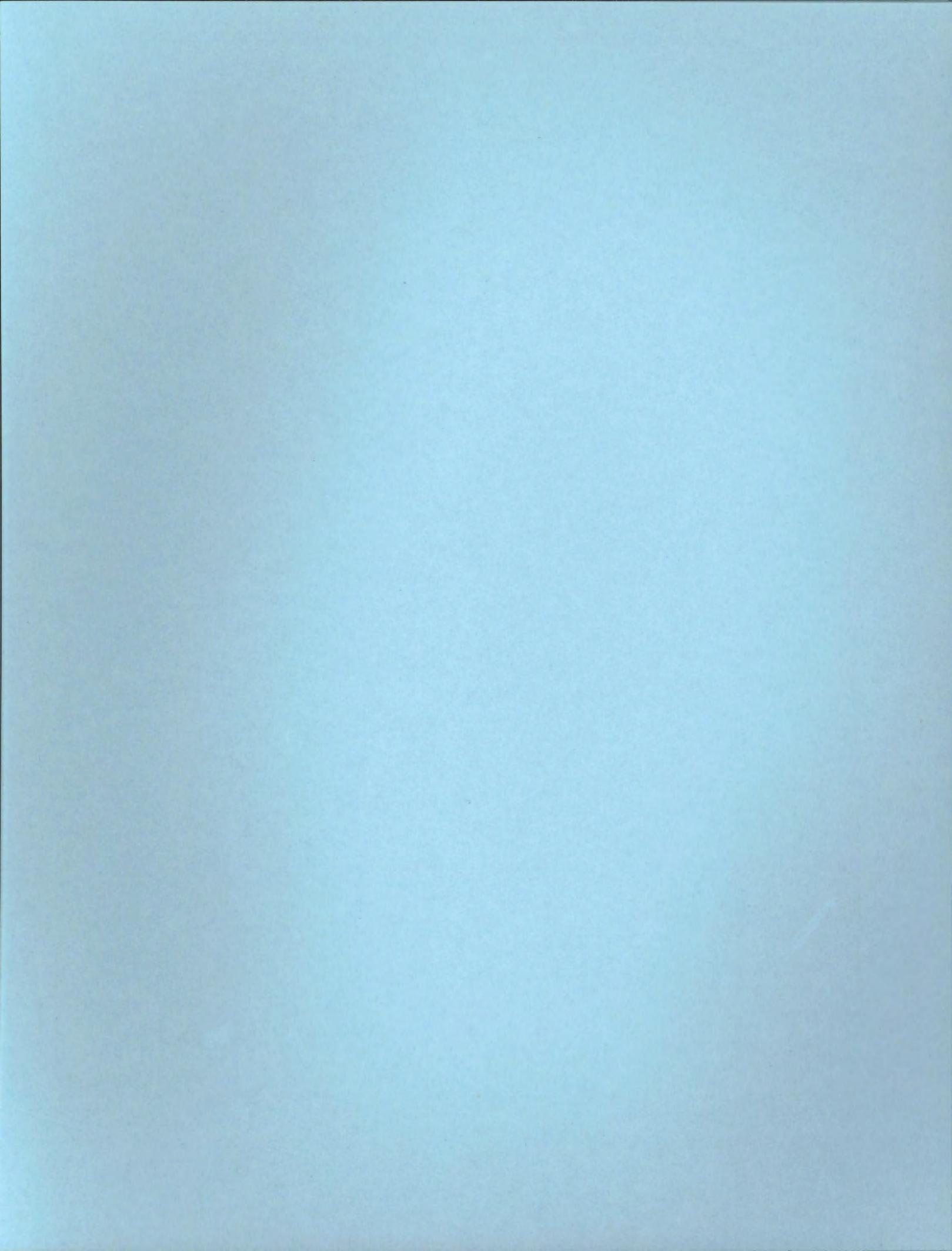
The stabilization program will contain the following quantitative performance criteria: (1) quarterly phased ceilings on the expansion from July 1, 1980 of net domestic assets of the Central Bank of Kenya; (2) quarterly phased ceilings on the expansion from July 1, 1980 of net credit to the Government from the banking system and (3) a ceiling on the contracting of nonconcessionary borrowing by the Government. The letter of intent will provide for a review before December 31, 1980 of progress in implementing the stabilization program; the review will include understandings with the Fund on exchange rate policies and exchange restrictions.

The mission will also inquire as to when Kenya expects to be able and willing to consent to the increase in its quota under the Seventh General Review; what steps have been taken so far by the authorities; and what steps will still be necessary before such a consent might be forthcoming.

Relations with the Fund 1/

Status:	Article XIV
Date of membership:	February 3, 1964
Quota:	SDR 69 million (Proposed maximum quota under the Seventh General Review is SDR 103.5 million)
Fund holdings of currency as per cent of quota:	SDR 174.00 million (252.17 per cent of quota)
Of which: oil facility	SDR 18.04 million (26.14 per cent of quota)
compensatory facility	SDR 69.00 million (100 per cent of quota)
gold distribution	SDR 0.72 million (1.0 per cent of quota)
extended facility	SDR 5.36 million (7.8 per cent of quota)
Holdings of SDRs:	SDR 84.5 million, or 282.1 per cent of net cumulative allocation (SDR 30.0 million)
Loan disbursement under the Trust Fund (first period):	SDR 19.89 million
Interim disbursement under the Trust Fund (second period):	SDR 24.528 million (including interim disbursement April 30, 1980)
Direct distribution of profits from gold sales:	US\$4.48 million
Gold distribution (four sales):	41,079.961 ounces
Exchange arrangement:	Pegged to the SDR at K Sh 9.66 = SDR 1
Intervention currency and rate for the U.S. dollar (December 31, 1979):	U.S. dollar; K Sh 7.58 = US\$1
Last consultation (Article IV):	March 1979, discussed by the Board August 20, 1979

1/ As of April 28, 1980.





Office Memorandum

cc: P. Kanesa-Thasar



TO : Managing Director ✓
 Deputy Managing Director

FROM : B. Karlstroem *BK*

SUBJECT : Kenya--Review Mission

DATE: February 5, 1980

Handwritten initials and scribbles:
 WBI
 [scribbles]

A mission consisting of Messrs. R. Stillson (AFR), H. De Zoysa (FAD), T. Gylfason (ETR), Mrs. D. Heflin (secretary-AFR) and myself visited Nairobi during the period January 17-29, 1980 to review progress under a stand-by arrangement currently in effect with Kenya. Mr. Bornemann joined the mission on January 23. Discussions were held with officials in the ministries of Finance and Planning, in the Central Bank and other agencies. Mr. Bornemann and I had a meeting with the Vice-President and Minister of Finance, Mr. Kibaki.

On August 20, 1979, the Executive Board approved Kenya's request for a two-year stand-by arrangement in the fourth credit tranche for an amount equivalent to SDR 122.475 million, including use of supplementary financing, and granted Kenya's request for a purchase under the compensatory financing facility equivalent to SDR 69 million. The program called for a review before December 31, 1979 (the mission was postponed at the request of the Kenyan authorities) of the progress made in implementing the stabilization program and, as a performance criterion, for the Government of Kenya to reach understandings with the Fund on exchange rate policy and on the early elimination of advance import deposits. At the request of the Kenyan authorities, a staff study on exchange rate policy was carried out and presented to the Kenyan officials in November.

The advance import deposit scheme has been substantially liberalized. The only items still covered at the original rate are cars and textiles (covering some 10 per cent of total imports); the effective cost of the scheme on other imports has been reduced by three-quarters. Discussions on the exchange rate were more open and fruitful this time than on previous occasions but action has not yet been taken. The Kenyan authorities see an exchange rate change very much in the context of a liberalization of the import regime (a move from quantitative restrictions to tariffs). A considerable amount of preparatory technical work has been done on this issue.

The ceiling on bank credit to the Government was exceeded in September and the excess widened in December to K Sh 950 million (73 per cent above the December ceiling). Kenya is therefore not eligible to draw under the stand-by arrangement (neither did they draw before the ceiling was broken). Although part of this excess is likely to be removed over the next few months as a result of expected non-bank borrowing (essentially from the National Social Security system) the existing ceilings for March and June, 1980 are unlikely to be observed. The Kenyan officials argued that an increase in the ceilings was warranted mainly because the level of government credit at the base period (June 1979) had been underestimated, reflecting an unusually large "float" of uncashed checks at the turn of the fiscal year. Although this argument and some other points concerning the definition of the credit ceiling might have some merit, the staff mission felt that changes of the kind proposed by the Kenyan authorities would weaken the program and reflect negatively on Kenya's credibility. (The credit ceilings in a preceding, first credit tranche program were exceeded by large amounts). It was therefore agreed between the staff

mission and the Kenyan officials not to attempt any modification of the program at this point but instead to aim for new discussions in a few months time with the purpose of designing a financial program for the second year of the current stand-by. That program would be based largely on the 1980/81 budget, due to be released in early June. By that time, it is also likely that some measures will be taken concerning the import regime and hopefully also on the exchange rate.

At the request of Kenyan officials, the mission held a number of technical meetings on possible modifications of the exchange rate regime (alternative baskets, methods of introducing more flexibility into the use of exchange rate policy). Both the Governor of the Central Bank and the Permanent Secretary of Finance indicated strong support for changing the exchange arrangement to a managed peg and it appears likely that they will do this before the next budget. We agreed to send a paper on the technical issues involved in managing such an exchange system. The mission was also asked to conduct a few seminars on the exchange rate study prepared in November by Messrs. Artus and Stillson. The study was widely appreciated.

The external position remains fundamentally weak. However, this was temporarily concealed in 1979 when exceptionally low import demand and large reversible short-term capital inflows (the result mainly of the advance import deposit scheme and a requirement for a minimum term for import financing) led to an unexpected overall balance of payments surplus of some SDR 150 million (the current account was in deficit by about SDR 340 million or about 8 per cent of GDP). The surplus in 1979 has eased the foreign exchange reserve position. In view of this and a prospective program loan from the IBRD, the Kenyan authorities were not overly concerned about being ineligible for the next several months under the stand-by program with the Fund.

However, the officials agreed that the balance of payments outlook is worrisome (a deficit of some SDR 200 million is forecast for 1980) and said that Kenya will need Fund resources later in the year. A strict budget and, hopefully, measures now under consideration to liberalize the import system and to depreciate the exchange rate could form the basis of a program for 1980/81, the second year of the stand-by arrangement.

cc: CBS
ETR ✓
FAD
INST
LEG
RES
TRE
Mr. Watson

INTERNATIONAL MONETARY FUND

KENYA

Briefing Paper--Stand-by Review

Prepared by the African Department and the
Exchange and Trade Relations Department

(In consultation with the Fiscal Affairs,
Legal, and Treasurer's Departments)

Approved by J.B. Zulu and S. Kanesa-Thanan

January 14, 1980

I. Introduction

A mission comprising Messrs. B. Karlstroem (head-AFR), R. Stillson (AFR), H. De Zoysa (FAD), T. Gylfason (ETR) and Ms. Heflin (secretary-AFR), will visit Nairobi beginning January 21, 1980 for about a week to review progress under the stand-by arrangement currently in effect with Kenya. Messrs. Stillson, De Zoysa, and Gylfason will arrive in Nairobi on January 15 to undertake technical work prior to the mission. Mr. Bornemann will join the mission on January 23.

A summary of relations with the Fund is attached.

On August 20, 1979, the Executive Board approved Kenya's request for a two-year stand-by arrangement in the fourth credit tranche for an amount equivalent to SDR 122.475 million, including use of supplementary financing, and granted Kenya's request for a purchase under the compensatory financing facility equivalent to SDR 69 million. Kenya has not yet requested any drawings under the stand-by arrangement, which calls for a review before December 31, 1979 of the progress made in implementing the stabilization

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program, and, as a performance criterion, for the Government of Kenya to reach understandings with the Fund on exchange rate policy and on the early elimination of advance import deposits; reviews of the stabilization and exchange rate policies were postponed one month at the request of the Kenyan authorities. Mr. Stillson (AFR) and Mr. Artus (RES) visited Nairobi in September to gather information for a study on exchange rate policy which had been requested by the Kenyan authorities. The study was completed and sent to the Kenyan authorities in November and will form the basis for the exchange rate review.

II. Background and Performance under the Stand-by Arrangement

In 1978, the current account of the balance of payments recorded a deficit of K Sh 5.1 billion (SDR 531 million) primarily due to a decline in coffee and tea prices and a decline in volume of coffee exports, the latter in part due to unfavorable weather. The overall balance of payments deficit was K Sh 1.6 billion (SDR 161 million). Net international reserves by the end of 1978 stood at a level of K Sh 2.1 billion (SDR 217.4 million) or about 1.7 months' imports, compared with a level of about 5.5 months' imports a year previously. In the first half of 1979 economic growth was adversely affected by the declining earnings from coffee exports and by the introduction in December 1978 of an advance import deposit scheme. The main effect of the advance import deposit scheme was to reduce imports and absorb liquidity, thus accentuating the overall economic slowdown which began in the last quarter of 1978.

In 1979, the overall balance of payments appears to have substantially improved, with net foreign assets increasing by K Sh 1.5 billion (SDR 155

million) to K Sh 3.6 billion (SDR 372.7 million) through October, and with indications of a further increase in November. The main reasons for this improvement are substantially lower imports (nominal imports in 1979 may be K Sh 3.0 billion, or 20 per cent, below the level in 1978) partly due to the effect of the import deposit scheme implemented in December 1978, a short-term capital inflow, which may be about K Sh 1 billion, due to a temporary requirement that import financing of a minimum of 180 days be obtained for most imports, delayed foreign payments of as much as K Sh 500 million for oil imports, and a drawing of K Sh 740 million (US\$100 million) on a Eurocurrency loan. If adjustment is made for these temporary factors, there would have been a substantial balance of payments deficit. In November 1979 the import deposit scheme was relaxed, and the requirement for 180-day import credit was abolished. Payment for oil imports had been delayed because of the refusal of the oil companies to pay the advance import deposit; this problem has now been resolved. Therefore, it is likely that the balance of payments would show a substantial deficit in 1980 which will be increased further due to the large rise in oil prices during 1979.

Key elements of the financial program discussed by the Board on August 20, 1979 were a reduction in the budget deficit and a greater reduction in bank financing of the deficit. The main emphasis was on increasing revenue through various tax measures, including an increase in the general rate of sales tax and additional increases in specific sales taxes, excise duties, and various fees. Budgetary expenditure was planned to decrease in real terms primarily due to a planned decrease in military

expenditure. These measures were expected to enable the authorities to reduce the overall budget deficit to K Sh 3.3 billion in 1979/80 (July-June) (7.5 per cent of GDP compared to 9.0 per cent of GDP in 1978/79). Ceilings on bank credit to the Government were set consistent with the budget and the expected levels of nonbank financing; for the purpose of the program, the ceiling was defined to include use of the Eurodollar loan. The actual level of bank credit to the Government has, however, substantially exceeded the September ceiling and indications are that the December ceiling will also be exceeded. The main reasons for the ceiling being exceeded are: (1) lower-than-expected revenue growth primarily reflecting the drop in imports and the slower-than-expected rate of economic growth; (2) higher-than-expected expenditures, probably due to the general election held in November 1979; (3) greater use by the budget than envisaged in the financial program of a Eurodollar loan signed in July 1979; and (4) an unusually large float of uncashed government checks at the end of the last fiscal year (ending June 30, 1979).

During the first quarter of the program period total credit increased by 4.4 per cent, which was slightly more than the 3.8 per cent increase envisaged in the financial program. However, the net domestic assets of the Central Bank were within the ceiling set for September. The stock of money plus quasi-money grew by only one per cent in these three months in spite of the more rapid increase in total credit and the rise in net foreign assets; it was held down by the accumulation of blocked import deposits in the Central Bank. Partial data for October indicate that the rate of increase of the June-September quarter was maintained at the same rate as in the previous quarter.

Kenya signed a US\$200 million Eurocurrency loan in July 1979 and drew US\$100 million of this amount in August. In addition to the remaining US\$100 million which can be drawn, there are indications that Kenya's credit standing in the international banking markets is still good and other Eurocurrency loans would be available if Kenya wished to negotiate them. However, the Kenyan authorities are reluctant to utilize banking credits to a greater extent than they have. The stand-by program included a maximum of US\$67.5 million of the Eurocurrency loan to be used as budget finance in 1979/80, and a commitment not to enter into other new nonconcessional external loans during the 1979/80 fiscal year.

Kenya is currently negotiating a program loan with the IBRD, the request for which is scheduled to go to the IBRD Executive Board after the return of the Fund review mission. The policy program in the loan request emphasizes a reduction in industrial protection through elimination of quantitative restrictions on imports and reduction of tariffs on final goods. The industrial protection system in Kenya has been built up since the mid-1960s, when it successfully fostered the establishment and early growth of the manufacturing sector. It is now causing substantial distortions in the manufacturing sector and biasing investment decisions of manufacturing firms against exports. The IBRD policy program also emphasizes a review of the interest rate structure as real interest rates in Kenya have been substantially negative for several years. The Fund and Bank staff concerned have consulted closely during the negotiations for the stand-by arrangement and the program loan.

III. Topics for Discussion

1. Exchange rate policy

The staff has not had any reaction so far from the Kenyan authorities to its study on exchange rate policy. We do know, however, that in the past the Kenyan authorities have been reluctant to take exchange rate action, partly because of its political sensitivity. During the last mission's visit, they took the position that they would be prepared to move the rate, if there was a clear-cut and compelling case for it. In the staff's judgment, given the seriousness of the underlying balance of payments situation in Kenya and the need for early action to meet the medium-term problem, such a case exists. The mission will discuss the findings of the staff study with the authorities and seek to persuade them to effect a devaluation of at least 15 per cent before a staff paper reviewing the program is presented for consideration by the Board. However, given the sensitiveness of the authorities on the question, and the possibility that they may wish to have further time to consider the question following discussions with the mission, and also in order to avoid an interruption of the first year's program in midstream, the mission will be prepared to agree, if necessary, that action may be taken later, although no later than June 30, 1980, before which date discussions on the second year's program will need to take place. However, such a deferment would be acceptable only if the mission is satisfied that measures are being taken to contain the overall credit expansion in the year to June 1980 within the agreed ceilings. Moreover, the mission will urge that further progress be made in the meantime toward the rationalization of the present system of industrial protection.

In order to make exchange rate flexibility more acceptable, the mission will discuss with the Kenyan authorities possible exchange arrangements which would permit movements in the effective exchange rate without substantial public notification, e.g., by changing the peg from the SDR to an unannounced and more appropriate basket, perhaps with the peg being changed periodically by small amounts.

2. Stabilization policies

The mission will review the most recent monetary and credit data and will ascertain whether any modifications to the ceilings are justified. Unless the Kenyan authorities can present a convincing case, the mission will argue that the overall credit ceiling for June 1980 should not be raised. Depending on the factors leading to the larger-than-expected budget deficit and thus the excess of credit to the Government, a reallocation of credit between the public and private sectors may be negotiated. Modifications to the credit program may also have to take account of the release of the advance import deposits and of an exchange rate change, if agreed. The exchange rate study included estimates of the effects of an exchange rate change on the budget, consumer prices, and wages. These estimates can be used to derive a credit policy consistent with financing the initial increase in import prices (thus avoiding large-scale disruptions in production in the short term) while still forcing the relative price change between traded and nontraded goods which is the pricing objective of the devaluation.

3. Policies with regard to restrictions

The import deposit scheme instituted in December 1978 was substantially relaxed in November 1979. For most imports still covered under the scheme, the required term of the import deposit was cut in half, to three months, and the amount of the deposit was cut in half, to 50 per cent of the c.i.f. import value; many products previously covered by the scheme are now totally exempt. Only passenger motor cars and textile imports still require the full 100 per cent deposit for six months. The relaxation of the scheme will release about K Sh 300 million into the private banking system, or about 2 per cent of the money stock.

The Government has publicly maintained that the scheme was temporary and would be removed as soon as balance of payments conditions permit. The mission will gather the information necessary to ascertain whether the scheme constitutes a multiple currency practice and will discuss with the authorities when the rest of the scheme can be eliminated. Given that the remaining parts of the scheme have a limited impact, the mission, while pressing for its elimination, will not require immediate action on this point. However, the mission will urge the authorities to eliminate the scheme as soon as possible.

4. Interest rates

Interest rates on time and savings deposits, most of which are fixed by the Central Bank, have been maintained between 5.0 per cent and 5.88 per cent since 1975 while the rate of inflation has averaged about 14 per

cent since that year with the lowest annual rate being 9 per cent. These persistent negative real rates have been a disincentive to financial saving and have caused the growth of deposits in the banking system to be significantly less than the growth of deposits in nonbank financial institutions. The growth of these institutions, which are not subject to the same interest rate or reserve requirement controls as commercial banks, reduce the effectiveness of the monetary control by the Central Bank. The Kenyan authorities agreed as part of the stand-by arrangement to undertake a study to determine the effect of interest rate adjustments; the IBRD has also instituted a study on Kenyan interest rate policy as part of the preparation for the program loan, and has required a thorough review of interest rate policy by the Kenyan authorities as part of the requirements for the program loan. The study is not yet completed. This mission will convey to the authorities the Fund's independent judgment that an adjustment in the interest structure is urgently needed.

5. Quota increase

The mission will also inquire as to when Kenya expects to be able and willing to consent to the Seventh Quota increase; what steps have been taken so far by the authorities; and what steps will still be necessary before such a consent might be forthcoming.

Relations with the Fund 1/

Status	Article XIV
Date of membership	February 3, 1964
Quota	SDR 69 million (Proposed maximum quota under the Seventh General Review is SDR 103.5 million)
Fund holdings of currency as per cent of quota	SDR 177.30 million (256.95 per cent of quota)
Of which: oil facility	SDR 21.34 million (31.5 per cent of quota)
compensatory facility	SDR 69.0 million (100 per cent of quota)
gold distribution	SDR 0.72 million (1.0 per cent of quota)
extended facility	SDR 5.32 million (7.7 per cent of quota)
Holdings of SDRs	SDR 89.2 million, or 298.0 per cent of net cumulative allocation (SDR 30.0 million)
Loan disbursement under the Trust Fund (first period)	SDR 19.89 million
Interim disbursement under the Trust Fund (second period)	SDR 14.54 million
Direct distribution of profits from gold sales	US\$4.48 million
Gold distribution (four sales)	41,079.961 ounces
Exchange arrangement	Pegged to the SDR at K Sh 9.66 = SDR 1
Intervention currency and rate for the U.S. dollar (December 31, 1979)	U.S. dollar; K Sh 7.3256 = US\$1
Last consultation (Article IV)	March 1979, discussed by the Board August 20, 1979.

1/ As of January 9, 1980.



BLUE FOLDER

Office Memorandum

TO : Mr. Karlstroem
FROM : S. Kanasa-Thanan *SK*
SUBJECT : Kenya - Briefing Paper

DATE: January 11, 1980

The paragraph on page 6 of the draft brief may be understood by the Kenyan authorities as being akin to an ultimatum. I would suggest the following substitute paragraph for your consideration. I have a few other comments which I will give verbally.

The staff has not had any reaction so far from the Kenyan authorities to its study on exchange-rate policy. We do know, however, that in the past the Kenyan authorities have been reluctant to take exchange rate action, partly because of its political sensitivity. During the last mission's visit, they took the position that they would be prepared to move the rate, if there was a clear-cut and compelling case for it. In the staff's judgment, given the seriousness of the underlying balance of payments situation in Kenya and the need for early action to meet the medium-term problem, such a case exists. The mission will discuss the findings of the staff study with the authorities and urge them to effect a devaluation of at least 15 per cent before a staff paper reviewing the program is presented for consideration by the Board. However, given the sensitiveness of the authorities on the question, and the possibility that they may wish to have further time to consider the question following discussions with the mission, and also in order to avoid an interruption of the first year's program in mid stream, the mission will be prepared to agree, if necessary, to a deferment of the reaching of understandings with the Fund on the question, to June 30, 1980, before which date discussions on the second year's program will need to take place. It is possible that the Kenyan authorities may be willing to take exchange rate action following similar action by Uganda. The Ugandan authorities have declared their intention to take appropriate exchange rate action before mid-1980 in their stand-by program with the Fund. Before agreeing to such a deferment, however, the mission will satisfy itself that the implementation of the current program will not be adversely affected to a material degree by a delay in exchange rate action. In order to make exchange rate flexibility more feasible to implement, the mission will discuss with the Kenyan authorities possible exchange arrangements which would permit movements in the effective exchange rate without substantial public notification, e.g., by changing the peg from the SDR to an unannounced and more appropriate basket, perhaps with the peg being changed periodically by small amounts.

Moreover, they would urge that further progress be made in the meantime toward the rationalization of the present system of excessive industrial protection.

