FILE COVER SHEET

DO NOT REMOVE CONTENTS OF FILE

CENTRAL FILES

CLASSIFICATION

C/Kenya/1794 Structural Adjustment Facility
June 1989 - December 1990

CROSS REFERENCES

C/Kenya/810 Missions

C/Kenya/1760 Stand-by Arrangements

CONTENTS

Kenya; 1794 01

IMF OFFICIAL MESSAGE

WASHINGTON, D. C. 20431

DO NOT SOFT ROLL EXCEPT WHEN ALIGNING INTO LINE 23

1990 DEC 18 AM 9:70

The Treasury
Ministry of Finance
P.O. Box 30007
Treasury Building, Harambee Avenue
Nairobi, Kenya

Executive Board took following decision December 14, 1990: quote

1. Paragraph 1(b) of the second annual arrangement for Kenya under the enhanced structural adjustment facility (EBS/90/64, Sup. 2, 5/3/90) is amended by increasing the amount of the second loan to the equivalent of SDR 60,233,333.

2. The Fund determines that the midterm review specified in paragraph 2(c) of the second annual arrangement for Kenya under the enhanced structural adjustment facility has been completed, and that, notwithstanding paragraph 2(a)(i), Kenya may proceed to request the disbursement of the second loan under the arrangement. unquote

Van Houtven, Secretary
Interfund

MARK XX FOR CODE ( ) CODE

DISTRIBUTION

CC: SEC
MD
DMD
MR. MONYAKE
AFR
ETR
FAD
LEG
RES
TRE
MR. P. ANDREWS

SPECIAL INSTRUCTIONS

TELEX NO.: RB

DRAFTED BY NAME (TYPE): BBurton/BJOwen EXT.: 6709 DEPT/DIV: SEC/EBPD DATE: 12/14/90

AUTHORIZED BY NAME (TYPE): Leo Van Houtven AUTHORIZED BY NAME (TYPE):

TYPE ** ON LAST OR ONLY PAGE OF MESSAGE **

Log A8246

SEC. 48 (a) REV. 3 11-21-88 CONTINUOUS

SIGNATURE (PLEASE KEEP SIGNATURE IN SPACE ALLOWED) SIGNATURE

C/Kenya/1794

1. KENYA - ENHANCED STRUCTURAL ADJUSTMENT FACILITY - REVIEW UNDER SECOND ANNUAL ARRANGEMENT

The Executive Directors considered the staff paper for the midterm review of Kenya's second annual arrangement under the enhanced structural adjustment facility (EBS/90/194, 11/15/90).

The staff representative from the African Department made the following statement:

> The Consultative Group for Kenya met on November 19-20, 1990 in Paris and was attended by representatives of 13 donor countries and 8 multilateral organizations. Aid commitments will continue at last year's level, but new commitments of balance of payments support presently appear insufficient to meet the estimated remaining external financing requirements for 1991. Donors agreed that it might be necessary to meet again in March 1991 to review aid commitments to Kenya since aid decisions for 1991 have not been finalized in a number of countries and multilateral institutions. The new details on the financing of the remaining financing requirements will be available at the time of the third annual arrangement under the ESAF. As indicated in the staff report, in the event that the remaining financing requirements--which are virtually equal to the additional oil bill--are not met in full, additional adjustment measures would be required, and a possible modification of the reserve target may be unavoidable.
>
> I will now comment briefly on recent economic developments. The month-on-month inflation at end-October 1990 was 13.0 percent, up from 10.6 percent at end-September 1990, largely reflecting the full impact of higher domestic oil prices and new indirect tax measures.
>
> The actual monetary survey data for end-September which have recently become available are consistent with the estimates indicated in the staff report (p. 9). Net domestic assets exceeded the program benchmark by K Sh 3.5 billion or 7 percent of the stock of broad money at end-September 1989. While credit to the private sector was well below the implied ceiling (by K Sh 3.5 billion) credit to the Government exceeded the subceiling by K Sh 4.3 billion.
>
> The auction system of treasury bills has been freed and is functioning. During the first three weekly auctions, the discount on the highest accepted bids were 17-18 percent compared with about 15 percent before the freeing of the auction.

The first export processing zone was inaugurated in late November, ahead of schedule. The export processing zone is privately owned and operated.

Kenya has arrears equal to an amount of $3.5 million, which are owed to the World Bank since November 15, 1990.

As to external nonconcessional borrowing, in the last week we have been informed of two recently signed loans, totaling together £57.6 million, which may have brought Kenya's nonconcessional borrowing at end-December above the quantitative benchmark for 1990. One loan is for the repair of the runway at Jomo Kenyatta International Airport; the other is a management services contract for Kenya Power and Lighting. The staff is in the process of verifying whether the two loans fall within the 15-year maturity period covered under the benchmark. The staff has also been informed that another large nonconcessional loan for the import of military aircraft is under discussion. The staff has indicated to the Kenyan authorities that it is extremely concerned about these developments. In discussions with the Kenyan authorities in relation to the third year annual arrangement under the ESAF, the staff will seek to ensure that policies are in place to contain the debt-service ratio over the medium term.

Extending his remarks, the staff representative from the African Department said that the Kenyan authorities' failure to make the payment to the World Bank on the due date had been unintentional. The Bank's office in Nairobi had not drawn the authorities' attention to the payment. Now that the authorities were aware of the arrears, they planned to settle immediately.

The authorities had assured the Fund that the two nonconcessional loans referred to in the statement had maturity dates that exceeded the 15-year maturity period covered under the benchmark, the staff representative from the African Department commented. They were forwarding documentation concerning the agreements. The President had also firmly reiterated his commitment to proceed with the military aircraft loan, despite intense pressures to delay from a number of sources.

Mr. Mwananshiku made the following statement:

In the post-independence history of Africa, Kenya has earned the reputation of having one of the best performing and most stable economies. There has been substantial development. Price rises have not gone above 21 percent. The balance of payments difficulties that have occurred have never completely halted the

growth of the economy. In fact, Kenya is one of the very few African countries where per capita incomes have been steadily rising in real terms in the second half of the 1980s.

Although the economy has been performing moderately well, it has not been desirably free of financial and economic difficulties. Although these difficulties can be partly associated with domestic policies that the authorities were forced to carry out in order to cope with the prevailing economic and social conditions, they are mostly the result of exogenous shocks or large unforeseen changes in key economic variables which are beyond the direct control of Kenyan policymakers, because the economy remains very open; the combined value of imports and exports was equivalent to over 50 percent of GDP in 1989. There is a continuing dependence on coffee and tea as the principal exports, which are subject to highly unstable world prices. Kenya's agro-based industrial sector is also subject to the vagaries of the weather. Moreover, the country is wholly dependent on imports of oil. In recent years, there has been a welcome diversification of exports, and tourism has become a large earner of foreign exchange.

The external current account position worsened more than originally expected for the first six months of 1990, owing mainly to exogenous shocks. The overall balance of payments in the same period is estimated to have been in deficit. As a result, net official reserves declined by SDR 86 million, compared with a targeted increase of SDR 14 million, and gross reserves fell to less than one month of nongovernment imports. The weak payments position can be traced to the deterioration in the terms of trade, the impact of the import liberalization program, and the lower-than-anticipated amount of cash assistance and import financing.

The rapid monetary expansion that led to strong domestic demand, particularly by the public and parastatal sectors, also partly contributed to the weak external payments position. However, during the second quarter of 1990, steps were taken to tighten monetary policy, including raising interest rates, removing caps on fees and charges, and imposing penalties on commercial banks that exceeded their credit ceilings. In spite of these monetary policy measures, the recent change in the ceiling for credit expansion from domestic credit to net domestic assets created monitoring difficulties for a number of large commercial banks, as a result of which the net domestic asset ceiling for end-June 1990 was exceeded.

Despite slippages with respect to the performance criterion on net domestic assets and the quantitative benchmark on net official reserves, Kenyan authorities were successful in implementing many of the key elements of the program. In particular, progress

was made in containing government borrowing from the banking sector, the performance criteria was observed for nonconcessional borrowing, and the structural performance criteria on export promotion and import liberalization were met, as were the structural benchmarks on freeing prices and on interest rates. Fiscal performance was broadly on target, with the overall budget deficit for 1989/90 being lower than the target. The revenue to GDP ratio was higher than the programmed level. The Government showed increased reliance on nonbank sources, and there was a modest net repayment by the Government to the banking system.

The Kenyan authorities expect a sharp deterioration in the balance of payments and a substantially weaker external reserve position during 1990/91. Accordingly, they have recently approved a package of far-reaching and difficult policy measures which will have significant short-term costs to the economy, particularly given the urgent need to improve vigorously the employment situation. The package of measures is also designed to contain the rate of inflation, which has risen recently as a result of the domestic oil price increases of 31 percent to 49 percent in September 1990 and to keep new tax measures within the revised target of 12 percent for end-1990.

Fiscal policy will aim at reducing the 1990/91 budget deficit from the original target of 3.8 percent of GDP to 2.5 percent of GDP, and further to 2 percent of GDP in 1991/92. Already, a number of discretionary revenue measures which will broaden the tax base and enhance the elasticity and equity of the tax system have been implemented, along with numerous nontax measures. The Government has also moved swiftly to put in place the new value-added tax law. The role of user charges in financing recurrent expenditures will continue to be strengthened, with due protection provided for vulnerable groups. The overall share of recurrent expenditure as a ratio of GDP is projected to decline, mainly with a reduction in the wage bill and nonwage expenditures on public administration and defense. To limit the rate of employment growth in the civil service, the authorities intend to reduce the number of authorized posts in the 1990/91 fiscal year, severely limit the increase in posts in 1991/92, and restrict the intake of new university students. The authorities have committed themselves to a midyear and third-quarter review of the budget, in order to enforce firm control over expenditure.

Monetary policy will seek to maintain the growth of domestic credit and liquidity, consistent with the target for inflation and the buildup of external reserves. As a gradual move by the Central Bank toward the use of indirect instruments of monetary control, treasury bill rates have been fully liberalized, and new bearer treasury bonds introduced. My authorities fully recognize

that a more flexible, market-oriented interest rate policy will contribute to enhancing financial intermediation, improving resource mobilization, and increasing the efficiency of credit allocation. To this end, interest rates will be further liberalized, in line with the target set for June 1991.

In the external area, the authorities intend to rely on the flexible management of the exchange rate, insofar as the efficiency gains from other policies, including fiscal and monetary measures, are not adequate. As reflected in the 1990/91 budget, and also expressed in the staff report, the Government is strongly committed to trade liberalization and reducing existing biases against the production of exportables, particularly of nontraditional industrial goods. The authorities intend that nonconcessional borrowing by the public sector, including leases, stay within a reasonable limit, in order to ensure that the debt-service burden remains manageable.

My authorities regard structural reforms as essential to strengthen the growth potential of Kenya's economy. As mentioned above, significant measures have already been implemented in the area of the tax system, the financial sector, and trade. In addition, the first export processing zone was inaugurated in late November, ahead of schedule.

With respect to the reform of state corporations, the authorities are working on a draft policy framework paper, which, among other things, will facilitate designation of state corporations as either strategic or nonstrategic, and will identify candidates for privatization in 1991. A reform program that begins with both a clear statement of objectives and is well planned and sustainable is an effective way of demonstrating the authorities' commitment to reform, and phasing in the implementation of changes helps to make adjustment costs less onerous. Such a program justifies the case-by-case approach in the context of Kenya's effort to reform the public enterprise sector.

The Kenyan authorities are fully aware of the difficult task ahead in achieving durable economic growth, free from many distortions. At the same time, however, they are hopeful that they will succeed in overcoming their difficulties in a coherent fashion. I have no doubt that their full awareness of the present situation and their broad agreement with the thrust of the staff report will facilitate their task in rectifying the present imbalances in the economy--particularly, those relating to demand pressures.

I would like to take this opportunity to express the authorities' wish to thank official creditors and the multilateral financial institutions, including the Fund, for their continued

support of Kenya's adjustment efforts. Such support will continue to be required to meet the needs of the economy in 1991 and beyond. The substantially strengthened policy package should receive the support of the Fund through the approval of the authorities' request for a waiver of the performance criterion on net domestic assets for end-June 1990 and an increase in the amount of the second disbursement under the ESAF by the equivalent of SDR 20 million, in view of substantially rising oil import bills. We believe that the seriousness of Kenya's balance of payments need and the strength of its adjustment program merit the Board's approval of the requested acceleration of disbursement. It is to be noted that the Fund is now prepared to augment oil importing countries' access to ESAF resources, within the framework of its recent decision to assist countries affected by developments in the Middle East.

In conclusion, I would like to express my authorities' wish to commend the staff for the spirit of cooperation it showed during the review of the program in Nairobi. In my authorities' view, the staff has presented a well-balanced review of the Kenyan economic situation and offered a faithful account of the discussions with them.

Mr. Wright made the following statement:

In previous discussions of Kenya's arrangement under the ESAF, Directors have increasingly expressed concerns about the modest ambitions of the authorities' programs and the long-term dependence on concessional external assistance. These concerns were reinforced by doubts as to whether compliance with program criteria and benchmarks concealed rather less favorable underlying developments.

Unhappily these worries have proved to be justified. The modest achievements so far have left the economy more vulnerable to the shock of higher oil prices than it might have been, and these difficulties have been compounded by a shortfall in official capital inflows. Underlying developments have become more evident, showing through in the breach of the net domestic assets performance criterion and in the fiscal deficit. The net result has been lower growth, higher inflation, and a precipitous fall in reserves.

I am not suggesting that the authorities' difficulties are entirely of their own making; clearly, Kenya has been hit very hard by a series of adverse external developments, of which higher oil prices and shortfalls in official inflows are only the most recent. And the authorities' response to these latest

difficulties has been swift and appropriate. But it is unfortunate that the much-needed fiscal tightening now planned had to be forced on the authorities by such a turn of events, rather than being adopted earlier.

Turning now to the specifics of the proposed adjustment to new circumstances, it is clear that the fiscal position holds the key. The scale of the envisaged adjustment is impressive, but achieving it will no doubt be difficult. In the longer run improved revenue administration must play an important role, but for the remainder of this fiscal year one-off receipts also make a significant contribution, just as they did last year. If adjustment is to be sustained, the authorities will have to stand prepared to find other sources of revenue, should the buoyancy of the tax-take continue to fall short of expectations.

On the expenditure side, the authorities' plans will require significant further improvements in monitoring and control, as identified by the recent Fiscal Affairs Department mission. Once again, development spending will bear some of the brunt, and I would have been happier to have seen even greater emphasis on curtailing recurrent expenditure. In particular, the scale of civil service growth, even after the latest revision, is staggering and makes a firm grip on wage growth essential. I would appreciate more information on what share of this wage growth is accounted for by new teaching posts and whether the other new post are essential.

As the staff notes, fiscal adjustment will make a significant contribution to reducing net domestic asset growth, while allowing headroom for private sector borrowing. In this context it was disappointing to learn that despite restrained growth in private sector credit, the performance criterion on net domestic assets has been exceeded. Yet I could find nothing in the paper to give reassurance that the monitoring problems in banks--blamed for this excess--have been satisfactorily resolved; perhaps the staff could clarify the position. More generally, I recognize the need for the temporary expedient of the penalty deposit scheme, but very much welcome the progress made by the authorities in liberalizing interest rates and fostering conditions for indirect means of monetary control. I urge them to take the necessary steps to allow an early end to the penalty deposits.

Performance on structural measures as specified in the program has not posed problems, and I applaud the authorities' determination to persist in trade liberalization in the face of unhelpful external developments. However, the plans for reforming and privatizing the parastatal sector remain inadequate in scale and in timing. Recent adjustments to some parastatal budgets and

progress in the legal and monitoring areas are essential steps, but do not go far enough. Any third-year program brought to the Board must have as a central element a tight timetable for reform and divestiture of the parastatals, if the arrangement under the ESAF is to be considered as having achieved its objectives.

Still with structural measures, the various export-related measures seem sensible. But I wonder if the authorities may not be expecting too much, too quickly of Export Processing Zones. If the intention is at least in the part to attract inward investment for export capacity, there is no substitute for an environment which is generally conducive to investors. Such an environment entails a sound macroeconomic framework, not least to give investors confidence in being able to make dividend payments as desired, and a minimum of bureaucratic obstacles.

Turning now to the external position, I welcome the staff's clear presentation of the net cost impact of the increase in oil prices. But even without higher oil prices, the prospects for the external position would look bleak. Despite considerable projected import compression and growth in nontraditional exports, rebuilding reserves is almost entirely dependent on additional financing through 1994. This reliance on additional financing heightens concerns previously expressed by the Board about the long-term dependance of Kenya on official inflows. Such concerns were being expressed when inflows had apparently been identified; yet in the short term, even these inflows seem not to be forthcoming. Notwithstanding the problems of timing noted by the staff and taking into account related government import compression, the net inflow of official capital in 1990 and 1991 taken together is now expected to be considerably smaller than previously envisaged. The reference in the staff's statement to a possible need to modify the reserves target in the light of shortfalls is of particular concern, and I agree with the staff's overall judgement that no relaxation of policy can be contemplated unless a significant and--it must be said, unexpected--improvement in the external position were to materialize. Indeed, the staff is right to identify the possibility that further adjustment measures will be needed if there is an overall shortfall in financing next year.

There are several issues arising out of the deterioration in the external position on which I wish to focus. First, as I just noted, import compression will have to be considerable, which makes achievement of the authorities' fiscal targets essential, and the public sector's new foreign exchange budget process must be made to subordinate spending to the needs of the reserves target. At the same time, there must be careful prioritization, to minimize as far as possible the impact of growth.

Second, nontraditional export growth will have to recover from its disappointing showing so far this year. As I have already noted, the authorities seem to be placing great emphasis on various structural and tax measures; could some revision to land-use laws also be helpful in this connection? With respect to the price of tradable goods, there are several references in the staff report and the authorities' letter to exchange rate policy which--taken together--are somewhat ambiguous. The staff appraisal and Mr. Mwananshiku's statement suggest that exchange rate action will be taken only if other policies raise exports are unsuccessful. I have no difficulty with this approach. The last paragraph of the authorities' statement, however, suggests that it may take a more prominent place. I would welcome some clarification from the staff. Exchange rate action will be a subject of central importance in negotiations for a third-year program, and we will be better informed when the long-term study commissioned by the Deputy Managing Director in the last Board discussion of Kenya is completed.

Third, strict control of debt-servicing obligations has become even more important, if Kenya is to maintain its admirable record of debt service. The information from the staff this morning that nonconcessional borrowing remains within limits is encouraging, but it is essential not only that the new limits are strictly kept to, but that accounting and reporting procedures are sufficiently rigorous that the staff can have confidence that these limits are, indeed, being observed.

My concern about debt-servicing capacity is especially great, because the deterioration in external prospects has important implications for Kenya's ability to repay the Fund. Scenario B in Table 9 of the staff report brings out very clearly the consequences for the Fund's exposure if there are further adverse developments. The staff also notes the serious implications for growth and investment. The authorities should take careful note of this fragile position, and recognize what it means in respect of the absolute necessity of successfully implementing their strengthened adjustment policies, with further adjustment should it prove necessary.

The Kenyan authorities have taken prompt action in response to both adverse exogenous developments and evidence of emerging domestic policy inadequacies. I commend them for this action and fully support the decision concluding this review. As for the rephasing of disbursements, the parlous state of Kenya's reserves and the proper pass-through of oil price rises make this rephasing appropriate and acceptable. But the authorities must recognize

that the rephasing leaves them more exposed to adverse developments next year, and therefore requires strict adherence to the planned adjustment this year.

This adherence is also required if donors and creditors are to have the necessary confidence to allow them to continue to support Kenya and, indeed, provide the support that the new external projections suggest will be required. I urge the authorities to show that such confidence will be justified by following through on the bold and admirable steps they have now taken to help themselves.

Mr. Spencer made the following statement:

Kenya's overall performance under the ESAF has been rather mixed, and this mixed performance remains true of the most recent period under review. A significant deterioration in economic performance over the past year has resulted both from a worsening external environment and a degree of policy slippage, particularly on the fiscal front. The balance of payments has suffered from the recent oil shock, the downturn in commodity prices, and poor export supply conditions. But it has also been adversely affected by excessive fiscal and domestic demand pressures which have been reflected in strong domestic credit growth and inflationary pressures. The staff has told us that growth in net domestic assets has exceeded both the September 1990 benchmark and the June 1990 ceiling and that credit to the Government also exceeded its ceiling in September.

More importantly, however, Government expenditure exceeded its target by one-half percent of GDP and, despite the offsetting effect of increased taxation and seignorage from the Central Bank, the staff is suggesting on page 6 of its report that the 1989/90 budget deficit will exceed the 4 percent target by 0.5 percent to 1 percent of GDP. More recently, we have seen strong actions by the Kenyan authorities to improve the fiscal situation and facilitate economic adjustment to the worsening external environment. We particularly welcome the efforts being made to contain the recent rapid increases in the public sector wage bill and exert greater control over parastatal expenditures.

However the underlying concern I have is whether the overall policy response will be sufficient to put Kenya in a sustainable financial position in the medium term. A financing gap--some SDR 107 million--remains for 1991. Clearly, if donors maintain their present positions, then, as the staff has told us in its statement, additional adjustment measures will be required in the near future.

More importantly, the medium-term balance of payments projections in Table 5 point to a very slow improvement in the external balance, with the current account deficit remaining around 6 percent of GDP through 1991-93, despite export volume growth of 10 percent to 12 percent per annum projected in both 1992 and 1993. From a savings-investment perspective, this prospective outcome is perhaps surprising, given that the government cash deficit is assumed to fall to 2 percent to 2.5 percent of GDP, and firm monetary and fiscal policies are intended to promote private savings at the expense of domestic demand. Perhaps staff could comment on this matter. In particular, are there constraints to the development of the traded goods sector that require additional expenditure and resource switching policies, as opposed to the expenditure reduction measures included in the recent package?

Despite the significant real depreciations shown in Table 2 of the staff report, the staff still seem to be suggesting that further improvements in the profitability of the traded goods sector will be required. I would be interested to hear the staff's views on whether this improvement will require significant further nominal depreciations, or whether structural policies are the key to achieving a competitive traded goods sector. In other words, will depreciations be futile in the absence of other actions?

My concerns in this area would suggest that, if anything, faster adjustment may be required. Certainly I would see no scope for the slower adjustment path that would be preferred by the authorities should external conditions become more favorable. I agree with the staff that a very substantial improvement would have to be seen before any relaxation could be considered.

Finally, in considering the proposed decision, I am in agreement with the staff that the renewed commitment of the authorities--as evidenced by the recent policy package--and the very clear financing need warrant continued support for this program. Furthermore, the demonstrated impact of the oil shock on Kenya's balance of payments provides good grounds for the remaining disbursements to be rephased in the manner requested. We therefore support the proposed decision.

Mr. Fernando made the following statement:

The present review questions whether the underlying trends carry sufficient conviction that the Kenyan economy is on a path of durable adjustment. Nearly at the end of its second arrangement under the ESAF, and preceded by an extended Fund facility and

successive stand-by arrangements, it comes as an unpleasant shock that the balance of payments and external reserves position are precarious.

Today's review is a stark contrast to that of the first arrangement when some Directors were favorably disposed to complete that review on a lapse-of-time basis. Yet, within the short space of a year, and before the effects of the Middle East crisis can sink in, the external sector is in bad shape. The vulnerability of the economy to external shocks is obvious enough, but the shortcomings in monitoring a deteriorating situation and the inadequacy of the policy response to deal with it call into question how well the adjustment momentum is anchored. Shortfalls and processing delays in external financing are highlighted as contributory factors. But, to what extent do these reflect the authorities' difficulties in satisfying the policy conditionality demanded by the lending institutions? The experience to date suggests that, in drawing up the financing scenario, a larger safety margin should be built in to absorb timing lags in policy-based borrowing. Even if the recent corrective measures are successful, the prospects are that at the end of the second arrangement under the ESAF, external reserves would be no higher than at the outset of the arrangement and, therefore, in an important respect would fail to strengthen the balance of payments.

Even though certain performance criteria and many benchmarks were observed, clearly the slippages have undermined the macroeconomic targets. The shortfalls in the application of macroeconomic policy tools have not been compensated by performance or even overperformance in the structural area, simply because the deterioration from previous macroeconomic failures had set in far sooner than the benefits of structural reforms, which show up only with considerable lags.

Even with respect to fiscal adjustment--seemingly a success--we have concerns about the quality of that adjustment. First, the lack of control over wages and the wage bill has contributed to an erosion of competitiveness through a worsening of inflation. Even at the outset of the arrangement under the ESAF, Directors emphasized the need to exercise restraint over the wage bill. But, under both the first and now the second year arrangements, the benchmark has been broken. The regularity of wage increases has derived legitimacy at times from the recommendations of government-appointed commissions. The authorities, however, are solely responsible for financially prudent policies.

Second, pressures for current consumption have been met at the expense of expenditure on maintenance of capital assets. This

policy undermines the contribution of total factor productivity to production. The lowering of potential GDP as a result could hardly be made good when the other variables--namely, capital and labor--are costly.

Third, the large outlay on universities can potentially contribute to greater efficiency of production. But, can the staff give us an assurance that this investment in training matches the skills requirements of Kenya?

Fourth, the operations of state corporations have offset budgetary corrections. A true assessment of public finance conditions and the surveillance of the fiscal adjustment path is possible only on the basis of broader statistical measures that include state corporations. The policy response here has been long on intentions and short on implementation. The first policy framework paper for the ESAF targeted industrial parastatals for comprehensive reform in 1989. According to the latest documentation, even by 1991 only the identification of candidates for privatization is possible. For an ESAF program that is entering the final stages, emphasis on further studies and further layers of administration of a diagnostic nature--for instance, the inquiry into reasons for default on foreign debt obligations--are indeed worrisome. We wonder what incentives there are for the authorities to pursue enterprise reform and indeed the lengthy unfinished agenda in other areas after the arrangement under the ESAF runs out.

In the external sector, the critical issue is the competitiveness of Kenyan exports. The worsening terms of trade and insufficient domestic efforts at cost control would have contributed to a decline in the ratio of relative prices between tradables and nontradables. How much of the burden of adjustment should be borne by exchange rate action is rightly dependent on the efficiency gains from other policies. But clearly, the staff paper recognizes that the effects of financial tightening on the external sector involve a time horizon in excess of the margin allowed by the low level of reserves. The direct restraints over specific imports of the Government and state corporations and the inevitability of lengthening the schedule of trade liberalization is evidence of the need for early results. The latter, though a further setback to the arrangement's objectives, is unavoidable. The pace of action on the exchange rate, and, indeed, its timing should be more fully articulated. Is a step adjustment preferable to a gradual exercise in Kenya's present circumstances? In building up policy credibility, consideration should also be given to expectations on the part of economic agencies of a market-clearing exchange rate. If, however, past performance argues against this approach, then assurances of external financing would have to look

much stronger, in order to provide a safety margin when placing primary reliance on domestic policies. The staff update is not helpful in this respect. Rapid action is vital to restore export growth to service external debt, including heavy repayments to the Fund, and to support import liberalization.

Further, on import liberalization, we would underline the importance of more pervasive financial sector reform to establish a proper incentives framework. It is of interest that the recent monetary tightening has given an impetus to the development of a more market-oriented monetary policy. Although welcome, these steps--to the extent their scope and timing is determined by the imperatives of the present need for stabilization--will likely have costly side effects, which could undermine the momentum of structural reform in this area. We hope the authorities stand resolute here.

Finally, on page 30 of the staff report, it is said that Kenya would like a slower adjustment path in the event of an improvement in external prospects--namely, a budget deficit of 2.5 percent to be achieved only by the end of the century. Kenya must be the best judge here, although we would remind the authorities that, in the presence of loosely-managed state corporations, a broader concept of a public sector fiscal balance would be a more meaningful indicator of public finance conditions than the budget deficit per se. The Fund can only give advice. But as between 1986--when the target was set--and now, important developments in the world economy have occurred. Energy prices are likely to be higher in real terms; there are larger claims on world savings. Kenya will have to compete basically on the strength of its policies and results. Current population pressures require a high growth rate to achieve per capita income growth. Capital inputs will be constrained by its high real cost, and the production function would be increasingly determined by labor input and total factor productivity. Thus, emphasis on making more efficient use of existing capital stock and proper pricing of labor to preserve incentives is essential.

Mr. Hogeweg made the following statement:

Apart from the monetary expansion, above and beyond the limits set by the program, two other, rather disturbing developments have taken place in the relatively short period which is under review: inflation which should not have exceeded 7.5 percent is now estimated at 13 percent and foreign exchange reserves are now estimated to have dwindled to the equivalent of only two weeks' worth of imports. No doubt, the increase in the price of petroleum imports accounts for much of this deterioration, but the

vulnerability of the economy to a shock of this kind leads me to conclude that the Fund program has not been rigorous enough in the first place. The preference expressed by the authorities to return to a slower adjustment path once the external prospects improve, bears this conclusion out. In deciding on these matters, I would advise the authorities to keep in mind their dependency on aid financing. All these factors provide all the more reason to insist that performance criteria are fully met and the waiver which we are requested to approve today should be accompanied by the strongest cautionary wording.

Of course I welcome the recent strengthening of Kenya's policy stance to counter their difficult external situation. In particular, I welcome the authorities' decision to reduce the 1990/91 fiscal deficit to 2.5 percent of GDP--a level previously thought to be attainable only in the late 1990s. Again, the importance of attaining this target can not be overemphasized. The situation whereby credit to the Government exceeds its subceiling while private sector credit falls short needs urgent repair.

On the monetary side, the transition from targeting total domestic bank credit to net domestic assets should enable better monitoring and control. Another positive step is the introduction of the auction system of treasury bills. I note with satisfaction that, as a result, the discount rate has increased by some 3 percentage points. I also note that as a result of the removal of fees and charges from the definition of interest rates subject to ceilings, effective interest rates are now market determined.

When Kenya was discussed by the Board earlier this year, a number of Directors questioned the sensibility of a flexible exchange rate strategy. The evidence before us indicated that, in spite of repeated nominal devaluations, no real effective depreciation had, in fact, taken place. It was shown to us then that, in terms of labor costs, the exchange rate had even appreciated somewhat since 1987, and yet the cumulative nominal depreciation over that period had reached 38 percent. We are now told that during 1990, the Kenya shilling has been devalued in nominal terms by a further 14 percent, and no mention at all is made of the developments of labor costs, which may have risen at a similar rate. I noted with interest Mr. Spencer's question on the futility of nominal exchange rate adjustments without tackling underlying structural impediments. The report says that the aim of exchange rate policy will be to help in reversing the continuing decline in domestic relative price incentives for production of tradables; another objective cited is the importance of stimulating exports, given the tight reserve situation and the need to continue import liberalization. However, in practice this policy

seems to amount to a form of real exchange rate targeting, taking efficiency gains into account. In this way, I fear we are getting into a situation of a dog running after its tail. In the recent Board seminar on exchange rate policies, most Directors agreed that the targeting of real exchange rates tended to accelerate inflation, while rarely achieving any real devaluation. I would like to express, once again, my reservations concerning the exchange rate strategy which is advocated by the staff in this program.

In reading the report, I felt assured that the staff have taken every necessary precaution to ensure the full implementation of the program. They made certain that all the necessary administrative and legislative measures were introduced so that the targets set by the program could be attained. I would like to commend them on their excellent work.In closing, I would like to impress upon the Kenyan authorities the urgency of Kenya's economic situation. It seems to me that the success of this program is now hanging in the balance, which only a full adherence to the targets will tilt in the right direction.

Mr. Santos made the following statement:

The staff report for this midterm review reveals that, despite the commitment to economic adjustment and structural reform demonstrated by the Kenyan authorities in the past and during the first annual arrangement under the ESAF, a number of difficulties--such as the deterioration in the external terms of trade--have prevented the second annual program from being kept firmly on track.

While we commend the authorities for implementing many of the measures under the 1990 program, we are concerned that the results for the first six months have been somewhat mixed. We note that the policy slippages that occurred included a greater than projected monetary expansion that contributed to the failure to meet the performance criterion on net domestic assets of the banking system for end-June 1990. Also as a result of these slippages, the quantitative benchmark on net official international reserves for end-June and end-September 1990 could not be met.

Against this background, it is reassuring to note that in response to the unforeseen difficulties encountered in the implementation of the program and the weakening of Kenya's external position, the authorities tightened their policy stance and have now adopted a comprehensive policy package to deal with the major structural and financial problems facing them.

I welcome and endorse the general thrust and policy objectives of the revised program for the second and third years of the arrangements under the ESAF, as outlined in the staff report, and I share the staff's assessment that the current policy package should be fully and firmly implemented as scheduled, in order to achieve these objectives, and, in particular, facilitate the progress toward a viable external payments position in the medium term.

In the area of domestic financial policies, the authorities have recognized the clear need to tighten and to exercise considerable expenditure restraint in the operations of the public sector. Toward attaining the overall fiscal deficit reduction objective, it is encouraging to note that bold revenue-raising and expenditure-reducing measures were put in place in September 1990 and more recently in November 1990, in the context of the 1990/91 budget. On the revenue side, we note the substantial adjustment of domestic retail prices of petroleum products, as well as the adjustments of excise duties and the elimination of import duty exemptions on certain mass-consumed items. Additional revenue would be generated by public corporations and state enterprises through loan and dividend payments.

On the expenditure side, the authorities have focused on cutbacks in wages and salaries and outlays on plant and equipment, as well as low-priority, locally-funded investment projects. It is also significant that the authorities have reviewed the structure of recurrent expenditure with a view to reducing the size of the civil service--a help in containing the growth in wages and salaries and in reducing their burden on the budget. To ensure the success of the strong fiscal adjustment envisaged under the program, it is our expectation that the authorities would continue to strengthen expenditure control and closely monitor fiscal developments. In this connection, I am pleased to note that a high-level committee is to conduct quarterly reviews of the budget.

With respect to state corporations, we welcome the steps that are being taken to effect cutbacks in the budget of specific entities and to institute a regular review of their budgets. Also welcome are the structural measures being put in place to strengthen and accelerate their restructuring, as well as to identify candidates for privatization.

I would like to raise a few questions on the state corporation sector. First, as part of the process to increase the accountability of state corporations, it is the intention to require them by law to prepare and submit their annual budgets to the Ministry of Finance for scrutiny. On this issue, we shall

appreciate the staff's comments on the status of the proposed amendments to The State Corporations Act which will give legal effect to this requirement. Second, we shall be grateful for some information on the completion date for the preparation of the comprehensive policy paper on state corporations. Third, what are the latest developments in securing the services of technical experts for the restructuring of development finance institutions?

Turning now to monetary policy, it is indeed in order that the authorities are taking firm steps to deal with the problem of excess liquidity, in line with the program's objective for inflation and external reserve accumulation. The measures being taken to broaden and enhance the instruments available for market-oriented monetary control are steps in the right direction, and they should contribute significantly to the efficiency of the financial system.

In the external sector, the staff's elaborate analysis of Kenya's balance of payments outlook and external policies leaves no doubt that Kenya's external prospects have worsened. Moreover, despite determined efforts at import liberalization and measures to strengthen the export sectors, through specific export incentives, the outlook is still uncertain, especially given the weak world market demand for coffee and tea, the deteriorating terms of trade, and the prospects for less external financing. In light of these uncertainties, we would urge the authorities to continue their efforts to promote nontraditional exports through feasible measures to increase the economy's responsiveness to export market opportunities.

Finally, we feel encouraged by the authorities' commitment to their program objectives for 1990/91. But given the challenges ahead, it is essential that the international community continues to provide the necessary financial assistance to help the Kenyan authorities in their determined adjustment efforts. In this connection we note the rephasing of Kenya's purchases under the three-year arrangement, and in line with Mr. Mwananshiku's statement I wonder whether the staff is considering an increase in Kenya's access to resources under the ESAF, given the countries substantial rising import bill. I support the proposed decision.

Mr. Hammoudi made the following statement:

After having successfully implemented the economic program in 1989, the authorities are encountering difficulties in reaching the objectives set for the 1990 program. As indicated in Mr. Mwananshiku's opening statement, these difficulties are mainly

due to exogenous factors, largely beyond the control of the authorities. Indeed, the adverse external environment has hampered the authorities' efforts to attain the targets planned for the external sector. Therefore, the deterioration in the terms of trade and the impact of import liberalization, in addition to the shortfall in capital inflows, appear to be major factors in Kenya's economic performance for 1990.

We are, nevertheless, encouraged by the authorities' commitment to pursue their adjustment efforts, in order to address economic and financial imbalances. In this context, we support the requests for a waiver of the performance criterion on net domestic assets for the end of June 1990, and for an increase in the amount of the second disbursement under the ESAF, as indicated by the staff.

We are in general agreement with the content of the authorities' letter of intent and the staff's conclusions and would like to make a few general observations. Generally speaking, we welcome the authorities' intention to implement tight policies with respect to the budget and money and credit and support the reform proceedings, which we believe to be headed in the right direction. Concerning the budget, we agree with the authorities and the staff that measures are needed to augment the revenues and to reduce only the nonessential outlays in order to lower the deficit further. One has to proceed cautiously if the economy is to be strengthened. Indeed, Kenya needs to rehabilitate its social infrastructures, and in rationalizing capital expenditures, new and substantial changes in taxes would be costly to enterprises. In this respect, the measures taken by the authorities on the revenue side in order to avoid increasing taxes on corporations and businesses in this delicate period of economic recovery are the right steps.

With respect to money and credit, the increase in monetary aggregates and the expansion of credit have fueled inflation in 1990 to an estimated 12 percent, compared with an estimated 10.1 percent in 1989, while the targets were 8 percent and 7.5 percent respectively. This result suggests that some measures are needed in those areas to correct the effects of expansionary policies. On the other hand, to encourage the private sector and improve the functioning of public enterprises, it would be advisable to moderate the reduction planned for the allocation of credit in order to avoid any counterproductive developments for economic growth. We agree that bonds and treasury securities should be developed for providing nonbudgetary financing to the Government and additional resources to the Central Bank, in order to reduce the excess liquidity in circulation.

With respect to reforms, the authorities are to be commended for their efforts to improve the rentability of the tax system and to enlarge and diversify the tax base, as well as to modernize the management of the budget. Reforms are also under way to improve the accountability of public enterprises and transform their management, so that the enterprises can operate on a commercial basis. These reforms should open new opportunities for these enterprises and strengthen their financial situation. Furthermore, we welcome the opening of free trade zones in order to promote exports of nontraditional products and the continuation of the trade liberalization policy which, although it constitutes a levy on the Kenyan economy, may--along with other measures--help Kenya to improve its external position.

With respect to the external sector, the authorities have continuously depreciated their currency in nominal and real terms in order to improve export performance, but export volumes have not improved as expected, despite the improvement in quality and packaging. And worse, the terms of trade have been eroding since the implementation of the program. This outcome raises the question of whether the depreciation of the currency is the only way to improve export performance. The case of Kenya seems to cast some doubts. We wonder if the staff would have any comments on this issue.

Before concluding, given Kenya's need for financing on concessional terms, it is vital that the international financial community, especially the multilateral institutions, assist the authorities in their efforts to mobilize resources in order to finance their economic program adequately.

Finally, we can go along with the proposed decision.

Mr. Yamazaki made the following statement:

Since the onset of the current arrangement for Kenya under the ESAF, concerns have been expressed about the economic prospects during the program period, particularly the vulnerability of the external position. This chair was one of those that expressed serious concern about the program and strongly urged the authorities to strengthen their adjustment measures.

Very regrettably, the overall performance during the first half of the second annual arrangement was not satisfactory, owing not only to adverse external factors, but also to inadequate policy implementation. The balance of payments position was particularly critical. The external current account deficit, which worsened in 1989, could not be reduced to the program target

level. With the substantially lower capital inflows, the gross international official reserves declined to less than one month of nongovernment imports and are not expected to improve by year end. On the domestic side, the overall fiscal performance appears to be broadly on target. But, in fact, the overall deficit--excluding grants--was marginally higher than in the previous year. The inflation rate at year-end has been estimated at around 12 percent--larger than both the 10 percent figure for 1989 and the original targeted rate of 7.5 percent.

The immediate cause of these developments was the adverse external conditions, including the recent oil price increase and the deterioration in the terms of trade. This being said, the macroeconomic framework was not sufficiently strong, despite more than a decade of Fund-supported programs. In addition, there were some shortcomings in policy implementation. While we welcome the Government's intention to engage in stronger adjustment efforts, in spite of the sizable economic setback, we nevertheless have a number of concerns about program implementation in the remaining period and the external imbalance in the medium term. With these concerns in mind, let me briefly touch upon a few points.

With respect to fiscal policies, the authorities decided to reduce the 1990/91 fiscal deficit to 2.5 percent of GDP--a more ambitious target than the original one of 3.8 percent. In view of the present critical external situation, it is imperative that this target be achieved. Despite the progress made so far in reducing the budget deficit, it is essential to strengthen the revenue base further and restrain expenditure. On the revenue side, we welcome the Government's measures, including the introduction of a value-added tax and several user charges. These reforms should be accompanied by necessary administrative reforms to ensure that the estimated revenue is achieved. On the expenditure side, there is a clear need to strengthen restraint, particularly with respect to the government wage bill and outlays for university education, as the authorities planned in the revised budgetary allocations in 1990/91. To support the fiscal adjustment, the authorities should pursue the reform of state corporations without delay. These fiscal measures should be managed with a policy that would identify and cut low priority expenditures with relatively high import content, in order to improve the balance of payments.

On the monetary front, it is disappointing that the performance criterion on net domestic assets for end-June 1990 was not met. Needless to say, a tighter monetary stance is essential. Every effort should be made to contain inflationary pressure

through a reduction in domestic credit. In this connection, the recourse of the Government to the banking system should be reduced with the sharp cut in the budget deficit.

With respect to exchange rate policy, I share the staff's opinion that further exchange rate action should be considered as a supplementary measure at a time when tighter financial policies would not have a sufficient effect on external competitiveness. Much concern remains about the external viability of Kenya's balance of payments position. First, we are concerned about the weakness of the medium-term financing assurance, including the period under the ESAF. Furthermore, the staff's long-term balance of payments scenarios show a continued substantial current account deficit throughout the 1990s. The scenarios also suggest that Kenya will continue to rely heavily on external concessional financing after the current period under the ESAF. At this stage, we cannot help having some serious concerns about the final effectiveness of this program under the ESAF, which had originally aimed at restoring Kenya's external viability through the adjustment process.

With respect to the rephasing of disbursements for this arrangement under the ESAF, I would appreciate if the staff could comment in more detail about the need to augment the amount of the second disbursement. The staff paper shows that Kenya's balance of payments situation this year is critical. On the other hand, the staff's statement suggests that significant nonconcessional borrowing will be put in place shortly. The authorities' external borrowing policy does not seem sufficiently strict, and I wonder whether they have not too easily requested an augmentation of the Fund disbursement. In addition, Kenya's outstanding debt and debt service to the Fund will be substantially larger in the coming years. If the external position does not recover according to the program, there would be concern about the assurance of repayment of the ESAF to the Fund.

In conclusion, we recognize the adverse factors surrounding Kenya's economy and the Government's comprehensive efforts to cope with them. However, in view of the performance so far, we have serious concern about the achievement of the original objectives of the arrangement under the ESAF. In order to redress past slippages and to recover a viable external payments position, the authorities need to implement on schedule the ambitious and strong package of policy measures which has been settled on. I would like to emphasize the strong hope of my authorities that the corrective measures will be put into practice in a timely manner. At the time of the next review, we should assess the performance

and effectiveness of this arrangement under the ESAF, prior to the third annual arrangement. We can go along with the proposed decision.

Mr. Fernando asked whether there would be a further review before the third arrangement.

The staff representative from the Exchange and Trade Relations Department replied that there would be no further review before the third arrangement under the ESAF.

Mr. Fernando continued that he had gotten the impression from Mr. Yamazaki that he thought there was a further review before the third arrangement.

Mr. Yamazaki responded that he had wanted to emphasize that at the time of the third review, disbursement should not be an automatic process; instead, at the time of the third review, Directors should assess Kenya's performance carefully.

The staff representative from the African Department said that the staff essentially agreed with the Board on the need for Kenya to implement its adjustment program with dispatch and with vigilance; the authorities had a very difficult road ahead which would require sustained and tough monitoring of their program.

Any increase in access would be considered at the time of the third annual arrangement, the staff representative remarked. It would have to be associated with a sufficiently strong package of adjustment measures and would have to take account of the medium-term balance of payments position and the country's repayment capacity, particularly to the Fund. Kenya's exposure to the Fund was quite high.

Kenya had indeed tightened its monitoring of credit to the private sector by commercial banks--a move clearly in evidence in the September data, which showed that bank credit to the private sector was well below the targets that had been set, the staff representative observed. The penalty deposit scheme that had been implemented, largely on the basis of Fund technical assistance through the Central Banking Department, was starting to have an effect and would be reinforced by the freer auction on treasury bill rates which should also serve to contain credit.

The staff agreed with Directors that reform of the parastatal sector would be an essential component of the next arrangement, the staff representative commented. A number of actions had been taken, and the authorities had assured the staff that a policy framework paper would be completed before year-end. It was his understanding that the amendments to the State Corporations Act had been passed by Parliament; as a result,

state corporations would be required to submit their annual budgets to the Treasury for approval. The authorities had drawn up a list of the technical assistance experts who were candidates for positions to monitor the assets and liabilities of the development finance institutions; they had secured financing for those experts, and that project was likely to get underway shortly.

The pressures for the growth of the wage bill had come from two sources, the education sector and political influences, the staff representative explained. As to education sector pressures, a number of factors were at work leading to the large growth in employment. First, the demographic pressures associated with a high population growth rate had been reflected in the demand for education at the primary school level. Second, the structural reform of the education system that had taken place a number of years ago had generated demand for one additional year's worth of teachers--particularly increasing the need for secondary school teachers. Third, in 1989 the university freshman intake had almost tripled on a one-time only basis. The other source of growth in public sector employment had been politically motivated, with pressures coming from the military and from the Office of the President. That type of growth pressure was difficult to control. At the time of the midterm review, the authorities had agreed to freeze 10,000 positions--out of a total increase of 50,000 that had been authorized in the budget. It was a fairly substantial freeze, because a number of those positions had already been filled. In the education sector, 20,000 positions had been added, and all those positions had effectively been filled. Therefore, there was very little room to freeze remaining vacancies.

A number of conditions had been added relating to the third year of the program, the staff representative noted. Those conditions included a severe limitation on university intake, which had been reduced from 20,600 in 1990 to 8,000 in 1991; curtailment of the use of government training institutions as vehicles for additional employment; a reduction in the number of university graduates hired by the public service in an effort to lessen the underlying demand for university enrollments; and the use of in-service training for untrained primary and secondary school teachers, who would increasingly fill new teaching posts at those educational levels.

The authorities were concerned about whether the investment in training matched the skill requirements of the economy, the staff representative said. There was a major commission on unemployment, and one of the issues it was focusing on was the composition and structure of university education. The correlation between education and employment was a complicated but important issue and was one of the structural areas which had given rise to the growth in the public sector wage bill. The Government would be trying to deal with that correlation in the third year arrangement under the ESAF.

As to the rephasing of the second-year arrangement, it was a rephasing, not an augmentation, of the amounts in the total arrangement, the staff representative remarked. It had been necessary in the context of the oil shock. The augmentation was expected to cover about a third of additional oil costs. The staff representative also expressed concern about the amount of nonconcessional borrowing. The staff had made it clear to the Kenyan authorities that the level of nonconcessional borrowing needed to be reduced in 1991.

In the staff report for the 1990 Article IV consultation with Kenya, the staff had indicated that from 1985 to 1989, the incentives in the tradable goods sector had deteriorated, with real returns to export production falling and prices of domestic import substitutes rising faster than prices for competing imports, the staff representative observed. The staff was currently completing a study on the role of exchange rate policy in Kenya, which suggested that Kenya's tradable goods production had only begun to benefit from the incipient efficiency gains resulting from more restrained financial policies and trade liberalization. In the past year, Kenya's external position had weakened sharply--owing to a terms of trade decline and a sharp decrease in foreign financing inflows--and as reflected in the extremely weak foreign reserve position. The staff had worked with the Kenyan authorities to develop a program which relied primarily on monetary and fiscal policy instruments--particularly fiscal policy--in both the central government and public enterprises to achieve financial adjustment.

Over the past year and a half, Kenya--with the help of the World Bank--had been actively implementing structural measures to strengthen exports, including the implementation of a duty exemption drawback scheme, a finance facility for exports, specific steps to facilitate the removal of constraints on such nontraditional exports as horticulture, and the creation of Export Processing Zones.

In the past, when the authorities had been confronted with an external reserve problem similar to the current one, they had relied on quantitative restrictions to buy time, the staff representative recalled. They had not done so currently. They were moving ahead with the trade liberalization process, and there was no evidence that they intended to bring that process to a halt. Under the circumstances--given the structural measures affecting exports, the continuation of import liberalization, and the strongest possible tightening of fiscal and monetary policies--the recent exchange rate actions that had been implemented had been necessary.

The authorities would likely continue their flexible exchange rate policy in the coming year, the staff representative from the African Department remarked. Such a policy stance largely meant keeping their real exchange rate at the current level. The staff did not anticipate very much in the way of additional real exchange rate action, although it was felt that exchange rate action did have a role to play in such circumstances.

Although primary reliance was not being placed on the exchange rate, but on fiscal and monetary policy, it nevertheless remained an important policy instrument, given the very difficult situation in Kenya.

Mr. Fernando asked for clarification of actions taken to curtail budgetary expenditure. It had been mentioned that, from the original budgetary authorization to create some 50,000 new civil service posts, some 10,000 positions had been cut as the result of budgetary pressures. He wondered whether the original intent to add 50,000 positions had been consistent with understandings under the program and with the budgetary projections.

The Executive Directors were being asked to decide on an extra SDR 20 million in access, Mr. Fernando remarked. Kenya had access of 170 percent of quota under the ESAF. He wondered whether the extra SDR 20 million came out of resources that would otherwise be available from the third year; in other words, was it an acceleration?

The staff representative from the African Department replied that the increase in posts that had been contained in the formal budget for 1990/91 had certainly been higher than the staff would have liked to see and had probably been inconsistent with the growth in the wage and salary bill that the staff had been projecting, although the authorities had made other adjustments in the budget to try and stay within the overall budget deficit ceilings. The Kenyans had made it very clear in February 1990 that although they were fully committed to the program goals, they faced difficulties in pursuing them, owing to strong pressures coming from the education sector and the political side of the Government.

With the cutbacks in the growth of civil service employment currently envisaged, the authorities would probably be within the targets set for the second annual arrangement, the staff representative from the African Department continued. More important, the budget deficit was dramatically smaller--and budget cuts were the key to reducing the number of posts. The staff was concerned about the growth in employment, but felt that the focus should be on dealing with the underlying structural determinants which caused the pressures that the authorities had to accommodate; otherwise, the authorities would have almost no choice but to allow a higher growth in employment than was desirable. Therefore, some of the program's longer-term measures were probably more important than the initial actions that had been taken.

Mr. Wright asked whether the staff could confirm that in the Monetary Survey--Table 5 of the staff paper--parastatals were included with the Government in the credit aggregates. He also asked for the staff's views on the relative importance of controlling credit to nongovernment financial institutions; he wondered whether improved monitoring would be preferable to the penalty deposit scheme. Ideally, it was hoped that the penalty deposit scheme would be temporary, whereas the need for adequate monitoring

would be ongoing. He would also be interested to have the staff's comments on the role of "Other Items (net)" in the Monetary Survey, because those items seemed to gyrate substantially; indeed, in the June benchmark, there had been a large difference between the credit aggregates and the outcome from net domestic assets.

The staff representative from the African Department responded that improved monitoring was important, but had clearly not been sufficient on its own to contain the growth in credit; therefore, the penalty deposit scheme had been relied on. A strengthening of the monitoring by the Central Bank would be preferable to the penalty deposit scheme. In that context, moral suasion pressures on the commercial banks--exerted informally through guidelines--could help. Monetary statistics for parastatals were included in private sector credit. The authorities needed to collect more data on parastatal operations through the commercial banks. The normal commercial bank reporting system could be used to obtain more detail on parastatal activities.

"Other Items (net)" had, indeed, gyrated substantially, the staff representative continued. If the monthly numbers were examined, the gyrations were even more apparent. In terms of the Central Bank, "Other Items (net)" consisted of the reserve of the Central Bank and the liabilities and assets of transactions that had not yet cleared. For the commercial banks, the liabilities balance in "Other Items (net)" was composed of liabilities due to bank branches, provisions for bad debt, other liabilities, and, on the asset side, balances due to bank branches, items in transit, and interest accrued.

However, some of the gyrations in the past had reflected the Government's attempts to meet the performance criteria by a number of actions that would influence "Other Items (net)," the staff representative from the African Department said. Wages and salaries and bills to suppliers were paid on the last day due or the day before the benchmark period, which meant that uncleared checks showed up in "Other Items (net)," rather than as a drawdown in the Government's deposits and an increase in government credit. Many governments that were trying to meet performance criteria used such techniques. The staff's concern about that practice had been the principal motivation for shifting to a net domestic assets performance criterion, rather than focusing on domestic credit. Kenya's failure to meet the June 1990 net domestic assets target had reflected the fact that that technique of increasing Other Items (net) was no longer effectively available, although it had been used to meet the benchmark on credit to the Government. The staff had stressed to the authorities the urgency of keeping within the overall net domestic assets target.

Mr. Spencer asked how serious the breach of that June target on net domestic assets had been, given that the components of domestic credit and Government credit had been within target, so that the slippage was attributable to "Other Items (net)".

The staff representative from the African Department said that the staff was extremely concerned about the breach. The fact that "Other Items (net)" might have contributed to the breach was somewhat irrelevant. The Government had been certainly as much responsible for the breach as the private or parastatal sectors had been. Strong action by the Government had been needed to reduce substantially the fiscal deficit in 1990/91. For that reason, a Treasury Circular implementing very specific budgetary cuts on a line-item basis had been issued and approved by the Cabinet. Those cuts were about the most that the staff could urge the Government to adopt and were necessary if there was to be a reasonable chance of staying within program limits.

Mr. Spencer responded that he had not wanted to give the impression that there might not have been a clear need for actions on the fiscal front. However, in 1989/90 an improved revenue picture had compensated for the excess of actual over planned expenditure. The fiscal deficit, the public sector borrowing requirement, and the impact on monetary growth of government policies had not seemed to be major problems. The fiscal problem was real, but he wondered what the monetary implications of the Government's actions were.

The staff representative from the African Department explained that if the data for June 30, 1990 were excluded, an examination of the monetary profile in July and August showed that the government's operations had had significant monetary implications. In part, that situation stemmed from the fact that the amount of external assistance that Kenya had received in the first three months of the year was less than Kenya had anticipated, for a variety of reasons not wholly the Kenyans' fault. There had been significant delays in the disbursement of funds under World Bank credits. Some program assistance had been delayed as a consequence of the Middle East crisis. Therefore, from a cash management point of view, the authorities had needed recourse to bank financing in the short term.

Mr. Towe commented that a component of the 1989/90 fiscal outturn noted in the staff paper was the very substantial transfer from the Central Bank to the Government. He wondered whether the staff could provide a few details on that transaction and place it in the context of the Government's ability to meet its target for 1989/90--for the fiscal deficit, as well as for bank credit to the government at end-June 1990. In particular, he wondered if the authorities had accelerated the transfer of profits to avoid a breach of that performance criterion, and minimize the fiscal slippages. Therefore, he would appreciate some background information on the breach of the benchmark for end-September credit to the government, and an assessment of the prospects for the end-December benchmark and the year as whole.

The staff representative from the African Department said that the profits accrued during the year by the Central Bank normally went to the government, which had simply requested that the Central Bank disburse those profits before the end of June, rather than in July and August, when they

would normally have been transferred. That early disbursement was one factor that contributed to the strength of the fiscal position at the end of June. The breach of the end-September target had not been unexpected, nor would the failure to meet the December benchmark for net credit to the government, because it would take some time before the effects of the cuts specified in the Treasury Circular became evident. However, failure to meet either of those benchmarks did not mean that the program was not on track vis-à-vis the fiscal targets for 1990/91. The authorities were certainly trying to implement the cuts in the budget and to mobilize additional revenue.

The Acting Chairman said that "Other Items (net)" was a subject that the Board would look at in some depth and across a number of countries in its next review of conditionality. Many countries evidenced a good deal of volatility in that category.

Mr. Iqbal made the following statement:

After substantial progress toward structural adjustment over the past two years, Kenya is presently encountering worsened economic and financial prospects. Expansionary domestic policies, combined with exogenous developments, have caused the external disequilibrium to worsen dramatically in 1990, while economic growth has slowed down and inflation has picked up. The authorities have had difficulties in adhering to a tighter financial stance. In 1989/90 expenditure overruns were registered, and certain new tax measures introduced under the ESAF had to be rescinded.

The inability in 1990 to meet performance criteria and quantitative benchmarks applying to net domestic assets and external reserves are but symptoms of underlying economic vulnerabilities. At the equivalent of less than half a month's imports, the low level of gross official reserves very aptly demonstrates the extremely delicate position of the Kenyan economy. The recent emergence of arrears to the World Bank is a very serious development which further highlights deteriorating conditions.

It is noteworthy that the authorities have attempted to restore the pace of adjustment by taking a series of important corrective steps in the second half of 1990. Measures to reduce the budget deficit, cutbacks in parastatal expenditures, liberalization of interest rates, and an upward adjustment in energy prices are steps in the right direction to address the emerging difficulties in 1990/91.

However, these measures may not be enough. For example, the major turnaround projected for external reserves in 1991 is predicated on a very large inflow of additional donor funding. Given

the usual pace of donor disbursements to other countries, it would be risky to link the external reserves target primarily to such a source. Moreover, the staff statement casts doubts on the adequacy of aid commitments for 1991 to meet external financing requirements. If the requisite funding fails to materialize, imports would have to be curtailed further, with the attendant contractionary effects on growth. However, the authorities must not increase their external indebtedness on nonconcessional terms and should roll it back if it has been undertaken. As a minimum, I would urge a speedy disbursement of donor commitments. I agree with the staff that a possible modification of the reserve target may become unavoidable.

The program seems to call for a continued real effective depreciation of the exchange rate to sustain and strengthen external competitiveness, so that import liberalization can be continued. Given the low level of reserves, the staff has also implied that further exchange rate action may be necessary. Therefore, the active exchange rate policy would continue the present trend of a real effective depreciation. Such an approach would be of concern because of an inherent inflationary bias and its implications for competing countries. But, more importantly, we should have a clear notion of an equilibrium rate toward which this policy is supposed to lead. Therefore, a continued real effective depreciation would be distortionary, to say the least. I would like to know whether there is such a rate. If so, how was it derived, and what indicators would be used to approach it?

The exchange rate should not be viewed as a panacea for all ills. What is needed is a dramatically strengthened budget, combined with a truly autonomous parastatal sector. Accelerated privatization should be pursued. It surely will not be easy and will be time-consuming. However, decisive initiatives should be taken, and I believe that the recent strengthening of budgetary measures can be viewed as a reasonable beginning. In this context, I fully endorse the staff's recommendations for intensifying the monitoring of expenditures by both the Government and parastatals. I wonder what the Fund can do in this respect. Moreover, steps should be taken to reallocate expenditures to nonwage categories in conjunction with a strengthened incomes policy. I support the approval of the proposed decision.

Extending his remarks, Mr. Iqbal said that a real effective depreciation of the exchange rate might not have the necessary effect on import liberalization, especially if liberalization were intended to replace quantitative restrictions by price-related measures, like tariffs. He looked forward to a full discussion of the issues in the staff paper under preparation on exchange rate policy in Kenya.

A substantial buildup of reserves must remain a core objective of the program in the short run, Mr. Iqbal remarked. Therefore, a stronger adjustment effort would be needed. He asked the staff to comment on whether it had revised its medium-term forecast and had identified specific measures to put Kenya on a new adjustment path.

Mr. Towe said that most of the questions and comments that he had intended to raise had already been addressed by previous speakers, particularly Mr. Yamazaki and Mr. Fernando. Hence, he would decline to make a statement.

Mr. Ismael remarked that he was in general agreement with the staff assessment and recommendations. Taking into consideration Kenya's good track record, he was confident that the authorities would do their utmost to adhere closely to the revised program for the remainder of the second annual arrangement. He supported the proposed decision.

It was encouraging to note that the authorities recognized the seriousness of the external position, Mr. Ismael said. He fully endorsed the steps taken to curtail imports through cancellation, postponement, and reduction of government and parastatal imports.

A more fundamental step was the policy to reduce demand for imported goods through tight fiscal and monetary policies, without resorting to the quantitative measures employed in the past, Mr. Ismael continued. Because the authorities intended to continue their import liberalization efforts, it was therefore imperative that exports grow. Tight monetary and fiscal policies should then be supplemented with a policy of active exchange rate depreciation to restore profitability of exports and make imports more expensive. The authorities should not wait until efficiency gains from other policies were shown to be inadequate. Better still, import liberalization should be temporarily discontinued. He supported the efforts to continue with trade liberalization as part of the overall structural reform. However, the continuation of import liberalization would make sense only if the imports could generate greater export productive capacity and exports in the medium term.

He shared the staff's concern about the external nonconcessional borrowings, Mr. Ismael commented. With the recent signing of the last two loan agreements, total loans had reached about $180 million and, therefore, had exceeded the $155 million benchmark for 1990. He was pleased to hear from the staff that the authorities had decided not to proceed with the importation of military aircraft to be financed by further nonconcessional borrowing. He asked the staff to comment on how external borrowings were monitored and coordinated and how their effectiveness could be improved.

Mr. Prader made the following statement:

I broadly agree with the staff appraisal and would like to limit myself to a few points. As in 1989, the Kenyan authorities have again demonstrated the seriousness of their development strategy and their resolute commitment to a modernization of their economy toward a market-oriented production and trading system. They certainly deserve to be commended for the structural change that they have achieved. In order to succeed fully and to yield, over time, the results expected in terms of growth and a viable balance of payments, these structural changes have to take place in the context of macroeconomic stability. We have to acknowledge that the external environment Kenya faces has deteriorated over the past couple of years. Therefore, the terms of trade deterioration is a further justification for strong implementation of structural change, in order to diversify the economy and foster exports in nontraditional sectors.

At the same time, the deterioration of the external environment reinforces the need for monetary and fiscal policy to follow a restrictive path. From this point of view, one cannot but regret the new slippages that have happened in the monetary field. Excessive monetary expansion had already occurred during the previous annual arrangement, but that expansion does not seem to have served as the serious warning it probably should have been. Excessive monetary expansion holds the potential to undermine the whole strategy to diversify and broaden the export base of the economy toward nontraditional export products, because it tends to weaken the competitive position of the export sector.

When the Board discussed the approval of this second annual arrangement under the ESAF, much attention was paid to the staff's analysis of the position and evolution of Kenya's competitiveness in export markets. Therefore, reading the report now leaves an impression of déjà vu. Kenya has consistently applied the Fund's advice with respect to her exchange rate, which has depreciated by more than 50 percent in nominal effective terms over the past several years. Still, the report confronts us again with the necessity to implement further exchange rate corrections, insofar as the efficiency gains from other policies are not adequate. I wonder what exactly the report means in that respect, as it seems to me quite obvious that as long as the inflationary process erodes the competitive edge gained from exchange rate depreciations, the process can only hold further exchange rate depreciations in store.

Such a finding can only reinforce the need for strong fiscal and monetary policies, and I welcome in that respect the progress embodied in the reformulated program in front of us. Such

a tightening of policies is particularly in order, as the country again faces declines in its terms of trade. Exchange rate corrections cannot make up the loss of resources accompanying a terms-of-trade loss--and there should be no illusion that they can. In the event of exchange rate depreciation and a deterioration in the terms of trade, the internal adjustment mechanisms have to play a decisive role--particularly when the country faces both of these developments at the same time. In such circumstances, a case can easily be made for an incomes policy, which should take care of the loss of resources and would support tight fiscal and monetary policies. Other speakers have also referred to the need to control the wage bill and labor costs.

The slippages that have occurred in past months in monetary and fiscal policy are, as I see it, in part related to the introduction of new policy instruments. With respect to monetary policy, the excessive credit expansion is now explained by monitoring difficulties in a number of commercial banks--difficulties created by the change in the ceiling for credit expansion from total domestic credit to net domestic assets. It is rather interesting to note here that this shift was justified at the time in order to close a loophole--identified as "Other Items (net)"--responsible for overshooting the credit target during last year's arrangement. So by trying to solve one problem, we have, in fact, created another one.

In the case of fiscal policy, the authorities were encouraged to transform the existing sales tax into a value-added-tax (VAT). However, we learn now that there was a revenue shortfall due to weak administration of the newly introduced VAT. In addition, we are now told that a comprehensive rationalization of VAT rates has already become necessary. I would not like to give the impression that the changes in policy instruments were unjustified. But the examples I have cited raise serious doubts about whether those changes were adequately prepared and hence, lead to the question of whether more attention should not be paid to the better preparation of the administration, which, after all, has to handle and live with these changes. These points are, in my view, quite important, because the resulting slippages have created their own problems which have to be corrected and because they tend to shed a dubious light on the reform process itself.

As I said before, I agree with the proposed decision, including the increase in drawings on the Fund. The strengthening of the program is justified in the face of a degradation in Kenya's environment. This strengthening of the program also allows for increased access, which results in a higher exposure for the Fund. The medium term balance of payments scenarios and the repayment schedule to the Fund are quite striking in that respect. Despite

reassurances from the staff today, I am still extremely concerned about the latest developments concerning external nonconcessional borrowings. Such borrowings have the direct effect of further worsening the debt and debt-service ratios and can only lead to a softening of the resolve multilateral organizations have shown up to now in support of Kenya's development strategy. I would be interested in hearing any further comments the staff has on that issue.

Continuing his remarks, Mr. Prader noted that one reason given for the overshooting of wage costs was the military situation. He wondered whether incomes policy could actually work in such circumstances.

Mr. Filosa made the following statement:

This midterm review of the arrangement under the ESAF with Kenya comes at a very important juncture, as the authorities--after some serious slippages in the implementation of the program--have agreed with the staff on a number of important measures to bring the program back on track. Of course, I welcome such measures, which indicate the authorities' renewed intention to achieve a lasting economic adjustment, and I share the positive assessment made by the staff. Nevertheless, I believe that some important issues which I would need to have clarified before giving my wholehearted support to the proposed decision are not fully addressed in the report prepared by the staff.

I would like to raise three main issues. The first issue concerns the country's request for a waiver of the nonobservance of the bank's net domestic assets limit set for June 1990. In supporting such a request, the staff attributes the nonobservance of this important performance criterion to a recent shift in the focus of the performance criterion from total domestic bank credit to net domestic assets of the banking system--a change that has apparently created monitoring difficulties for commercial banks.

The staff, however, does not clarify the nature of such monitoring difficulties, nor does it illustrate what measures, if any, have been taken to rectify the situation. The need for such measures are clearly indicated by the fact that in September the limit to the net domestic assets of banks, as a quantitative benchmark, was once again not observed. Like Mr. Wright, I would therefore be grateful if the staff could elaborate on the continuing inability of the banks to obey the credit limits set by the program, as well as on the measures agreed with the country to prevent the recurrence of such problems.

The second issue I would like to raise concerns Kenya's request for a sizable augmentation of the second disbursement as a result of the recent increase in the cost of oil. I understand that this augmentation is supported by the staff on the grounds that important fiscal measures have recently been undertaken by the authorities, and domestic prices of petroleum products have recently been adjusted.

Nevertheless, I have difficulties in accepting Kenya's request for two main reasons. First, the authorities--in spite of the recent increase in the domestic price of petroleum products--do not seem to have adopted a comprehensive approach to the problem of the deteriorating oil trade balance. In fact, the staff indicates that continued inefficiencies at the local refinery can be held responsible for the low level of exports of oil products, which in 1990 have reached an estimated value of SDR 39 million, compared with a planned value of almost SDR 60 million. In passing, I would like to note that the expected shortfall in oil-product exports is equal to the augmentation--or, according to the staff representative from the African Department, the rephasing--of the second disbursement now requested from the Fund. In addition, exports of oil products in the medium-term are expected to remain at their present depressed level, probably on the grounds that such inefficiencies will not be removed--not even in a rather distant future. I would, therefore, be grateful if the staff could describe the nature of the inefficiencies at the local refinery and indicate the measures which are under consideration to improve its management.

I think that the importance of this point--considering the modest share petroleum products have in total exports--goes beyond the case under discussion today. In fact, the augmentation of resources on which we have recently deliberated for countries undertaking ESAF programs should not be seen as an entitlement; rather, augmentation should be justified in terms of the policies which aim at improving the deteriorating oil-trade balance. Such policies should not be confined to the adjustment of domestic prices of oil products, but should also include all other possible structural measures in the field of energy. This approach is fully justified by the ultimate goal of ESAF programs, which is the implementation of deep structural reforms.

The second reason that I have difficulties in accepting the request for an augmentation of resources is linked to the diminished willingness of donor countries to assist Kenya. As a matter of fact, I am reluctant to accept an increase in the exposure of the Fund while donor countries are reducing their

involvement in the country, given the country's sizable medium-term financing requirement and the already high level of Fund exposure.

This problem leads me to discuss the third issue which, I believe, needs a more thorough discussion, namely the ability of the country to repay the Fund. In fact, the staff recognizes that, under a rather favorable scenario, debt service to the Fund remains high as a percentage of nonreschedulable debt service through the end of the decade. The staff also indicates that obviously under a less favorable scenario the ratios of debt service to the Fund would substantially deteriorate in the near term which, of course, would aggravate the risks for the Fund.

However, the staff does not clearly express its opinion on whether such risks are acceptable in either case and whether the country can be expected to be able to discharge its obligations to the Fund. I would, therefore, be glad if the staff would take this opportunity to indicate more clearly whether Kenya is expected to be able to repay the Fund in due time.

Ms. Creane made the following statement:

We agree with comments made by several other speakers, particularly on fiscal policies. Kenya's performance during the first six months of its second arrangement under the ESAF has been mixed. Kenya successfully met the program targets on non-concessional borrowing and the amount of bank credit provided to the Government and has made progress on export promotion and import liberalization. But several other performance targets were missed, including failure to cut the public wage bill by the targeted level. The new policy actions outlined for the remainder of 1990 and for 1991 are tough, and full implementation is essential if Kenya is to return to a viable external payments position.

Kenya's external reserve position is extremely weak and leaves no room for further policy slippages on reforms. Therefore, we also are very concerned about the underlying meaning of the Kenyan authorities' request for a slower pace of adjustment should their external position improve. As we have stressed in the past, rather than contemplating slowing the pace of future reforms and therefore endangering the progress already accomplished, Kenya should be poised under any circumstances to move forward decisively and quickly to strengthen the economy and meet its potential. We observed at the last Board discussion that Kenya starts from a point of greater economic efficiency and

structural balance than many of its neighboring developing countries. Kenya should, therefore, be able to hold itself to a higher standard and set much more ambitious development goals.

The authorities' revised budget targets are tough but essential. We would like to join others in expressing our strong hope that these targets will be met. As a matter of deciding priorities, rather than focus on cutting development spending or spending on nonwage operating and maintenance categories of the budget which will affect already low levels of efficiency, more drastic action might be taken on the wage bill--at least, in part, by more serious curtailing of the increase in civil service posts. We note with satisfaction that the budgets of 65 state corporations have been reviewed, but wonder about the timetable for reviewing the remaining 100 or more state enterprises. While recognizing that the parastatal austerity measures will be tough to implement, it is critical that the Kenyan Government follow through completely. Therefore, we look forward with much anticipation to the policy framework paper promised by year-end and the eventual overhaul--including the likely privatization--of a large part of this sector.

In the financial and monetary sector, we are pleased with the effective lifting of ceilings on interest rates and look forward to their complete liberalization by next summer. The steps being taken to improve the treasury security market by introducing a true auction, extending maturities, and encouraging a secondary market will go far, both in enabling the introduction of more indirect methods of monetary policy control and phasing out the penalty deposit scheme, as well as allowing greater domestic financing of the public sector deficit and reducing dependency on foreign sources.

We would like to echo other speakers in being pleased with the news today that the limits on external nonconcessionary borrowing will be met, and we agree with Mr. Wright on the need for transparent reporting requirements on new contracts.

We believe that the flexible approach on exchange rate policy is appropriate, particularly given the concurrent tightening of financial policy.

On one final point, we are pleased to report that, pending some final internal clearances, the United States is moving ahead on providing about $58 million in debt forgiveness to Kenya in 1991.

Overall, we believe that the Kenyan authorities have made an important start in addressing the critical fiscal and monetary

policy issues. Therefore, we can support the proposed decision, including the rephasing of ESAF funds. We are pleased that the Fund is able to assist in providing some specific relief in response to the effects of the Middle East crisis.

Mr. Scheid remarked that he broadly endorsed the thrust of the staff appraisal and supported the proposed decision. He shared the many concerns expressed by previous speakers and Mr. Hogeweg's reservations about the staff's advice on exchange rate policy--a point his chair had already raised during previous discussions on Kenya. Given the positive level of real interest rates and the continued strengthening of external competitiveness that had been reflected in the downward trend in the real effective exchange rate in recent years, the key ingredients to an improvement in the external current account and the overall balance of payments position could have been expected to be in place. Nonetheless, the country had slipped into an extremely difficult external situation--virtually a balance of payments crisis. As the staff appraisal said, a much tighter policy stance from the outset of the program would have been more appropriate.

One possible explanation was that the policy of continued depreciations in both nominal and real terms had destabilized expectations, with adverse consequences for private capital flows and domestic savings, Mr. Scheid continued. He was concerned about the staff's pessimism reflected in the revised targets for gross domestic savings. Therefore, the authorities would be well advised to aim at a more stable exchange rate--a goal that would require that financial policies be flexibly adjusted to any weakening in the external value of the currency. In that event, fiscal policy would be of key importance. The substantial deficit reduction in the 1990/91 budget was most welcome. It marked a significant acceleration of the adjustment effort, because the deficit target of 2.5 percent of GDP had initially been expected to be achieved only by the end of the decade.

Right from the outset of the program, there had been substantial doubts about the appropriateness of the initial adjustment path, Mr. Scheid recalled. Against that background, he had noted with concern in the staff appraisal the authorities' intention to slow down fiscal consolidation as soon as the external situation improved. Although he took some comfort in the staff's view that any relaxation would require a significant improvement, he warned against an on-off approach. Given the substantial risks for Fund resources over the medium term--detailed in the staff paper--sustaining the momentum of adjustment was particularly important.

Mr. Zhang said that for the first half of 1990, Kenya's economic performance under the ESAF program had been mixed. Performance criteria on net bank credit to the government and on nonconcessional borrowing had been observed, as well as the two structural performance criteria on progress in development of an export promotion program and continued import liberalization. Structural benchmarks on price decontrol and on interest rates had

also been met. However, credit expansion had proved excessive and targets for external reserve accumulation had not been realized. The June 1990 performance criterion on net domestic assets had not been observed. The benchmarks on net official international reserves for June and September 1990 had gone off track by a substantial margin.

The economic difficulties encountered by the authorities were primarily due to exogenous shocks or large unforeseen changes in key economic variables, which were beyond the control of the country's policymakers, Mr. Zhang commented. However, in the face of a sharp deterioration in the balance of payments and the substantially weaker external reserve position during 1990, the authorities had already introduced a package of far-reaching and difficult policy measures--financial and structural--which would lead to the re-establishment of a more sustainable external position. His chair was in broad agreement with the staff's analysis and recommendations and supported the proposed decision.

The staff representative from the African Department said that, as part of the staff's preparation for the third-year arrangement, it would study whether a tightening of the investment path would be necessary in light of recent developments. At the Consultative Group meeting in Paris, aid flows were maintained roughly at 1989 levels; the additional amount that the staff had hoped would be forthcoming to fill the remaining gap had not been fully provided. Part of the reason had been that a number of the agencies were still in the process of firming up their aid flow decisions. In addition, a number of donors were waiting for more information from the Government on political reform. Recent electoral reforms might meet the World Bank's views of the minimum reform required and, it was hoped, would make donors more receptive to providing Kenya with the additional resources needed to fill the financing gap. Other factors needed to be considered in revising the medium-term forecasts. Oil prices had increased compared with the staff's original estimates.

Wages in Kenya were not indexed, the staff representative remarked. The formal labor market was small relative to the entire labor force. The authorities had been conservative in adjusting government wages for inflation. A formal adjustment for inflation had not been made for a number of years. The next adjustment--likely to be decided by the Salary Review Commission--would be phased in during a two- or three-year period beginning in July 1991.

Two factors underlay the difficulties with the refinery that had contributed to a decline in oil re-exports, the staff representative explained. The existing plant was old and inefficient, with resultant high costs; therefore, oil re-exports were not competitive vis-à-vis direct transshipments of refined products. There had also been a diversion of re-exports to Uganda, which was importing more refined products, through the port of Dar es Salaam. Political factors as much as economic factors motivated

those re-exports--with Kenya actively trying to improve its political relations with its neighbors. The World Bank and the Kenyan authorities were discussing whether to invest in overhauling the refinery.

The decision before the Board was a rephasing of purchases, not an augmentation, the staff representative from the African Department noted. Currently, the amount of access under the third-year arrangement would be reduced to SDR 60 million. The higher access had been proposed as a response to the authorities' policies and the need for Fund support to deal with the short-term crisis reflecting the higher oil prices. Short-term assistance from other donors was expected. The Bank was accelerating its loan disbursements, as well on some of its program grants. If the staff were to come to the Board to seek an augmentation in the third year, Kenya's capacity to repay the Fund would be looked at very carefully.

The staff representative from the Exchange and Trade Relations Department recalled that in proposing the rephasing, perhaps the most significant point had been how best to minimize the risks inherent in a forward-looking medium-term balance of payments scenario--scenario B in the staff report--by encouraging the authorities to tighten and improve the quality of the adjustment effort. Therefore, there were forward-looking commitments in the trend of the budget deficit, rather than just a review of the past six months. The Chairman's summing up on the recent discussion on the response of the Fund in the wake of the recent developments in the Middle East mentioned that decisions on individual access would be taken in light of strengthened adjustment measures.

In the same summing up, the prospects for financing from other sources to complete the financing plan had been alluded to, the staff representative continued. To garner financing from those other sources, Kenya had to show that it had a strengthened adjustment effort that the financing would be used to implement. Both the authorities and the Fund had approached donors. The best that Kenya could currently promise if there was a shortage in financing was that further tightening and strengthening of the policy package would be taken.

The same summing up referred to a member's capacity to repay the Fund, the staff representative remarked; in that connection, the staff had set out a scenario in which the risks were clearly stated. Some components, such as the composition of the outstanding stock of debt, could not be changed. He agreed with Mr. Filosa that the Fund's indicators showed that among the international financial institutions, the Fund's share of the debt was quite high. In fact, Fund indicators showed that debt service to the Fund exceeded Kenya's quota. The medium-term scenario which the authorities were expected to aim at and abide by allowed for a certain reserve buildup--and an improvement in the form of a decline in ratio of debt service falling due to foreign reserves. Table 8 on page 23 of the staff paper showed a downward trend not only in the ratio of debt service to exports of goods and services, but also in debt service to the reserves. If the adjustment path

were strictly adhered to, then Kenya's repayment capacity would be assured, simply because the authorities would be able to strengthen the reserve position to the extent required, even though a large share of their payments were to international financial institutions.

There would be no immediate augmentation of the whole three-year arrangement, the staff representative from the Exchange and Trade Relations Department said. Any such augmentation would have to be considered later and, obviously, with due caution and with due consideration being given to all the reservations raised by Executive Directors.

As to whether exchange rate policy had been ineffective, Table 25 of the background paper published on April 16, 1990 (SM/90/64) showed that non-oil exports had grown between 1984 and 1989: the volume index had increased from 100 to 134; in 1988 it had risen to 124. The indicators in the table on page 4 of the staff paper showed that growth of GDP at constant prices (factor costs) for 1986 through 1990 was 5 percent or more in real terms. Therefore, the growth scenario in Kenya had not been as depressed as other indicators might give the impression it was. The data for the past four or five years showed that economic growth had occurred despite an expansionary and weak financial policy stance. Importantly, after a downturn in the terms of trade in 1978 and 1979, Kenya had entered the 1980s with tremendous shocks--namely, a dissolution of the East African market, which had led to lost export markets in neighboring countries, and a huge oil shock--which had weakened the whole export sector. With substantial increases in export volume, the real exchange rate depreciation which had occurred had not been useless. Although it was difficult to come to a clear judgment on the exchange rate issue, it clearly had been relevant.

The issue of import liberalization was very important, the staff representative commented. During past foreign exchange crises--for example, in 1982-83 and 1987--the authorities had imposed exchange restrictions and held back on the liberalization program. Currently, they had rejected that strategy, even in the face of lower-than-expected capital inflows. In the staff scenarios, long-term projections for the balance of payments called for export volume to increase 6 percent per year--a considerable amount. If the exchange rate instrument were prejudged as completely futile, it would be extremely difficult to reach that export target.

Inflation in Kenya had been about 5 percent higher than inflation in the five industrial countries, the currencies of which formed the composite basket to which Kenya's currency was pegged, the staff representative observed. But that record of inflation was much better than the record of some of the neighboring countries. The staff's concern to see inflation lowered was indicated by the proposal in the staff paper to reduce the fiscal deficit.

For the previous review, the staff had provided information on real effective exchange rates, as well as an updated study of sectoral price

indices and tradable goods, the staff representative from the Exchange and Trade Relations Department said. That study had shown that there had, in fact, been a weakening of the relative price incentives for the productive sectors. Currently, with capital flows below the level earlier expected, reserves at low levels, and GDP growth aimed at 6 percent--and a history of export growth because of real exchange rate changes in the right direction--exchange rate behavior would be important in the future. The staff would thoroughly review the exchange rate issue, but it was an open issue.

Mr. Filosa remarked that he wondered whether the Kenyan authorities fully understood the consequences of the fiscal package. They seemed to be looking at the more optimistic results that would be obtained from a strong adjustment effort but, at the same time, looked forward to a slow pace of adjustment in the future. Given that there was political support for a slow pace of adjustment rather than for the staff's recommendation to maintain strong adjustment for some time in the future, there was a major inconsistency, in his view, between the staff's position and the authorities'. Therefore, it seemed to him that the rephasing of the purchase under the ESAF, although a good decision, was actually substituting for other external financing which was not coming for many reasons, including the political ones he had referred to. The rephasing was a marginal addition, but it was difficult to imagine a large addition to the stock, when the stock was already large. The rephasing was a satisfactory transitory solution to a problem which needed to be addressed more forcefully. Mr. Fernando had given many examples of the slow pace of structural reform in the program--a program which had been expected to produce positive results by the time of the current review.

Mr. Hogeweg said that he acknowledged the force of the arguments by the staff representative with respect to the exchange rate. He looked forward to the staff paper currently being prepared on the exchange rate situation in Kenya. He had not meant to say that a nominal exchange rate change should be ruled out, or that some of the exchange rate measures might not have been appropriate in the past. His point was that a nominal exchange rate change was not always the best way to achieve a real depreciation. In addition, by stating so clearly that in the future exchange rate policy would continue to be used to strengthen export performance insofar as other policy measures failed, the authorities would open the door to giving in to pressures which might then--as self-fulfilling prophecies--continue to arise.

Mr. Mwananshiku commented that Kenya, with support under the Fund's different arrangements, had made significant gains, although there had been slippages in policy implementation. The authorities were conscious of the seriousness of the problems facing the country and were keenly aware that policy deficiencies and slippages in implementation could only worsen the situation. They equally realized that there was no easy route to growth and development.

The deviation from the performance criteria on net domestic assets was a temporary phenomenon, Mr. Mwananshiku remarked. In particular, the strong determination of the authorities to contain government borrowing from the banking system and steps being taken to improve the monitoring mechanism of the commercial banks would greatly contribute toward avoiding further slippages.

The continued external vulnerability of the economy, to which many Directors had referred, underlined the need for diversification, Mr. Mwananshiku said. There was no doubt that a stable macroeconomic environment to complement the various incentives being put in place would be crucial for meeting the diversification and other external sector objectives.

Kenya's external borrowing policy would continue to be one of caution, Mr. Mwananshiku noted. Sound financial and debt management had enabled Kenya to maintain its excellent record of debt servicing. The tight fiscal and monetary stance, coupled with the planned export promotion measures, would definitely enable Kenya to meet promptly its financial obligations to both the Fund and other creditors.

It was important that the strengthened adjustment measures be supported with timely and adequate amounts of external assistance, Mr. Mwananshiku said. In that respect, he stressed that the Board's approval of the proposed decision would be of considerable support to the efforts of the Kenyan authorities.

The Executive Board then took the following decision:

1. Paragraph 1(b) of the second annual arrangement for Kenya under the enhanced structural adjustment facility (EBS/90/64, Sup. 2, 5/3/90) is amended by increasing the amount of the second loan to the equivalent of SDR 60,233,333.

2. The Fund determines that the midterm review specified in paragraph 2(c) of the second annual arrangement for Kenya under the enhanced structural adjustment facility has been completed, and that, notwithstanding paragraph 2(a)(i), Kenya may proceed to request the disbursement of the second loan under the arrangement.

Decision No. 9607-(90/173), adopted
December 14, 1990

2. VENEZUELA - 1990 ARTICLE IV CONSULTATION; AND EXTENDED ARRANGEMENT - REVIEW, AND REQUEST FOR WAIVER, MODIFICATION OF PERFORMANCE CRITERIA, AND EXTENSION

The Executive Directors considered the staff report for the 1990 Article IV consultation with Venezuela and the review under the second year of the extended arrangement with Venezuela approved June 23, 1989, together with a request for a waiver and modification of performance criteria under the extended arrangement and an extension of the period of the arrangement (EBS/90/204, 12/4/90; Cor. 1, 12/11/90; and Sup. 1, 12/10/90). They also had before them a background paper on recent economic developments in Venezuela (SM/90/182, 9/13/90).

The staff representative from the Western Hemisphere Division said that the Executive Board of the World Bank had approved the previous day an interest support loan of $150 million for Venezuela in support of that member's financing package with the banks. At the same time, the release of set asides amounting up to $285 million had been authorized. The amounts had been in accord with those presented in the staff report currently before the Board.

Mr. Torres made the following statement:

The Venezuelan Government is especially grateful to the Fund's Management and Staff for their assistance, cooperation, and support during the discussions on the second year of the program. In the authorities' belief, the constructive relationship developed with the Fund and the continuous interchange of views in relation to the evolution of the economic program and the negotiations with the international community, have made possible the finalization of the economic program's second year and the debt-financing package with commercial banks. My authorities would also like to express their satisfaction for the technical assistance received from the Fiscal and Central Banking Departments on fiscal and financial reforms.

Just before the last Article IV consultation concluded by the Executive Board on March 29, 1989, the new Government initiated the most important and comprehensive transformation of the economy in Venezuela's history, through the implementation of a growth and market-oriented program and structural reforms, supported by an extended arrangement with the Fund, and structural and sectoral loans from the World Bank and the Inter-American Development Bank.

The main objectives of the program have been to correct external and internal disequilibria, re-establish sustainable economic growth with price stability, make the economy less dependent on oil, reduce the scope of the public sector in the economy by promoting a more active participation of the private

Kenya/1794

REPUBLIC OF KENYA

OFFICE OF THE VICE-PRESIDENT AND MINISTRY OF FINANCE

Telegraphic Address:
FINANCE-NAIROBI
Telephone: 338111
When replying please quote
Ref. No. ZZ/TS/IMF/32
and date

THE TREASURY
P.O. Box 30007
NAIROBI
KENYA

12th November 1990

ORIG: AFR
CC: MD
DMD
MR. MONYAKE
ETR
LEG
TRE
MR. P. ANDREWS

011488

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. Camdessus:

1. We have recently held discussions with the Fund staff on the mid-term review of Kenya's programme of structural and financial adjustment for 1990, which is supported by the second annual arrangement under the enhanced structural adjustment facility (ESAF) that was approved by the Executive Board of the Fund on April 30, 1990. The discussions focused on the progress made under the programme for 1990, as well as on the objectives and policies to be pursued for the remainder of the period. All performance criteria for end-June 1990 were met except for the one, on net domestic assets for which the Government of Kenya hereby requests a waiver. In view of the worsening external environment and the sharp deterioration in Kenya's external position, important and difficult policy actions have been taken which will have significant short-term costs to the Kenyan

RECEIVED
INTERNATIONAL MONETARY
1990 NOV 16
COMMUNICATIONS DIVISION

economy. Against this backdrop, we have formulated the indicative quantitative targets for end-March and end-June 1991 as specified in the annex. In this context, we wish to request an increase of the amount to be made available for the second disbursement under the current arrangement to the equivalent of SDR 60.2 million.

2. The economic growth target for 1990, which had been set at 5.2 per cent, has now been scaled down to 5.0 per cent. Favorable weather for major crops combined with a strengthening in international tea prices as well as the enhancement of production incentives in the early part of the year have played an important role in mitigating the impact of the new "oil shock." The inflation rate of 10.6 per cent at end-September, however, was higher than the end-1989 level, reflecting the rapid monetary expansion of the second half of 1989 and early 1990, and the initial impact of the 31 to 49 per cent increase in domestic oil prices of early September 1990. Notwithstanding the tighter financial policies currently in place, the inflation rate, which was expected to decelerate to 7.5 per cent by year-end, is now projected at 12 per cent, largely as a result of the oil price increases and new tax measures. The overall balance of payments for the first six months of 1990 is estimated to have been in deficit. As a result, net official reserves declined by SDR 86 million compared with a targeted increase of SDR 14 million, and gross reserves fell to less than one month of nongovernment imports.

3. While the programme had anticipated a surplus similar to that in 1989, the balance of payments for 1990 is now expected to lead to a reserve loss of some SDR 191 million. The current account deficit is projected at 5.8 per cent of GDP compared with 4.4 per cent in the programme (This deficit excludes the planned leases of two planes by Kenya Airways, which the Government has

postponed pending the restructuring of the company). This deterioration follows a weaker trade position than estimated in 1989, which contributed to a current account deficit of 7.4 per cent of GDP, 1.5 percentage points higher than estimated.
Net capital inflows are forecast at 3.8 per cent of GDP, compared with 9.5 per cent in 1989.

Part of the weak payments position in 1990 can be explained by the worsening trade account from continued adverse movements in the terms of trade. After a deterioration (in SDR terms) of some 9 per cent in 1989, the terms of trade are estimated to decline by a further 8 per cent during 1990, with falling coffee and tea prices and a sharp dip after August as oil prices rose. Other problems continued to affect exports. The volume of nontraditional exports fell substantially in 1989, in large part due to a 30 per cent drop in horticultural export volume as a result of heavy rains at the turn of the year, problems with air freight capacity, difficulties in importing packaging material, and the nonrenewal of one large trial order for pineapples. Recovery from this low base has been slow, although the Government has begun to address the removal of some institutional constraints on horticultural exports. The aftermath of vigorous import growth in 1989 also undermined the trade account during the early part of this year. Trade liberalization contributed to a structural increase in the demand for imports in the second half of 1989, including a buildup of inventories with continuing effects in 1990. An equally important source of the higher deficit was strong domestic demand, particularly by the public and parastatal sectors. Finally, the reserve loss in 1990 also reflects lower-than-expected inflows of cash assistance and import financing.

4. The overall budget deficit for 1989/90 of 4.0 per cent of GDP was lower than the target of 4.2 per cent despite a

significant shortfall in some components of revenue. However, the overall deficit, excluding grants, at 6.5 per cent of GDP was marginally higher than in the programme reflecting larger-than-projected external grants in the first half of the fiscal year. Revenues from two new taxes--the presumptive tax on agricultural produce and the value-added tax-- were lower by Kshs 1.7 billion (0.9 per cent of GDP). However, this was offset chiefly by better than envisaged nontax receipts, including an interim dividend from 1990/91 of Kshs 1.3 billion in Central Bank profits. Notwithstanding, the revenue to GDP ratio was higher at 24.1 per cent against the programme target of 23.7 per cent. User charges relating to agriculture, livestock, roads, health, and education services, which are intended to increasingly finance recurrent expenditures in the future, amounted to 1 per cent of GDP.

Recurrent expenditure in relation to GDP was somewhat higher than in the programme, partly because of supplementary appropriations in April for the financing of higher salaries for the defence forces, increased enrollment in the universities, higher expenditures on national security, and greater than envisaged outlays on domestic interest. Because of strong pressures for employment growth, primarily to meet the demand for additional trained teachers with the implementation of the new 8-4-4 education system, as well as the decision of the Government to grant wage increases to the defence forces in April 1990, the structural benchmark to limit the wage and salary bill growth to 7.5 per cent is estimated to have been exceeded. Mirroring partly the larger than programmed inflow of external grants, development expenditures also rose to 7.3 per cent of GDP in contrast with the programme target of 7.1 per cent. Dependence on domestic sources for financing the deficit was lower than envisaged in the programme, with net repayment to the banking system of 0.2 per cent of GDP. Reflecting continuing

difficulties in controlling and monitoring expenditures, the value of unpresented cheques at the end of 1989/90 exceeded the programme target of Kshs 1.1 billion by Kshs 0.2 billion.

5. Overall domestic credit developments through the first half of 1990 were more expansionary than envisaged in the programme. During the second quarter of 1990, steps were taken to tighten the stance of monetary policy. Accordingly, the ceilings on interest rates on deposits and on short- and long-term commercial banks loans were raised by one percentage point, effective April 1, 1990, to 13.5 per cent, 16.5 per cent and 19.0 per cent, respectively; the ceiling on short term loan rates was raised by a further 0.5 percentage points to 17.0 per cent before end-August, 1990. Furthermore, the legal requirement that loan interest rates subject to ceilings be inclusive of all lending-related fees and charges was removed, thus allowing effective interest rates to exceed significantly the formal ceilings and, in effect, to be market-determined. Also, in order to control better money and credit aggregates, and to ensure compliance by the commercial banks with credit ceilings, the Central Bank of Kenya in May introduced an additional cash deposit scheme for commercial banks that exceed their credit ceilings. This deposit scheme should encourage the banks to place excess funds in government securities, and pave the way for the full implementation of open market operations.

These measures notwithstanding, the recent change in the ceiling from domestic credit to net domestic assets (NDA) created monitoring difficulties for a number of large commercial banks; as a result, the NDA ceiling for end-June 1990 was exceeded by Kshs 1.6 billion, equivalent to 3.3 per cent of the stock of broad money at end-June 1989. Net domestic assets of the banking system grew by 13 per cent in 1989/90 (July-June) compared with 11.2 per cent in the programme. Net credit to the Government

increased by 5.7 per cent during this period, in contrast to the targeted 9.7 per cent. Net foreign assets were substantially lower than targeted; as a result, broad money expanded by 8.7 per cent in 1989/90, in contrast to the 10.4 per cent growth expected under the programme.

6. External sector policies during the first half of 1990 were in line with the original programme, although the worse outturn for 1989, once it was identified, has now required stronger measures for the last quarter of the year. The exchange rate was managed flexibly, depreciating by 11.8 per cent in real effective terms between end-December 1989 and end-September 1990, broadly in line with the terms of trade. Nonconcessional external borrowing contracted by the public sector in the 1-15 year maturity range (as defined in Table 1) was US$150 million by mid-October, consistent with the programme limit of US$155 million for the year. This included three 13-year maturity loans, of a combined amount of US$124 million, which had been mostly negotiated in the previous year when the maturity limit, for the purpose of the programme ceiling, was 12 years.

7. The structural measures in the programme were also implemented as anticipated and the structural performance criteria relating to export promotion and import liberalization were both met. The 1990/91 budget, which was presented to Parliament in June, represents a strong commitment for the promotion of exports, particularly of nontraditional industrial goods. One element of the strategy is to open the trading system to promote competition. In line with the performance criterion under the second annual arrangement under the ESAF, quantitative restrictions on 35.4 per cent of eligible imports still subject to controls (according to the new classification system) were shifted to the liberalised category, and are now protected only by tariffs. The number of exports eligible for the Export

Compensation Scheme was increased by nine new items, and improvements in the administration of the scheme have been announced to expedite payments. An exemption scheme for refunding duty paid on imported inputs to eligible exporters (targeting exporters of horticultural goods and agro-based products) has been gazetted and is backdated to be effective from September 1, 1990.

Rules relating to the duty/VAT exemption scheme have recently been gazetted. A bill establishing the legal and administrative framework for Export Processing Zones has been tabled and is expected to be enacted by the end of 1990. Two of these zones have been identified as well as the general area of the third; the private zone in Nairobi is ready for occupancy and is expected to be in production by early 1991. Infrastructure work on the government zone in Nairobi, at Athi River, is to commence shortly and this zone is expected to be in production by mid-1992.

Two measures are planned in an effort to alleviate the capacity constraint on airfreight for horticultural exports. First, the handling of air cargo at Jomo Kenyatta International Airport will be demonopolized by mid-December 1990, thus allowing the cost of handling horticultural shipments to decline. Second, the base for the calculation of the import duty rate on imports delivered by air will be reduced, effective in the first half of 1991, from 50 per cent of the air freight cost to 10 per cent. The latter measure will put air and sea freight costs on a more equal footing, thus providing a greater incentive for the chartering of cargo flights for horticultural exports.

The IDA-financed study of the textile sector has been submitted and discussed with the Government, which is to adopt an action plan for the restructuring of the sector by no later than

end-January, 1991. This strategy should address the main constraints identified by the report--the inefficiency of publicly owned firms and cotton availability and quality--prior to removing constraints on textile imports. The budget has already announced measures to overcome bottlenecks to the availability of cotton; an auction system is to be introduced, ginneries are to be restructured and private ownership will be encouraged. Further progress was made in the removal of price controls, as 74 items under the General Price Control Order were decontrolled in mid-March 1990, and 6 additional items under the General Price Control Order and 9 items under the Specific Order were decontrolled in mid-June, 1990.

8. The Government has continued its financial sector reform supported by a credit from IDA, that aims to increase the role of market forces in allocating financial resources and implementing monetary policy. Real interest rates continued to be positive during the first half of 1990. As part of the effort to strengthen the financial system, ten financial institutions were merged into the Consolidated Bank of Kenya in May, with financial backing by the Deposit Protection Fund. Stronger regulations on capital adequacy for banks and nonbank financial institutions have been issued by the Central Bank which would go into effect in early 1991. To encourage the expansion of equity markets, the Capital Market Authority was established in January to review the activities of the Stock Exchange and to establish rules to encourage more active trading. A Unit Trust (Amendment) Bill was tabled in June to encourage share trading by improving the tax treatment of purchases of unit trusts.

9. In line with its policy to improve the efficiency of the agricultural sector, producer prices for coffee and tea will continue to be based on auctions, and committees established to expedite payments to farmers after delivery have led to

elimination of payment delays. It is the policy of the Government to ensure that payment delays to farmers will not occur in the future. The Coffee Board has developed a strategy for handling and financing its stocks.

Policies for 1990/91

10. In the face of a sharp deterioration in the balance of payments and the substantially weaker external reserve position during 1990, the Kenyan Government has recently introduced a package of far-reaching and difficult policy measures, financial and structural, which should lead to the re-establishment of a more sustainable external position. In addition to a large increase in domestic petroleum prices in early September 1990--ranging from 31 to 49 per cent--the measures include a very sizable reduction in the budget deficit for 1990/91, sharp cuts in parastatal imports, a freeing of the treasury bill rate in order to enhance the Central Bank's capacity to conduct open-market operations, actions to strengthen tax administration, and measures to increase accountability of public enterprises. The Government will maintain this restrictive policy stance throughout the following fiscal year if the external situation continues to remain weak and the reserve position tight.

In the external area, the Government is committed to continue the pace of trade liberalization, despite the very difficult external circumstances. Priorities will be established to reduce the level of government and parastatal imports for the remainder of 1990 and for 1991 in the context of a foreign exchange budget with indicative quarterly ceilings. The options on the leases for planes due to be delivered to Kenya Airways in 1990 and 1991 will be postponed pending the restructuring of the company. The Government has also decided to limit the contracting of public borrowing on nonconcessional terms in 1991 to US$77.5 million

(half the limit for 1990). With these policies and the more restrictive fiscal and monetary measures, the current account deficit should fall to some 5.8 per cent in 1990, and 4.3 per cent in 1991. While the reserve position will remain very difficult through the end of 1990 (at two weeks of nongovernment imports), reserves are targeted to rise to two months of nongovernment imports by the end of 1991.

Fiscal policy

11. In view of Kenya's unusually adverse external position, fiscal policy will aim at reducing the 1990/91 budget deficit from the original program target of 3.8 per cent of GDP (5.6 per cent, excluding grants) to 2.5 per cent of GDP (5.1 per cent excluding grants), and further to 2 per cent of GDP in 1991/92 (3.8 per cent, excluding grants), relative to 3.4 per cent in the original 1990 programme. In 1990/91, revenue as a share of GDP is projected at 23.3 per cent, while total expenditure and net lending is now expected to decline to 28.4 per cent, (relative to 30.6 per cent of GDP in 1989/90), reflecting a significant cutback from the approved budget estimates for both recurrent spending and locally financed development expenditures. The budget deficit is to be financed from domestic nonbank and foreign concessional sources, with a repayment by the Government to the banking system of Kshs 2.5 billion (1.2 per cent of GDP). The level of unpresented cheques at the end of 1990/91 will remain unchanged at the end-June 1990 estimate of Kshs 1.3 billion.

12. As part of the 1990/91 budget (presented in June 1990), a number of discretionary revenue measures, with a net yield of K shs 1,068 million (0.5 per cent of GDP), have already been implemented to broaden the tax base and enhance the elasticity and equity of the tax system. The bulk of the revenue from new

measures was anticipated from higher excise duties on cigarettes, tobacco, and beer, some adjustments in the value-added tax, (including raising the general rate from 17 per cent to 18 per cent, and a higher tax rate on beer), and changes in income and profits tax bases. The revenue gain from these measures will be partially offset by the lowering and rationalization of import duty rates, as part of the ongoing reform of the tariff structure.

Some major changes were also introduced in the area of taxes on income and profits; a current payment system from business income is to be phased in over five years, eventually requiring businesses to pay 75 per cent of the estimated annual tax at the end of the third quarter or end of the ninth month of a firm's financial year; the corporate income tax rate has been lowered further from 42.5 per cent to 40 per cent; tax holidays for ten years are being offered to attract foreign investment in the Export Processing Zones; and the tax on dividends has been lowered to promote the development of the capital market, in particular Unit Trusts.

More recently, to achieve the revised budget deficit target, numerous nontax measures have been implemented that would yield an additional Kshs 650 million (0.3 per cent of GDP). The revenue from nontax sources will increase with higher-than-budgeted loan repayments and dividends by certain public corporations (Kshs 217 million), the partial recovery of tax arrears pertaining to telecommunication revenue (Kshs 250 million), and previously unbudgeted repayments of past loans by some public enterprises (Kshs 184 million). In addition, certain discretionary tax measures, to be implemented by mid-November, will generate net revenue of about Kshs 900 million (0.4 per cent of GDP).

In line with the recent development in the international oil market, the Government was prompt in adjusting the prices of petroleum products by 31 to 49 per cent in early September. In order to continue the efforts to conserve energy, the Government is committed to not reduce retail petroleum prices and to capture any fiscal benefits accruing from a reduction in international oil prices in 1991. Should oil prices rise above the levels foreseen for the remainder of 1990 and for 1991, the Government intends to pass them rapidly through to the consumers. The Government has limited the revenue loss from import duty exemptions by canceling those in existence for more than five years, with the exemption of some granted on a case-by-case basis to diplomats, aid agencies (with respect to projects), charitable institutions, religious bodies, and handicapped persons. Most exemptions granted to parastatals will be eliminated immediately.

13. The Government has moved rapidly to implement the new Value Added Tax (VAT) law. Despite the achievements to date, there is a need to address some remaining difficulties so as to further enhance VAT revenue generation. During the next two months, it intends to fill outstanding vacancies in middle management, and provide adequate accommodations and training facilities and the full complement of equipment and vehicles. With respect to computerization, the Government intends to finalize contractual arrangements for further computerization of the VAT Department by December 15. With respect to VAT enforcement, the Government will move in the next two weeks to establish an operating VAT tribunal. By end-December, it will begin to prosecute VAT defaulters (including parastatal enterprises) and those that have failed to register under the VAT Act and will take the enforcement actions required under the law.

14. In order to ease the pressure on the external current account, the Government, following a careful review of the budgetary allocations of the different ministries, has decided to cut both recurrent and locally funded development allocations by KShs 766 million and Kshs 1,135 million, respectively. These expenditure savings measures are expected to reduce demand for foreign exchange by about SDR 32 million in 1990/91, either directly or indirectly through their impact on private sector imports. A Treasury Circular has been issued to each affected Ministry to give effect to these budgetary cutbacks prior to the submission of the Supplementary Budget in February 1991. The Government is committed to staying within the agreed programme limits and will not approve any supplementary expenditures in 1990/91, particularly of an ongoing nature, without a fully offsetting increase in tax effort, user charges, and/or cuts on other expenditure items.

The overall share of recurrent expenditures is targeted to decline to 21.4 per cent of GDP, compared to 23.3 per cent in 1989/90. In part, this reflects the Government's efforts to reduce the provision for transportation expenses, and the purchases of vehicles, plant and equipment included in the recurrent budget. A part of these cutbacks have been directed at public administration and defence expenditure and some effort has been made to insulate outlays directed at the more vulnerable groups (e.g., no cutbacks in the Ministry of Health's budget for transportation expenses).

To limit the rate of growth of central government employment, the Government has recently issued a Treasury Circular to limit the unauthorized creation of new posts as well as the upgrading of positions and to freeze all vacancies unfilled for more than six months. The Government has also

recently reduced the number of authorized posts included in the 1990/91 budget by 10,400 positions, which should result in budgetary savings of about Kshs 314 million. In its 1991/92 budget, the Government intends to provide no further increase in the number of posts, other than those relating to the expansion of primary school teachers. Consistent with the Government's commitment to stabilize the level of civil service and teaching employment within the next few years, the Government will hire no more than 1,500 new graduates from the 1990 graduating class of the university system, and training institutions run by ministries will begin to limit their activities to in-service training. In order to ensure that the personnel expenditure targets are being adhered to, cash limits on the wage bill will be set and enforced for each ministry and the Teacher's Service Commission by end-1990. The recommendations of the Salary Review Commission appointed in July 1990 are expected in December 1990. The salary revision emanating from the Commission's recommendations will be made effective from July 1, 1991, and phased in over a three-year period.

As a result of cutbacks in budgeted locally financed development outlays of about 16 per cent, total development outlays will decline to 7.0 per cent of GDP, relative to 7.3 per cent in 1989/90. Considerable efforts are also under way to strengthen the budgeting and implementation of development outlays. A detailed ministry-by-ministry project list is being prepared for the first time for 1990/91 and will be ready by December 1990. A similar exercise will be carried out for the 1991/92 budget. A forward budget for the outlays for the period 1990/91-1991/92 will be prepared, which will improve the quality of selection of development projects. A comparable project list is being prepared for the major nonfinancial state corporations for 1991/92. In the preparation of the 1991/92 budget, the Government will seek external assistance in reviewing and

assessing the relative economic merits of the major projects to be included in the public investment programme. In this connection, the Government will prepare, with the assistance of IDA, a public investment programme consisting of the capital expenditures of the Central Government and gradually increasing its coverage to a larger number of major nonfinancial state corporations.

15. University education has claimed an increasing share of budgetary resources and is crowding out funds for both other levels of education as well as for the implementation of the Government's development strategy. To limit this growth in coming years, the Government intends to move from the present open-ended system of direct budgetary allocations to individual universities to a system whereby a flat grant is provided to an autonomous university commission fiscally responsible for the planning, management, and financing of the university system. In the interim, to limit the cost of university education to the budget, the intake to the university system will be restricted to 8,000 in 1991. The Government intends to strengthen its existing in-service programmes in primary and secondary education, so as to ensure that as teaching posts at these educational levels are primarily filled with untrained teachers, the quality of education continues to be maintained at a high level. No teacher's training colleges will be established beyond those agreed with the World Bank.

16. In the course of 1990, some changes were made to the plans for increasing user charges for health and education services. In the health sector, maternity fees were reduced in January and civil servants were exempted from paying outpatient charges in April. In August, outpatient charges were abolished. However, the Government remains committed to the progressive strengthening of the role of user charges, consistent with an

improved quality of medical care. With regard to education, in 1991 fees will be levied so as to cover a significant portion of the tuition of university students, and a policy will be implemented to strengthen substantially the collection of loans from university graduates.

17. In order to strengthen the expenditure control and monitoring system, and as recommended by a recent technical assistance mission of the Fund, the Budget Department of the Office of Vice-President and Ministry of Finance, effective from January 1991, will start monitoring non-wage, non-pension, and non-interest commitments of the major ministries. The coverage will encompass recurrent local and foreign purchase orders and development expenditures. The Department will also ensure that the different ministries adhere to the number of authorized posts agreed with the Fund. In addition, midyear and third-quarter reviews of the budget will be conducted to facilitate the introduction of corrective measures by a review committee.

State corporations

18. In August 1990, a major effort was initiated to establish an information system and database for all state corporations, that is, to provide regularly quarterly and annual indicators of economic and financial performance. On the basis of the information collected, the Government will extend the number of monitored state corporations from 10 to 20 by December 1990. In order to improve the financial control and discipline of state corporations, the Government has further announced that it is no longer prepared to assume the defaulted foreign debt obligations of public enterprises without an investigation of the circumstances behind the payment default. For any state corporations that defaults in its foreign debt obligation, the Government will take appropriate action with respect to

addressing the payments difficulties of this corporation.

Furthermore, financial data from commercial banks with respect to an initial sample of 15 state corporations (as agreed with the Fund staff) will be collected by the Office of the Vice President and Ministry of Finance with a copy sent to the Central Bank, beginning December 1. Each commercial bank will report on outstanding credit and loan payments due to it, loan payments received each month, deposit balance, overdraft position, and level of outstanding nonperforming debt. In addition, a UNDP -funded expert has been appointed to quantify, on a quarterly basis, the level of commitments and payments of debt owed by state corporations to the Government and to categorize loans that are performing and nonperforming.

A draft policy framework paper for state corporations is under consideration and will be finalized by December 1990. This policy paper, besides setting forth the Government's policy, will facilitate designation of state corporations as either strategic or nonstrategic, and will identify candidates for privatization in 1991. Progress in the restructuring of the DFIs will be accelerated and the contracts with the six technical assistance experts on the management of assets and liabilities will be signed by December 1, 1990. Some amendments to the State Corporations Act have been proposed and will be submitted to Parliament by mid-November 1990 for ratification. Under the amended Act, the state corporations will be required to prepare and submit to the Office of the Vice President and Ministry of Finance annual budgets and exemption from the Act will be granted only on a case-by-case basis.

19. As a part of the commitment to reduce imports and to correct external imbalances, the Office of the Vice President and Ministry of Finance has issued a Circular instructing all state corporations to cut back on self-financed imports, such as motor

vehicles, acquired directly from abroad and from local sources during the remaining part of 1990 and in 1991. It will enforce the implementation of this measure through a Treasury circular identifying the reductions, through a review by the Government Investment Division of the draft budgets of state corporations, and by the Treasury's participation on the boards of all state corporations. In this respect, the Foreign Exchange Allocation Committee, responsible for clearing foreign exchange requirements will not allow any low priority imports of state corporations. It is estimated that these steps will reduce imports by about SDR 29 million during 1990/91 and the policy will be maintained during the remainder of 1991 to prevent a resurgence of imports by state corporations.

20. During 1989/90, the Government had taken several steps to strengthen the financial position of Kenya Airways. Towards this end, in December 1989 Kenya Airways purchased/leased two new aircrafts and laid off 1,000 permanent employees in early 1990. An assessment of the financial and management operations of the airline was completed by an internationally reputable accounting firm in early 1990. Since then, a government-appointed committee has also studied the issue pertaining to the restructuring of the airline. An IDA-funded consultant has been asked to prepare an action plan for the restructuring of the airline by March 1991, to be implemented in April 1991. Purchases of aircraft in 1992 will take account of the consultant's recommendations and will be subject to prior consultations with the Fund staff. Some additional measures have been initiated to strengthen the functioning of the company. Two experts on finance have been recruited internationally, some organizational changes have been effected, a UNDP-funded project is providing training to the staff, and some routes have been rationalized.

Monetary policy

21. During the remainder of 1990, the Government will continue its reform of the financial system, with a view to improving the efficiency of resource mobilization and allocation and to broadening the range of financial instruments available to savers and investors. Interest rate liberalization will be furthered by active steps to develop a market for treasury securities. Accordingly, yields on treasury bills have been fully liberalized, effective November 15, 1990, allowing price to be set by a true and proper auction, thereby making these instruments attractive to investors. The amounts to be offered will be set in consultation with the Central Bank and take account of monetary policy considerations. The results of each treasury bill auction will be published in Reuters, indicating the amounts to be issued and redeemed, the range of rates accepted, and the weighted average rate.

As regards treasury bonds, immediate efforts will be undertaken to establish an effective marketing and distribution system capable of broadening this market. Thus, the Central Bank will begin the floatation of bearer treasury bonds with maturities of one, two and five years through the Post Office Savings Bank before end-November, 1990, and will also begin to issue bearer bonds denominated in foreign exchange. With the liberalization of treasury bill and bond markets, the Central Bank intends to gradually move away from quantitative credit ceilings towards open-market operations as a more efficient means of controlling monetary aggregates. To facilitate the development of short-term money markets, secondary trading in treasury securities will be encouraged. In order to enhance the effectiveness of monetary policy, nonbank financial institutions (NBFIs) will be required to reduce the current three-month lag in

submitting their financial returns to the Central Bank of Kenya to no more than two months.

22. Monetary policy in the period ahead will seek to maintain growth of domestic credit and liquidity, consistent with reducing inflationary pressures, and building up of reserves. In order to ensure compliance with the limits on the expansion of credit, the additional cash deposit ratio on the amount by which banks exceed their ceiling on NDA will be maintained at 20 per cent. Credit targets for the first half of 1991 will be as indicated in attached Table 1. These indicative targets, which will be reviewed at the time of the elaboration of the third annual arrangement under the ESAF in early 1991, are projected to be consistent with a stock of broad money at end-June 1991 virtually unchanged from the end-June 1990 level.

External and industrial policies

23. The weak reserve position, coupled with no expected improvement in the terms of trade, has led the Government to take strong actions to improve the payments position through the end of 1991. Most of the burden of the higher current deficit and weaker capital account in 1990 is expected to result in a drawdown of reserves. The current account deficit is estimated at 5.8 per cent of GDP, compared with 7.4 per cent in 1989--an improvement of 1.5 per cent of GDP similar to that originally programmed--and at 4.3 per cent in 1991.

The main impetus for improvement is expected to come from lower imports both from strong restraint of direct and indirect imports by the public sector and from tight credit policies limiting private sector expenditures. Exports are expected to remain sluggish after the setback in 1989. Some improvement in the domestic competitiveness of nontraditional export production

is to be achieved during 1991 from efforts to reduce domestic costs, from the continued flexible management of exchange rate, and from the specific export incentives noted in paragraph 7. In particular, duty exemption on imported packaging, participation in the Export Processing Zone, and the removal of such institutional constraints such as limited air freight capacity, are expected to reverse the decline in horticulture export volumes and to lead to a 10 per cent growth in 1991. But the overall growth of the export sector will be dominated by weak international demand for coffee and tea, which is expected to contribute to a slackening in the volume of exports by domestic producers.

As domestic currency prices for imports are likely to continue to be high and monetary and fiscal policies constrain demand, import volumes are expected to be significantly lower than earlier anticipated. First, as a result of the increase in domestic prices of petroleum products in early September, and significant demand contraction, zero growth of oil import volumes is expected for 1990, with a 2 per cent decline in the following year. Zero growth for 1990 would represent a considerable achievement given that the value of oil import approvals in the first half of the year was 24 per cent higher than that for the first six months of 1989, when annual imports grew by 3.1 per cent.

Second, in order to increase the efficiency of public investment as well as to reduce pressure on the payments position, the Government has taken a number of steps to ensure that expenditures by the Central Government and state corporations are consistent with the foreign exchange constraint, given long-term investment needs (as also discussed in paragraph 14); the measures being implemented should result in total savings of some SDR 116 million for 1990 and 1991.

Third, the planned leases of aircraft by Kenya Airways will not be made in 1990 and 1991, and future leases will be reconsidered in the light of the restructuring report which is due in early 1991. Fourth, while the liberalization of private imports will be maintained, some restraint on still-restricted items will be exercised until full liberalization in June 1991.

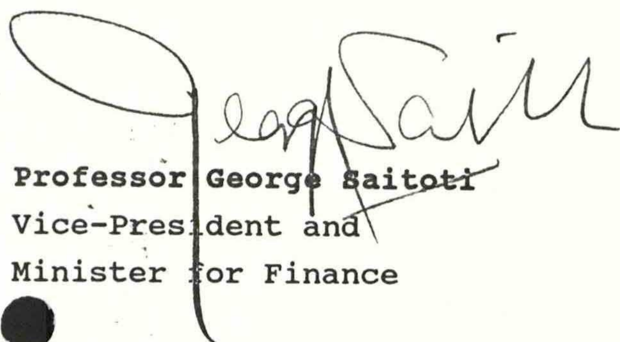
With tourism continuing to grow strongly--rates of 10 to 11 per cent in travel receipts (in SDR terms) are expected this year--the improved current account position will be largely financed by concessional official capital inflows. To reduce debt servicing costs, commercial borrowing will be reduced, while imports contingent on some already contracted loans will be delayed where related investments do not receive priority.

To monitor the impact of these steps, and signal the need for further actions when necessary, a foreign exchange budget has been prepared with indicative quarterly ceilings on foreign exchange spending by the Central Government and state corporations, consistent with a reserve accumulation target of some SDR 200 million during 1991. Achievement of this target will bring gross foreign exchange reserves to two months of nongovernment imports by the end of the year. The Government will monitor the movement in gross official reserves closely and in the event that the reserve position deteriorates significantly from the reserve accumulation path targeted under the programme, the Government will promptly consult with the Fund staff.

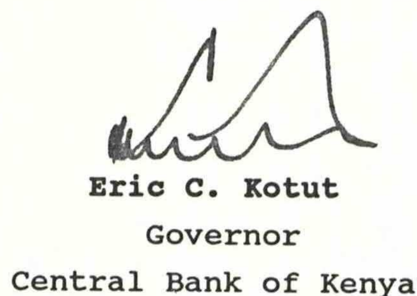
24. Most of the improvement in the payments position is expected to come from restraint on demand, particularly by the public sector. However, exchange rate policy will be combined with supportive fiscal and monetary policies to strengthen the domestic incentives for export production in conjunction with the

measures taken to reduce anti-export bias. As noted above, given the current foreign exchange constraint and the need to reduce future debt-servicing costs, the Government has decided to limit the contracting of public borrowing on nonconcessional terms in 1991 to US $77.5 million (of which US $55 million is earmarked for the Nzoia Sugar Project). In the event of a serious deterioration in the external security situation, the Government intends to consult with the Fund staff to review the nonconcessional debt ceiling.

Sincerely yours,



Professor George Saitoti
Vice-President and
Minister for Finance



Eric C. Kotut
Governor
Central Bank of Kenya

Attachment: Annex

Table 1. Kenya: Performance Criteria and Benchmarks of the Second Annual Arrangement Under the Enhanced Structural Adjustment Facility

	1989	1990			1991	
	December actual	June actual	Sept[1]	Dec[1] revised	March indicative target	June indicative target
Quantitative performance criteria/benchmarks	(In millions of Kenya Shillings)					
Net domestic assets [2/3]	54,428	58,150	58,610	62,300	60,700	61,300
Net bank credit to the government [3] [4]	12,671	15,143	17,110	21,729	17,729	13,229
Memorandum Items:						
Net bank credit to the government in monetary survey	17,481	20,414	21,920	27,000	23,000	18,500
Less: CSFC	4,040	3,847	4,040	3,847	3,847	3,847
Less: Debt assumed from parastatals	770	1,424	770	1,424	1,424	1,424
New nonconcessional external loans or leases contracted or guaranteed by the Govt[5] (Cumulative per calendar year)	(In millions of US dollars)					
a. 1-15 years maturity	167.0	71.0	155.0	150.2	77.5	77.5
b. Short-term credits of less than one year's maturity[6]	-	-	-	-	-	-
Quantitative benchmark	(In millions of SDRs)					
Minimum stock of net official international reserves[7]	-60.3	-146.6	-55.3	-240.0	-215.0	-205.0

Source: Memorandum attached to the letter of request of Kenyan authorities of March 28, 1990.

1/ Quantitative benchmarks

2/ Net domestic assets of the banking system is broad money minus net foreign assets of the banking system.

3/ This target will be adjusted downwards to the extent that net external financing of the deficit during the July 1990-June 1991 period, excluding A-in-A financing, exceeds Kshs 3,900 million, or to the extent that domestic nonbank financing exceeds Kshs 1,300 million. Such net external financing is defined to include all cash loans received by the Paymaster General's Account during this period.

4/ Net credit to the Government is net credit to the Government from the banking sector. The ceiling excludes the operations of the Cereals and Sugar Finance Corporation (CSFC) (Kshs 3,847 million), and the amount of public enterprise debt (Kshs 1,424 million) assumed by the Government by June 1990 and reclassified from outstanding private sector credit. For the purpose of the calculations of this ceiling, these amounts of Kshs 3847 million and Kshs 1,424 million will be assumed as constant through the programme period ending June 1991.

5/ In addition to nonconcessional borrowing contracted or guaranteed by the Government, this ceiling also applies to the borrowing of all state corporations (including cases where their borrowing is associated with a "letter of awareness" from the Government), as well as leases. For the purposes of this definition, a loan or lease is noncocessional if it has a grant equivalent of less than 25 per cent. Grant equivalence shall be determined by reference to published DAC tables and is a function of the interest rate, grace period, and maturity. "Maturity" is defined as the sum of the grace period and the terms of payment. For purposes of converting new nonconcessional external loans into U.S. dollars, the U.S. dollar exchange rates cabled to the Central Bank of Kenya from the Federal Reserve Bank of New York for January 2, 1990 will be used. For 1991, this ceiling assumes that US$ 55 million is earmarked for the Nzoia Sugar Project.

6/ Other than normal import-related credits, this limit also excludes nonguaranteed borrowing by the Coffee Board of Kenya associated with short-term trade financing.

7/ Net official international reserves are defined as the Central Bank of Kenya's foreign reserve assets (SDRs, gold, and foreign exchange holdings) plus government foreign exchange holdings with Crown Agents; plus Kenya's reserve position with IMF; less CBK liabilities to external banks; less net use of Fund resources.

Kenya, 1794

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

EBS/90/64
Supplement 2

CONFIDENTIAL

May 3, 1990

To: Members of the Executive Board

From: The Secretary

Subject: Kenya - Enhanced Structural Adjustment Facility - Second Annual Arrangement

Attached for the records of the Executive Directors is the text of the second annual arrangement for Kenya under the enhanced structural adjustment facility as agreed at Executive Board Meeting 90/68, April 30, 1990.

Att: (1)

Kenya--Second Annual Arrangement Under
the Enhanced Structural Adjustment Facility

Attached hereto is a letter dated March 28, 1990, with an attached memorandum on the economic and financial policies of the Government of Kenya from the Minister for Finance and the Governor of the Central Bank of Kenya, requesting from the International Monetary Fund the second annual arrangement under the three-year arrangement and setting forth the objectives and policies of the program to be supported by the second annual arrangement.

To support these objectives and policies, the Fund grants the requested arrangement in accordance with the following provisions, and subject to the Regulations for the Administration of the Structural Adjustment Facility and the Instrument to Establish the Enhanced Structural Adjustment Facility Trust:

1. Under the second annual arrangement:

(a) the first loan, in an amount equivalent to SDR 40,233,334, will be available on May 15, 1990 at the request of Kenya; and

(b) the second loan, in an amount equivalent to SDR 40,233,333, will be available on November 15, 1990 at the request of Kenya subject to paragraph 2 below.

2. Kenya will not request disbursement of the second loan specified in paragraph 1(b) above:

(a) if the Managing Director finds that at the end of June 1990

(i) the limit on net domestic assets of the banking system referred to in paragraph 31 of the memorandum and specified in Table 1 attached to it was not observed, or

(ii) the limit on net credit to the Central Government by the banking system referred to in paragraph 31 of the memorandum and specified in Table 1 attached to it was not observed, or

(iii) the limit on contracted or nonconcessional external loans guaranteed by the Government referred to in paragraph 31 of the memorandum and specified in Table 1 attached to it was not observed, or

(iv) the limit on short-term loans contracted or guaranteed by the Government referred to in paragraph 31 of the memorandum and specified in Table 1 attached to it is not observed

(v) the implementation of the import liberalization program described in paragraphs 27 and 32 of the memorandum was not carried out; or

(vi) the implementation of export measures described in paragraphs 27 and 28 of the memorandum was not carried out; or

(b) if Kenya

(i) imposes or intensifies restrictions on payments and transfers for current international transactions, or

(ii) introduces or modifies multiple currency practices, or

(iii) concludes bilateral payments agreements which are inconsistent with Article VIII, or

(iv) imposes or intensifies import restrictions for balance of payments reasons; or

(c) until the Fund has determined that the midterm review of Kenya's program referred to in paragraph 33 of the memorandum has been completed.

If the Managing Director finds that any of the performance clauses that have been established in or under this paragraph 2 have not been met, the second loan specified in paragraph 1 above may be made available only after consultation has taken place between the Fund and Kenya, and understandings have been reached regarding the circumstances in which Kenya may request that second loan.

3. Before approving the third annual arrangement, the Fund will appraise the progress of Kenya in implementing the policies and reaching the objectives of the program supported by the second annual arrangement, taking into account primarily:

(a) the indicators referred to in paragraphs 7 and 11 of the attached memorandum;

(b) imposition or intensification of restrictions on payments and transfers for current international transactions;

(c) introduction or modification of multiple currency practices;

(d) conclusion of bilateral payments agreements which are inconsistent with Article VIII; and

(e) imposition or intensification of import restrictions for balance of payments reasons.

4. In accordance with paragraph 3 of the attached letter, Kenya will provide the Fund with such information as the Fund requests in connection with the progress of Kenya in implementing the policies and reaching the objectives supported by these arrangements.

5. In accordance with paragraph 4 of the attached letter, during the period of the second annual arrangement, Kenya will consult with the Managing Director on the adoption of any measures that may be appropriate at the initiative of the Government of whenever the Managing Director requests such a consultation. Moreover, after the period of the second annual arrangement and while Kenya has outstanding financial obligations to the Fund arising from loans under that arrangement, Kenya will consult with the Fund from time to time, at the initiative of the Government or whenever the Managing Director requests consultation on Kenya's economic financial policies. These consultations may include correspondence and visits of officials of the Fund to Kenya or of representatives of Kenya to the Fund.

Nairobi, March 28, 1990

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. Camdessus,

1. The objectives of a three-year programme of economic and financial adjustment are set out in the policy framework paper (PFP) for the period January 1990-December 1992, which was prepared in collaboration with the staffs of the Fund and the World Bank and which is being transmitted to you herewith.

2. The attached Memorandum on Economic and Financial Policies of the Government of Kenya, based on the PFP referred to above, sets out the objectives and policies that the Government intends to pursue in the three-year period beginning January 1, 1990, and the objectives and policies for the second annual programme thereunder. In support of these objectives and policies, the Government of Kenya hereby requests, the second annual arrangement under the three-year arrangement under the enhanced structural adjustment facility (ESAF), in an amount equivalent to SDR 80.5 million (56.7 percent of quota).

3. Kenya will provide the Fund with such information as the Fund requests in connection with Kenya's progress in implementing the economic and financial policies and achieving the objectives of the programme.

4. The Government believes that the policies and measures set forth in the attached Memorandum on Economic and Financial Policies are adequate to achieve the objectives of its programme, but will take any further measures that may become appropriate for this purpose. During the period of the second annual arrangement, Kenya will consult with the Managing Director on the adoption of any measures that may be appropriate, at the initiative of Kenya or whenever the Managing Director requests such a consultation. Moreover, after the period of the second annual arrangement and while Kenya has outstanding financial obligations to the Fund arising from loans under that arrangement, Kenya will consult with the Fund from time to time, at the initiative of the Government or whenever the Managing Director requests consultation on Kenya's economic and financial policies.

5. In addition, Kenya will conduct with the Fund a midterm review of its second annual programme. The review, expected to be completed by the end of November 1990, will assess the budget for 1990/91 and the implementation of the program and agree on targets for net domestic assets and net credit to the Government for the second half of fiscal year 1990/91.

Sincerely yours,

Professor George Saitoti	Eric C. Kotut
Vice President and	Governor
Minister for Finance	Central Bank of Kenya

Attachment: Memorandum on Economic and Financial Policies

Memorandum on the Economic and Financial Policies of the Government of Kenya

1. In the face of deteriorating financial and economic conditions, in late 1987 Kenya adopted a major stabilization and structural adjustment programme supported by an 18-month stand-by arrangement and arrangements under the structural adjustment facility. The major elements of the adjustment programme were successfully implemented during 1988, and its objectives with respect to growth, financial stability, and the external sector were to a large extent achieved. Concurrently, the Government began introducing important structural reforms in agriculture, industry, and international trade, the financial sector, government expenditure, and public enterprises. In early 1989 the Government requested that the programme for 1989-91, which would broaden and reinforce the adjustment process, be supported by arrangements under the enhanced structural adjustment facility (ESAF). On May 15, 1989, arrangements under the ESAF were approved by the Fund, with a total access of SDR 241.4 million.

Programme implementation during 1989

2. During 1989, the first year of the Fund-supported programme under the ESAF, elements of the adjustment programme were implemented and all end-September 1989 performance criteria were met, as were most of the benchmarks for the year. Preliminary data for 1989 indicate that the real GDP growth rate was on target at about 5 percent--despite less favorable weather conditions at the beginning of 1989, and lower-than-anticipated coffee production. The end-period inflation rate of 10.1 percent, while representing a slight deceleration from 10.4 percent in 1988, was higher than the 8 percent programmed, largely because of greater-than-targeted growth in broad money. Gross domestic expenditure is estimated to have increased from 105.1 percent of GDP in 1988 to 105.9 percent of GDP in 1989, reflecting an increase of 1.7 percentage points in gross domestic investment, to 25.3 percent of GDP in 1989, largely on account of the leasing of aircraft by Kenya Airways, and higher private sector gross fixed capital formation. Consumption declined by 0.9 percentage point to 80.6 percent of GDP on account of lower private and public consumption. Accordingly, national saving is estimated to have risen from 15.4 percent of GDP in 1988 to about 16.5 percent in 1989.

3. The overall budget deficit on a commitment basis in 1988/89 (July-June), at 4.6 percent of GDP, was slightly above the programme target of 4.5 percent. Excluding grants, the deficit was 6.9 percent of GDP, equal to the programme target. In relation to GDP, both revenue and expenditure were lower than estimated in the revised programme. At 22.9 percent of GDP, revenue fell short of earlier estimates, reflecting lower-than-expected collection of import duties and sales tax, and to some extent user charges. Expenditure was lower than programmed in both the recurrent and capital categories. For recurrent expenditure, the larger-than-budgeted wage bill was more than offset by lower spending on operations and maintenance; and the lower-than-projected capital expen-

diture was associated with a somewhat lower rate of project implementation. The cash deficit, at 3.5 percent of GDP, was substantially below the commitment deficit, almost wholly reflecting a buildup in the stock of unpresented cheques by about K Sh 1.8 billion (about 1.1 percent of GDP) which was monetized in early July 1989. Adjusting for the liquidation of these cheques results in a cash deficit of 4.6 percent of GDP. External sources accounted for about half of the financing while recourse to the domestic banking system (inclusive of the liquidation of the K Sh 1.8 billion unpresented cheques) was about 1.3 percent of GDP; the nonbank sector financed the remainder of 0.9 percent of GDP).

4. Broad money grew by 17.8 percent in calendar year 1989 compared with the programme target of 11.6 percent. This rate of expansion of liquidity was largely a result of a 14.1 percent increase in net domestic assets, accounting for a 15.2 percent rise in relation to the stock of broad money at end-1988. Net credit to the Government declined by 5.6 percent (unadjusted for the sale of over K Sh 2.7 billion (net) of Treasury bills at end-December), far below the 17.4 percent growth expected in the programme. "Other items net" were considerably higher than in the programme. Credit to the nongovernment sector grew by 17.9 percent (6.4 percent in the programme) with private sector credit rising by 22.1 percent. In an attempt to tighten monetary policy, the minimum commercial banks' saving deposit rate and the maximum lending rate for loans of three years or less were raised in November 1989 by 0.5 percentage point to 12.5 percent and 15.5 percent, respectively, following substantial increases in lending and deposit rates in April. The maximum lending rate of 18 percent was applied to loans of more than three years.

5. Performance in the external sector was weaker than programmed during 1989, particularly during the final quarter of the year. The overall balance of payments surplus was some SDR 6 million below the target of SDR 58 million and as a consequence, the increase of SDR 33 million in gross reserves was short of the SDR 40 million target. This still represented a reversal of the overall deficits of the previous two years. The stronger-than-anticipated capital account included larger disbursements by multilateral organisations of balance of payments financing and the counterpart for leases by Kenya Airways for two aircraft in December 1989. These inflows virtually offset the weaker current account position and contributed the major share of budget financing in calendar year 1989. The current deficit, including official transfers and excluding the aircraft leases, was 4.5 percent of GDP--0.8 percentage point below the 1988 ratio, and 0.5 percentage points higher than originally anticipated. Including the leases, the deficit-to-GDP ratio was 5.9 percent. The larger current deficit in SDR terms reflected weaker trade performance. Lower export revenues were mainly due to the 30 percent fall in coffee prices and sluggish volumes of oil exports to neighbouring countries. The impact of these two effects was partially offset by tea exports, which grew by about 17 percent in volume terms, while other export volumes, notably horticulture, also continued to exhibit strong real growth. Import growth

rose by 3 percent in real terms, and an average price increase of over 18 percent in shilling terms led to both public and private import values that were above target levels. Public sector imports rose in volume terms by about 24 percent, partly reflecting the leases of the airplanes by Kenya Airways. Private non-oil imports remained unchanged in volume terms, despite the continued liberalization of import controls. Oil import values rose slightly as the lower prices of 1988 were reversed and volumes stagnated. Official transfers were some SDR 36 million lower than predicted, as disbursements under foreign financed projects were slower than had been anticipated. Kenya continued to pursue the flexible exchange rate policy agreed under the programme during 1989 to maintain external competitiveness while the second phase of the import liberalization programme was completed. Between December 1988 and December 1989, the Kenya shilling depreciated by 7.2 percent in real effective terms.

6. Progress continued to be made in 1989 in implementing the structural policy measures of the programme. In the agricultural sector, the annual review of producer prices was undertaken and producer prices for grain were raised; a cotton pricing system based on auctioning is being implemented; progress was made in developing a food security plan; and the financial restructuring of the National Cereals and Produce Board (NCPB) was virtually completed. Initial steps were also taken to restructure other public enterprises. A number of important measures were adopted in 1989/90 in the fiscal area. These included the elimination of the export tax on coffee and tea, the adoption of a presumptive tax on the value of gross sales of agricultural produce, the lowering of the effective corporate tax rate as well as the top rate of the personal income tax, the introduction of user charges in the health sector, adoption of a bank loan scheme for university students, and passage of legislation substituting a value-added tax (VAT) for the manufacturing sales tax at the beginning of 1990. Specific incentives to promote the efficiency of the industrial sector concentrated on consolidating the reform of the trade system by completing the second phase of the import liberalization programme. In mid-1989, quantitative restrictions were lifted on items in Schedule IIIB for imports, which consists of about 11 percent of all import items and about 5 percent of import values (in 1986/87 terms). Since Schedules I, II, and IIIA had been liberalized in 1988, almost 70 percent of all items and 93 percent of import values are now unrestricted and carry tariffs as the sole form of protection. The import licensing system was made more transparent in February 1989. As a result, the time between the application for a license and the approval of the foreign exchange allocation has been considerably shortened, from over six months to about three weeks. The combined import-weighted average tariff for goods in Schedules I and II has been reduced and the number of tariff categories cut from 17 to 12. Consequently, the structural performance criterion relating to the implementation of the import liberalization programme and the development of an effective system for monthly monitoring of its operations was met before end-September. In the area of price controls, with the decontrol of prices for fertilizer,

animal feed, and soft drinks, the number of categories under the Price Control (General) Order was reduced from 20 to 18. In the financial sector, an action plan has been prepared with IDA assistance and approved for restructuring development finance institutions; a revised Banking Act was passed by Parliament, and in late 1989 the Capital Markets Authority (CMA) was established.

II. Objectives and Policies for 1990-92

7. As indicated in the updated policy framework paper (PFP), the Government's overall objectives over the medium term are to achieve a sustained noninflationary real GDP growth rate that is higher than the population growth rate and to provide productive employment for the country's rapidly growing labor force. The Government's strategy stresses the important role of the private sector in revitalizing the economy and the need for the Government to establish market-based incentives to promote private sector activity. To achieve these objectives, the programme for 1990-92, supported by ESAF arrangements from the Fund, will emphasize increased productivity in agriculture, and the restructuring of industrial incentives to reduce the existing antiexport bias and to improve export competitiveness.

8. The key macroeconomic objectives for the 1990-92 programme are (a) to achieve an annual rate of growth of real GDP of over 5 percent; (b) to reduce the rate of inflation, on an end-period basis, from 10.1 percent in 1989 to about 5 percent by 1992, which would correspond to the level expected of Kenya's major trading partners in 1992; (c) in order to maintain a viable balance of payments, to reduce the external current account deficit from 5.9 percent of GDP in 1989 (4.5 percent of GDP excluding aircraft leases, and 8.6 percent of GDP excluding grants) to about 3.6 percent of GDP in 1992 (5.2 percent of GDP, excluding grants); (d) to lower debt service as a ratio of exports of goods, nonfactor services, and private transfers from 31 percent in 1989 to below 25 percent in 1992; and (e) to build up gross reserves from the equivalent of 2.2 months of nongovernment imports in 1989 to 3.0 months of nongovernment imports in 1992.

9. Accordingly, the investment-saving gap would be narrowed. During 1990-92 gross domestic investment would stabilize at about 25 percent of GDP but its composition would change, with an increasing share of private sector investment, and a higher efficiency of investment as distortions are removed. National saving would rise from about 16.5 percent of GDP in 1989 to about 19 percent of GDP in 1992 with about equal increases in both private sector saving and government saving. To achieve these objectives, the mix of financial policies will emphasize financial restraint and increasing productivity in the public sector, strengthen returns to domestic saving, ensure that the stance of monetary policy is consistent with the inflation and the external targets, and pursue an exchange rate policy that maintains competitiveness. In particular, the central government overall cash deficit will

be steadily reduced from 4.2 percent of GDP in 1989/90 (6.4 percent of GDP, excluding grants) to 3.8 percent of GDP in 1990/91 (5.6 percent of GDP, excluding grants) and to 3.4 percent of GDP by 1991/92 (4.9 percent, excluding grants).

10. Consistent with these financial policies, structural reforms will continue to be carried out in key areas. These reforms will emphasize new initiatives in the promotion of exports, and the reduction of anti-export bias in the continued liberalization of imports; the restructuring of government expenditure by restraining the rate of growth of overall personnel expenditure and, in the priority economic and social sectors, by increasing the share of outlays on nonwage operations and maintenance; the extension of the VAT to additional services and the strengthening of the tax administration system; the restructuring and revitalision of financial and nonfinancial public enterprises; continued financial sector reform; and price decontrol.

III. Programme for 1990

11. The Government's programme for 1990 seeks to achieve a real GDP growth rate of 5.2 percent, lower the rate of inflation to 7.5 percent in 1990, and narrow the external current account deficit (excluding the leases) to 4.4 percent of GDP. To achieve these objectives, the programme provides for a reduction in the overall budget deficit and a tightening of the monetary stance, supported by an appropriate exchange rate policy. To encourage a restructuring of the economy over the medium term and a broadened basis for growth, the programme aims to diversify export production and to reduce distortions in the external and industrial sectors.

a. Fiscal policy

12. The overall budget deficit for 1989/90 is programmed at 4.2 percent of GDP (6.4 percent, excluding grants), which represents a further tightening of the fiscal stance relative to the budget deficit on a commitment basis at the end of 1988/89 (4.6 percent of GDP). Revenues will rise as a share of GDP, from 22.9 percent in 1988/89 to 23.7 percent of revised GDP, just short of the initially-programmed target of 24.1 percent of GDP. This reflects some delays in the introduction of the presumptive tax on agricultural products, some transitional costs in moving from a sales tax to the VAT, and the ambitious original programme targets for collection of import duties under import liberalization. User charges play a greater role in financing recurrent outlays, rising from about 0.6 percent of GDP in 1988/89 to 1.3 percent, with increased tariffs in agriculture, livestock, roads, health, and education. The overall expenditure share in revised GDP is projected at 30.1 percent, compared with the original programme target of 30.9 percent of GDP, largely owing to a reduced pace of absorption of development expenditures. Foreign financing of the deficit will be higher than originally projected, reflecting higher programme loan assistance. A

strong effort will be made to mobilize nonbank resources through the sale of Treasury bonds and bills. In addition to increasing the attractiveness of the yields of these instruments, greater publicity will be given in the media to the effective yields offered in recent Treasury auctions. Bank financing of the deficit will be held to 0.5 percent of GDP in 1989/90, less than originally anticipated in the programme. The Government recognizes that meeting quantitative fiscal targets by an increased float or delays in the preparation of vouchers is inconsistent with the objectives of the programme. Therefore, the level of unpresented cheques at the end of 1989/90 will not exceed K Sh 1.1 billion, the level at end-1987/88.

13. Recurrent expenditures are likely to fall somewhat below the programme target of 23.1 percent of GDP. Difficult measures have been implemented relating to the structural benchmark calling for limiting wage and salary bill growth to 7.5 percent, including a freeze on vacancies exceeding six months as well as in the number of lower level posts, and a decision not to grant a salary revision, despite a cumulative inflation of almost 30 percent over the last three years and 67 percent since the last salary review in 1983. Nevertheless, the pressures for employment growth are strong, primarily as a result of the implementation of the new 8-4-4 education system, and the attendant demand for additional trained teachers. Regrettably, the overall wage and salary bill will grow by about 11 percent in 1989/90. In order to increase productivity in the priority economic and social sectors (livestock, agriculture, water supply, health, and roads), efforts were made to redress the imbalance between wages and nonwage operation and maintenance (O&M) expenditure in the budget. To facilitate analysis of expenditure, an economic classification of the budget has been prepared and a monthly system for the monitoring of wages and operating expenses is being developed. To control expenditure, a Parliamentary Committee is reviewing possible sanctions to apply in cases where ministerial outlays rise above authorized budget limits. With respect to development expenditure, the Government intends to take advantage of the availability of additional concessional external financing for meritorious projects, as long as such investments are compatible with the overall macroeconomic framework and the need to finance the future costs of O&M. In this context, the Government has postponed a number of lower priority projects and slowed the rate of project absorption so as to restrain development spending to well below the programme target of 7.6 percent of GDP.

14. Consistent with the medium-term policy framework and the need to tighten the stance of fiscal policy, the 1990/91 budget deficit will be reduced to 3.8 percent of GDP (5.6 percent of GDP, excluding grants). Revenue as a share of GDP is expected to rise to 24.1 percent. Total expenditure and net lending is budgeted to decline to about 29.7 percent of GDP, wholly reflecting slower growth in recurrent spending. Development outlays are targeted to rise to 7.2 percent of GDP. The deficit will be financed largely from domestic nonbank and foreign concessional sources. Bank financing of the deficit will be limited to about

K Sh 650 million, or 0.3 percent of GDP. The nonbank financial sector is expected to finance about two thirds of the domestically financed deficit.

15. Tax policy will focus on broadening the tax base and enhancing the elasticity, efficiency, and equity of the tax system. In particular, the Government will continue replacing the sales tax with a VAT. The institutional capacity for tax policy analysis will be strengthened, and computerization and other administrative improvements will be introduced in the Income Tax, Sales Tax, and Customs and Excise Departments, under the Tax Modernization Project supported by UNDP and other donors. Cost-sharing will be broadened and extended to other services.

16. In formulating the 1990/91 budget, the Government recognizes the need to decrease the overall share of recurrent expenditures in order to reduce the overall budget deficit, while maintaining the important role of the government development budget in promoting overall economic growth. To contain the growth of wages and salaries, a significant effort will be made to reduce further the rate of growth of government employment; civil service employment growth in the published 1990/91 estimates will be limited to 2 percent above the number of posts authorized in the 1989/90 budget, and the increase in the number of teachers employed by the Teachers Service Commission will not exceed 8 percent of the level outstanding on February 1, 1990. Together with the normal salary increments of 4 percent, the combined wage and salary bill of the Central Government will rise by no more than 9 percent in 1990/91. In the event of a salary revision award, the Government will undertake to begin the disbursement of such awards only in 1991/92. To ensure that the personnel expenditure targets are adhered to, cash limits on the wage bill will be set and enforced for each Ministry and the Teachers Service Commission. External assistance is increasingly being sought for the funding of operating expenses in the development budget (notably in the areas of agriculture, livestock, and water supply). Sectoral norms are being developed for defining appropriate staffing and nonwage inputs for different types of public services in key priority areas. By the end of 1990, the monthly monitoring and reporting system for the wage bill and operating expenses should be operational. Considerable efforts are also under way to strengthen the budgeting and implementation of development outlays. Progress in improving the project appraisal and investment budgeting process and in the preparation of a public sector project list will be key elements in ensuring a high productivity programme. A detailed ministry-by-ministry project list has been prepared for the first time for 1990/91, with a forward budget for proposed outlays for the period 1990/91-1992/93, permitting a more rational selection of development projects and a focus on more rapid implementation of ongoing projects. A comparable project list has begun to be prepared for the major nonfinancial parastatals in 1990/91. In preparing for the 1991/92 budget, the Government will seek external assistance in reviewing and assessing the relative economic merits of the major projects included in the public investment programme.

b. Public enterprises

17. In recent years, the Government has taken steps to clarify both the financial situation of parastatals and the Government's relationship with them. In 1989/90, with assistance from the Fund, a major effort has been initiated to establish an information system and database for an initial core group of enterprises, which will provide quarterly and annual indicators of economic and financial performance. Monitoring of the budgetary impact of enterprises has already been undertaken for ten large enterprises, and such monitoring will be extended in 1990 to another ten enterprises. The Government will also clarify its position as a creditor of state corporations by quantifying, on a quarterly basis, both their commitments and actual payments of debt service. In 1990, a policy framework paper for state corporations will be developed and the Government will formulate criteria on the basis of which some state corporations will be designated as strategic and others as potential candidates for restructuring. An active plan for restructuring the major development finance institutions in the industrial sector (the Industrial Development Bank (IDB) and the Industrial and Commercial Development Corporation (ICDC)) has been developed in consultation with IDA, for implementation beginning in 1990. Finally, the Government intends to undertake a reform of the present categorization of state corporations' salary scales in the commercially oriented enterprises with a view toward reducing rigidities and strengthening management.

18. Kenya Airways has experienced financial and organizational difficulties in recent years, reflecting deficiencies in its management, maintenance capacity, and excess staffing. A major part of its fleet is in need of upgrading. In 1989/90 the Government has taken several steps to strengthen its operations. It has recently purchased a Fokker jet, and has undertaken to lease an Airbus and four new Boeing jets. The Airbus and one Boeing were delivered in late 1989, and two more Boeings are due in late 1990. An initial assessment of the financial and management operations of the airline has been completed by an internationally reputable accounting firm, and the World Bank will shortly provide technical assistance in the formulation of a restructuring plan, which is to be completed by September 1990. Efforts are also under way to obtain management assistance from a major foreign airline. By late 1990, the Government is fully committed to implement a restructuring plan and to undertake the steps required to rationalize staffing.

c. Monetary and financial sector policies

19. Key objectives of monetary policy are to improve the efficiency of resource mobilization and allocation, reduce reliance of the Government on domestic bank financing, and broaden the range of financial instruments available to savers and investors. The Government adopted a major financial sector adjustment programme in 1989 supported by a financial sector operation from IDA, and technical assistance from the Fund. In 1990, the programme will seek increased reliance on market mechanisms for allocating financial resources and implementing monetary policy.

With technical assistance from the Fund, reserve money management will be introduced and active use of available monetary policy instruments through the Monetary Policy Committee initiated. Cash reserve ratios will continue to be an important instrument of monetary policy. Strong efforts will be made to publicize auctions of Treasury instruments in order to increase the volume of sales. At the same time, the Central Bank will gradually move away from quantitative credit ceilings toward open market operations as a more efficient means of controlling monetary aggregates.

20. Interest rates will be maintained positive in real terms. During 1990, the experience with a broader set of monetary policy instruments will be reviewed. Further progress will be made toward the establishment of a more market-determined rate structure through raising the ceilings on deposit and lending rates. Additional flexibility in adjusting interest rates will arise from the elimination of the legal requirement that the loan interest rates subject to ceilings must be inclusive of all lending-related fees and charges. This change in regulations will allow effective interest rates on loans (inclusive of such charges) to rise above the formal ceilings; developments in this regard will be monitored by the Central Bank. By June 1991, formal interest rate ceilings will be removed. To facilitate the development of short-term money markets, secondary trading in treasury securities will be encouraged. Nonbank financial institutions (NBFIs) will be required to shorten the current three-month lag in submitting their financial returns to the Central Bank of Kenya to one month. Commercial banks that meet prescribed criteria will be allowed to issue bearer-negotiable certificates of deposit. To strengthen the banking system, a revised Banking Act was passed by Parliament in 1989. By June 1990, regulations will be issued which link capital adequacy requirements to assets and require banks and NBFIs to maintain prescribed capital/assets ratios.

21. The financial sector programme also aims to promote capital market activity. To this end, in late 1989 the Capital Markets Authority (CMA) was established. The CMA will promote public issues and demand for securities as well as financial intermediation. Accordingly, by June 1990 the CMA and the Government will propose measures to reduce disincentives to holding and issuing securities, encourage greater participation of insurance companies and other institutional investors in private securities markets, and enhance investor protection. When the CMA becomes operational, the role of the Capital Issues Committee in setting share prices in respect of domestic companies will be discontinued.

22. Monetary policy in 1990-91 will seek to maintain the growth of domestic credit and liquidity consistent with reducing inflationary pressures, improving efficiency in the allocation of resources, supporting external adjustment through a slowing of the pace of import demand, and building up reserves. This requires a cautious credit policy that limits government recourse to the banking system, while

providing adequate credit to the private sector. In view of the observed wide swings of "other items net" in the monetary accounts, steps will be taken to minimize these swings so that "net domestic assets" move in tandem with domestic credit. The authorities are committed to observing benchmarks and performance criteria through end-December 1990 (Table 1 attached), which will be consistent with a projected expansion in broad money of 11 percent in 1990.

23. The current consumer price index is calculated utilizing a commodity basket and income groups based on 1975 weights. Recognizing that there may have been fundamental changes in the relative price and income structure in the Kenya economy, and given the importance of price-controlled items in the basket, the Government is preparing a new consumer price index, which will be chained back into the 1980s, and which is expected to be completed by the end of 1990.

d. External and industrial policies

24. With the implementation of the policies under the second-year ESAF arrangement, an overall surplus in the balance of payments of SDR 46 million is projected for 1990, with a targeted reserve accumulation of SDR 50 million. The current account deficit (with two more leases of airplanes by Kenya Airways) is expected to contract to 5.4 percent of GDP (including official transfers). Without the leases, the ratio of 4.4 percent of GDP should be close to the revised programme level of 4.1 percent. With continued declines expected in coffee prices, and the limited potential of the rest of the export sector to respond significantly to new price and other incentives in the short run, the main contribution to improved current account performance is expected to come from imports. In volume terms, real aggregate imports are expected to rise by about 3 percent in 1990. Within this total, nongovernment non-oil imports are forecast to rise by some 5 percent--a growth that allows for some adjustment by the private sector to the liberalized system for imports and less stockbuilding of foreign goods. Government imports are expected to decline by some 2 percent in real terms from the high level of 1989, partly as the Government further slows the rate of project absorption. With continued management of the exchange rate to achieve external balance, given the pressure on domestic resources and the need to improve competitiveness, total export volumes are expected to grow by about 10 percent in 1990. Coffee earnings are expected to remain sluggish, with a further 13 percent decline in prices (in SDR terms) projected on the assumption that the International Coffee Organization is not likely to establish a new agreement on quotas during the year. Despite lower prices, coffee volumes are estimated to rise by about 13.5 percent, in light of the high level of stocks held by the Coffee Board and the historical demand for good quality Kenyan coffee on international markets. Tea earnings are likely to remain buoyant. Higher earnings in local currency terms are expected to elicit some short-run supply response while continued strong demand and lower supplies of tea to international markets by producers such as Sri Lanka are expected to maintain firm international

prices. Nontraditional exports such as horticulture, manufactures, and pyrethrum are predicted to continue to grow strongly in real terms as competitiveness is improved and markets expand outside the region. Net service earnings are expected to grow steadily. During 1990, tourism earnings are expected to recover from the decline in receipts from the United States in the last quarter of 1989, partly from more tourist arrivals from Europe and partly as the impact of media reports on U.S. arrivals eases.

25. The capital account in 1990 is expected to weaken somewhat relative to 1989, but the lower current account deficit will be offset by net inflows of long-term capital, as it was in 1989. Official inflows from existing and new loan commitments are predicted to fall to about SDR 540 million and principal repayments are expected to be only somewhat less than half that level. Additional financing needs are expected to be met by cofinancing of the Financial Sector Adjustment Credit, new World Bank disbursements for the export development programme and the agricultural sector credit due in the last half of the year, and bilateral sources of balance of payments funds. Gross reserve accumulation would be SDR 50 million--bringing reserves to 2.5 months of nongovernment imports. In 1990 the debt service ratio should fall from 30.8 percent in 1989 to 27.5 percent. With respect to all external nonconcessional borrowing for development projects, the Government will ensure that such borrowing meets rigorous and acceptable tests of economic and financial viability.

26. During 1990 the authorities intend to maintain their policies aimed at broadening the growth base in the external sector. Diversification, in terms of both products and markets, has assumed critical importance in the light of the recent decline in coffee prices on international markets and Kenya's historical dependence on coffee for more than one fourth of its export earnings. Both exchange rate management and specific trade initiatives will be used to improve the overall competitiveness of production, move toward more uniform rates of protection, and reduce obstacles to efficient performance. To maintain the momentum of trade reform to a liberalized system, the Government intends to remove, over 1990 and 1991, quantitative restrictions on all nonexempt imports still subject to control (except textiles). These goods, currently in Schedule IIIC, will be shifted to the now unrestricted Schedule IIIB. The items to be shifted, which account for about 46 percent of import items in Schedule IIIC (on a SITC basis) and 5 percent of 1986/87 import values, will be liberalized in two installments in July 1990 and July 1991 and replaced by equivalent tariffs. Controls on at least 55 percent of the number of import items which are currently controlled and nonexempt in Schedule IIIc will be removed in July 1990. These represent a third of the 1986/87 import values of the goods to be liberalized. The remaining items, including five that account for 47 percent of the value of the goods to be liberalized, will be liberalized in 1991. A timetable for unrestricted licensing of textile imports in Schedule IIIC, which account for 51 percent of items in Schedule IIIC on a SITC basis, will be formulated when the IDA study of the sector is

completed in July 1990. With regard to price decontrol, a substantial number of the commodities in the 18 categories under the General Order will be removed in 1990 as well as several items from the Specific Order. In 1991, further significant reductions will be made in the number of commodities under both the General and Specific Orders.

27. The Government intends to act on a number of specific initiatives in 1990 to reduce Kenya's reliance on coffee and tea exports. Based on its discussions with IDA, the Government will decide before April 15 on measures to be implemented before July 1990 that would substantially improve access by exporters to raw materials and intermediate inputs at international prices. Such an initiative may include the formulation in 1990 of a duty drawback/exemption scheme for reimbursing exporters of manufactured goods for duties on imported inputs which would to be fully functioning in early 1991, as well as measures to facilitate exporters' access to credit. Meanwhile, current export incentive schemes will be made more effective. As an interim measure until an IDA-supported programme is in place, the Government will, before July 1990, broaden and publish the list of items eligible under the export compensation scheme and publish the criteria for eligibility for the scheme. The lags in disbursing payments by the Customs Office and Central Bank were considerably shortened from an average of 20 weeks in 1985/86 to 6 weeks in 1988/89. To reduce further the delays in the receipt of export compensation, by end-April 1990 the Government will begin to implement a system by which commercial banks pay compensation to exporters within 90 days, upon evidence of shipment of goods through customs. The Government will also formulate a programme for export processing zones; the requisite legislation will be prepared and submitted by January 1991.

28. During 1990, the Government is committed to adjusting the exchange rate to ensure external competitiveness and the achievement of a sustainable external position, and intends to support this level with appropriate monetary and fiscal policies. This rate would be consistent with other incentives being taken to diversify export production beyond coffee and tea as well as to support the import liberalization programme.

e. Impact of adjustment on poverty and the environment

29. Since the magnitude of Kenya's economic distortions and structural imbalances is less than in other adjusting countries, the structural reforms required and their potential social impact are correspondingly smaller. Nevertheless, the Government aims to minimize any adverse effects on disadvantaged groups. Specifically, there is a need to ensure that the recent introduction of user charges in health and increased cost-sharing in education does not limit access by low income groups to these services. In the health sector, the Government has exempted those who cannot afford to pay and the types of services that must be encouraged for social reasons. In the education sector, a bursary scheme has been introduced to assist poor and deserving students

to meet the high costs of secondary education. At the tertiary level, present policies exempting low-income students from the new university loan scheme will be maintained. A serious constraint on the Government's ability to design and implement targeted interventions to mitigate the social costs of adjustment has been the lack of an appropriate data base and welfare monitoring system. The Government has recently requested to join the Social Dimensions of Adjustment programme being implemented in sub-Saharan Africa with the assistance of IDA and other donors.

30. Kenya's environmental problems arise mainly from population pressures on limited land resources. These include: forest and woodland depletion, soil erosion and land degradation, and increasing conflicts with wildlife. Environmental problems are particularly severe in arid and semiarid lands (ASALs), which account for four fifths of Kenya's land area. Over the medium term, the Government's environmental priorities will focus on the forestry sector, wildlife resources, and ASAL areas. With the assistance of IDA and other donors, steps are being taken to strengthen forestry policies and institutional support for a reforestation programme. Recently, the Government has also begun to address the critical situation in the wildlife sector. In addition to strengthening antipoaching measures and banning the export of ivory, the Wildlife Department has been reconstituted as a separate agency to increase its effectiveness in policy formulation and the management and protection of wildlife. With the assistance of IDA, an ASAL Environmental Action Plan is being prepared, which will identify policies and investment priorities for the rehabilitation and environmentally sound development of these areas.

IV. Benchmarks and Performance Criteria

31. For the second annual arrangement under the ESAF, it is proposed that the quantitative benchmarks, as set forth in the attached Table 1, comprise quarterly limits on: (i) net domestic assets; (ii) net bank credit to the Central Government; (iii) new nonconcessional loans, leases or letters of awareness contracted or guaranteed by the public sector within the 1-to 15-year maturity range; (iv) short-term loans contracted or guaranteed by the Government (other than import-related credits); and (v) targeted minimum cumulative increases in net official international reserves.

32. The performance criteria and benchmarks for monitoring structural policy implementation under the second annual arrangement under the ESAF will relate to: (i) the implementation of the import liberalization programme; (ii) the streamlining of export promotion measures to reduce the cost to exporters of imported inputs; (iii) further reductions in the number of price controlled items; (iv) measures to contain the rise in personnel expenditures at 9.0 percent in 1990/91; and (v) increases in existing ceilings on commercial bank deposit and lending rates.

33. Under the second annual ESAF arrangement, the performance criteria for end-June 1990, as set forth in Table 1, will include the quantitative limits described in (i), (ii), (iii), and (iv) in paragraph 31 above, and the structural benchmarks (i) and (ii) included in paragraph 32 above. The standard clause regarding the exchange and payments system shall also constitute a performance criterion under the second annual arrangement. The disbursement of the second loan under the second annual arrangement will also be subject to a midterm review with the Fund, to be completed by end-November 1990. The midterm review will assess the budget for 1990/91 and implementation of the program and will set targets for net domestic assets and net credit to the Government for the second half of fiscal year 1990/91.

Table 1. Kenya: Performance Criteria and Benchmarks of the Second Annual Arrangement Under the Enhanced Structural Adjustment Facility

	1989	1990		
	December Actual	June 1/	September 2/	December 2/
Quantitative performance criteria/benchmark		(In millions of Kenya shillings)		
Net domestic assets 3/ 4/	54,428	56,513	58,610	59,450
Net bank credit to the Government 4/ 5/	12,671	16,370	17,110	17,313
Memorandum items:				
Net bank credit to the Government in monetary survey	17,481	21,180	21,320	22,123
Less: CSFC	4,040	4,040	4,040	4,040
Less: Debt assumed from parastatals	770	770	770	770
		(In millions of U.S. dollars)		
New nonconcessional external loans or leases contracted or guaranteed by the Government 6/ (cumulative per calendar year)				
a. 1-15 years' maturity	167	155	155	155
b. Short-term credits of less than one year's maturity 7/	— 8/	—	—	—
Quantitative benchmark		(In millions of SDRs)		
Minimum cumulative increase in net official international reserves from end-December 1988 9/	-60.3 8/	13.0	5.0	45.0

Nonquantitative performance criteria

Review: A midterm review will be completed by end-November 1990 to assess the 1990/91 budget, and the implementation of the program, and to set quantitative benchmarks and indicative targets for the second half of 1990/91.

Trade and payments restrictions: The Government of Kenya will continue to maintain a liberal exchange and trade system and will not introduce any new, or intensify existing, restrictions.

Structural performance criteria	Target Date
Implement the import liberalization program, by removing controls on at least 55 percent of the number of import items (excluding textiles) that are currently controlled and nonexempt (in Schedule IIIC).	July 1990.
To improve access by exporters to raw materials and intermediate inputs at international prices, and streamline and make more effective the export compensation scheme; the Government will begin to implement a system by which commercial banks pay compensation to exporters within 90 days upon submission of evidence of shipment of goods through customs.	May 1990.
Structural benchmarks	
Remove price controls on a substantial number of items under the General Order of price controls, as well as several items from the Specific Order.	September 1990.
Raise existing ceiling on commercial bank lending rates consistent with removing ceilings on interest rates by June 1991; maintain positive real interest rates.	Throughout 1990.
Confine the growth of the Government's personnel wage bill (including teachers employed by the Teachers' Service Commission) to 9.0 percent in fiscal year 1990/91, reflecting a limit of 2 percent in the growth of of civil service posts relative to the 1989/90 budget and 8 percent growth in the number of teachers relative to the number employed on February 1, 1990.	July 1990.

Source: Memorandum attached to the letter of request of Kenyan authorities of March 28, 1990.

1/ Performance criteria.
2/ Quantitative benchmarks.
3/ Net domestic assets of the banking system is broad money minus net foreign assets of the banking system. A one-time stock adjustment will be made when the new Consolidated Bank, which amalgamates nine failing nonbank financial institutions, with total assets tentatively estimated at K Sh 1 billion, commences operating as a commercial bank.
4/ This target will be adjusted downward to the extent that net external financing of the deficit during the July 1989-June 1990 period, excluding A-in-A financing, exceeds K Sh 816 million, or to the extent that domestic nonbank financing exceeds K Sh 600 million. Such net external financing is defined to include all cash loans received by the Paymaster General's Account during this period.
5/ Net credit to the Government is net credit to the Government from the banking sector. The ceiling excludes the operations of the Cereals and Sugar Finance Corporation (CSFC), and the amount of public enterprise debt (K Sh 770 million) assumed by the Government after June 1989 and reclassified from outstanding private sector credit.
6/ In addition to nonconcessional borrowing contracted or guaranteed by the Government, this ceiling also applies to the borrowing of all state corporations (including cases where their borrowing is associated with a "letter of awareness" from the Government), as well as leases. The ceiling excludes the lease of Kenya Airways aircraft expected in October 1990 that was signed in 1989, conditional on the formulation of a restructuring plan by August 30, 1990. For the purposes of this definition, a loan or lease is nonconcessional if it has a grant equivalent of less than 25 percent. Grant equivalence shall be determined by reference to published DAC tables and is a function of the interest rate, grace period, and maturity. "Maturity" is defined as the sum of the grace period and the term of payment. For purposes of converting new nonconcessional external loans into U.S. dollars, the U.S. dollar exchange rates cabled to the Central Bank of Kenya from the Federal Reserve Bank of New York for January 2, 1990, will be used.
7/ Other than normal import-related credits, this limit also excludes nonguaranteed borrowing by the Coffee Board of Kenya associated with short-term trade financing.
8/ Actual outstanding amount at end-December 1989.
9/ Net official international reserves are defined as the Central Bank of Kenya's net foreign reserve assets (SDRs, gold, and foreign exchange holdings) minus its short-term deposit liabilities to foreigners; plus the Central Government's net foreign reserve amounts (excluding those related to Fund transactions); plus Kenya's reserve position in the Fund; minus Kenya's net use of Fund credit.

Kenya, 1794

INTERNATIONAL MONETARY FUND

CENTRAL FILES
ROOM C-532 0408

PRESS RELEASE NO. 90/18

FOR IMMEDIATE RELEASE
April 30, 1990

The International Monetary Fund has approved a loan equivalent to SDR 80.5 million (US$104.5 million) for the Government of Kenya in support of the second annual arrangement under the enhanced structural adjustment facility (ESAF)1/. Of this amount, the first of two semi-annual installments of SDR 40.25 million (US$52.2 million) will be available immediately. Kenya has already received two disbursements of SDR 40.23 million each under the first annual arrangement of the three-year arrangement approved in May 1989 for a total amount of SDR 241.4 million (US$313.3 million). Kenya's quota in the Fund is SDR 142.0 million, and its outstanding financial obligations to the Fund's General Resources Account resulting from past operations and transactions currently total the equivalent of SDR 124.6 million (US$161.7 million).

Kenya's economic performance under the 1989 program was generally encouraging with economic growth estimated at 5.0 percent, despite unfavorable weather conditions and lower than anticipated coffee production. Inflation decelerated slightly to 10 percent. The overall budget deficit on a commitment basis was broadly on target at 4.6 percent of GDP, while the external current account deficit, including grants, decreased to 4.5 percent of GDP from 5.3 percent in 1988. Substantial progress was made in implementing structural reform measures in particular, in relation to agricultural producer prices, import liberalization, tax reform, and user changes.

The economic program for 1990, supported by the second annual arrangement under the ESAF, aims at a real GDP growth rate of 5.2 percent, a lowering of the rate of inflation to 7.5 percent, and further narrowing of the external current account deficit. To achieve these objectives, the program provides for a reduction in the overall budget deficit and a tightening of monetary policy, as well as pursuit of a flexible exchange policy consistent with the external aims of the program. In the course of 1990 progress will continue to be made in implementing the program's structural measures.

1/ The ESAF (enhanced structural adjustment facility) is a Fund lending facility under which loans are made available to low income members at current rate of interest of one half of one percent. These loans are repayable over ten years with a five and a half year grace period. Sixty-two members are presently eligible to apply for loans under this facility.

Kenya, 1794

1. KENYA - 1990 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL ADJUSTMENT FACILITY - SECOND ANNUAL ARRANGEMENT

The Executive Directors considered the staff report for the 1990 Article IV consultation with Kenya and Kenya's request for the second annual arrangement under the enhanced structural adjustment arrangement approved on May 15, 1989 (EBS/90/64, 3/30/90). They also had before them a background paper on recent economic developments in Kenya (SM/90/64, 4/16/90; and Cor. 1, 4/18/90), and a policy framework paper for the period 1990-92 (EBD/90/104, 4/4/90).

The Managing Director made the following statement:

> There follows for the information of Executive Directors the text of a memorandum that I have received from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Committee of the Whole of the Executive Directors of the Bank and IDA in their meeting on April 26, 1990:
>
> The Executive Directors concluded that the policy framework paper under review provides an appropriate basis for continuing Kenya's adjustment efforts. Directors noted progress in a number of areas despite adverse exogenous factors, especially in sustaining the recent economic recovery, implementing structural adjustment measures in key sectors, maintaining a flexible exchange rate policy, import liberalization, interest rate policy and other reforms in the financial sector, price decontrol, especially of fertilizers, improving the effectiveness of the Government's population program, and government measures to strengthen management of its wildlife resources. Several Directors also noted Kenya's continued good record in meeting its external debt obligations. Despite this good progress, it was felt that the Kenyan authorities should be aiming for quicker adjustment.
>
> The Executive Directors offered the following more specific observations regarding implementation of the program of adjustment. Improving fiscal discipline and meeting agreed macroeconomic targets are clearly conditions for the effective implementation of adjustment efforts in the financial, agricultural, and export sectors. Reducing inflationary pressures and containing the size of the budget deficit are critical.
>
> The level of public expenditures remains high, and efforts to reduce spending need to be strengthened. Several Directors expressed concern over the slow progress in containing the growth in the civil service and employment of teachers. More rapid progress was urged in the imbalance between wage and nonwage expenditures.

Speakers noted government efforts to improve the efficiency of public investment and its intention to seek the assistance of IDA to prepare the public investment program. It was important that only those projects that are economically viable should be undertaken.

Several Directors pointed to the lack of progress in dealing with the parastatal issue, which was a major impediment to realizing Kenya's full potential. Measures to improve their efficiency, including possible divestiture, should not be delayed.

Directors stressed the importance of financial sector reforms in achieving inflation and private savings targets.

The Government should further reduce constraints affecting the private sector and the environment for private and foreign investment. Greater emphasis should be placed on eliminating regulations on private sector activity, reducing price controls, encouraging capital markets, and opening up agricultural marketing to private traders. Directors also emphasized the need to move beyond import liberalization toward a reduction in effective protection and to correct the antiexport bias.

Progress in reducing the monopoly role of the National Cereals and Produce Board (NCPB) should be sustained and accelerated. Grain pricing policy needs to be reviewed in this context. Similar measures should be taken for other agricultural parastatals.

There is a need to ensure that the poor are protected from the adverse effects of adjustment measures. Although noting Government efforts to protect lower-income groups from increases in user charges in the social sectors, greater emphasis should be placed on ensuring that these mechanisms work effectively and to develop a system for monitoring and evaluating the impact of economic reforms on the welfare of disadvantaged groups.

Although government efforts to begin addressing environmental issues in such areas as wildlife, forestry, and arid and semiarid lands are welcome, these steps must be broadened into a comprehensive, national environmental action program.

Directors urged greater attention than is implied in the policy framework paper to the role of women, population issues, and land reform.

Although Directors looked forward to the forthcoming export development program, this should not be a substitute for a comprehensive trade liberalization effort.

Mr. El Kogali made the following statement:

The performance of the Kenyan economy in 1989 was generally satisfactory, despite the impact of the unfavorable weather conditions on the agricultural sector and the deterioration in the external terms of trade, attributable largely to the fall in international coffee prices. Estimated real growth of GDP was 5 percent; inflation was contained at about 10 percent; the current account deficit narrowed to 4.5 percent of GDP from 5.3 percent in 1988; and gross external official reserves rose by some SDR 33 million. It should also be noted that all the quantitative performance criteria and structural benchmarks for 1989 were fully met except for the SDR 6 million shortfall in net official external reserves and the excess growth in net domestic assets of the banking system. These positive developments are the result of Kenya's continued strong commitment to the implementation of sound policies under its adjustment program.

Fiscal policy was characterized by measures implemented to broaden the tax base and improve tax administration. Steps were also taken, in the wake of shortfalls in revenue receipts for 1988/89, to contain the growth of expenditure. Thus, the authorities were able to keep the budget deficit, on a commitment basis, at about the level of the program target. The deficit was financed largely from external and domestic nonbank sources, thereby limiting domestic bank financing to less than 1 percent of GDP.

Monetary policy remained generally restrictive in 1989, although a substantial growth in broad money was recorded during the second half of the year. Credit targets were observed in the aggregate, as the excess growth in private sector credit was more than offset by the decline in the banking system's claims on government. Interest rate levels remained high and flexible to encourage increased financial savings and discourage consumption spending by the private sector.

Further progress was made in the area of structural reforms, in terms of further trade liberalization, financial restructuring of public sector enterprises, and streamlining of marketing arrangements and pricing procedures of major agricultural commodities. Tax reforms, involving the introduction of user charges in the health sector and cost sharing in education financing, were also instituted.

In 1990, the stance of macroeconomic policies has continued to be supportive of the medium-term objectives of achieving sustained growth and a viable external position in a stable macroeconomic environment. In order to achieve the policy targets

outlined for 1990, and given the liquidity overhang in the economy during the second half of 1989, fiscal and monetary policies have been further tightened. The overall budget deficit is programmed to decline from 4.6 percent to its medium-term target of 4.2 percent of GDP. In this regard, tax efforts will be strengthened while capital expenditure will be adjusted downward. The newly introduced user charges have been assigned a vital role in reducing recurrent expenditure growth, and concerted efforts will continue to be made to limit the growth of the wage bill to only 11 percent during the year. A modest increase in total expenditure to 30.1 percent of GDP from 29.9 percent is therefore envisaged.

Adjustments will be made to development spending that are consistent with the program's overall macroeconomic framework, in order to offset any increase in recurrent expenditure above the program target. Since the banking system's financing of the fiscal deficit will be limited to a maximum of 0.5 percent of GDP, a greater role will be assigned to financing from external and nonbank sources. Further tightening of fiscal policy is envisaged during the next fiscal year, embracing a stronger revenue drive and further reductions in expenditure growth. Financing from the banking system will be limited to 0.3 percent of GDP.

Monetary policy will focus on a strict control of net domestic assets in the banking system as a strategy for curbing inflation and reducing pressure on the balance of payments. Accordingly, the growth of net domestic assets is programmed to decline from 14.1 percent in 1989 to 11.2 percent by mid-1990, and to 9.2 percent by the end of the year.

Interest rate policy will continue to be used actively as an instrument of monetary policy, with the objective of maintaining positive real rates. The legal ceilings on lending-related fees and charges have already been removed as a step toward total liberalization of interest rates by June 1991. The system of auctioning treasury bills and bonds will continue as part of the financial sector adjustment program introduced in 1989 and supported by IDA with technical assistance from the Fund. Steps are also being taken to put appropriate machinery in place, including expanding the financial market, to facilitate the phasing out of direct credit control and the adoption of market-oriented, indirect instruments of monetary management.

Flexible management of the exchange rate will be continued to ensure Kenya's external competitiveness and facilitate the achievement of the country's export diversification objective. It is important to point out, however, that the benefits of this policy would be fully realized only if complemented by an

improvement in the terms of trade and increased access to external markets. The Government will continue to provide the necessary incentives to attract private foreign investment.

In the area of public enterprise reforms, efforts of the Government to establish a quarterly and annual reporting system for monitoring the financial operations of these enterprises will be intensified. Restructuring plans for the Industrial Development Bank (IDB) and the Industrial and Commercial Development Corporation (ICDC) are scheduled for implementation this year. Steps taken in 1989 to strengthen the operations of Kenya Airways will continue in 1990. Meanwhile, additional enterprises are being identified for restructuring.

The introduction of user charges in health services and increased cost sharing in education has imposed an increased burden on the vulnerable groups in the society, and the authorities are taking steps to protect those least able to pay by monitoring the situation to ensure that the effect of the relief reaches the targeted group. The Government has recently approved an increase of 8-10 percent in the wages of teachers and low-paid civil servants effective July 1, 1990. In addition, the private sector has been enjoined to effect the same revision in order to improve the welfare of this group.

Kenya's environmental problems are receiving the attention of the authorities with the assistance of IDA and other donors. In the medium term, priorities will focus on the forestry sector, wildlife resources, and the arid and semiarid lands.

The Kenyan authorities appreciate the external assistance received from multilateral and bilateral sources in the form of concessional loans and debt cancellation. However, the economy remains vulnerable to adverse weather conditions and to the instability of the world prices of coffee and tea. It is against this background that my authorities appeal to multilateral institutions and bilateral donors to continue to support Kenya's adjustment efforts by providing needed assistance in the form of grants and concessional loans. The authorities would like to assure the international community of their continuing strong commitment to the adjustment efforts. They have also indicated their willingness to strengthen the existing measures, if need be, in order to keep the program on track.

Mr. Enoch made the following statement:

Despite a number of adverse external developments during the year, the Kenyan authorities have complied with the performance

criteria for the first year of their enhanced structural adjustment facility, and the program's objectives for 1990 are little changed from those originally envisaged. The authorities are to be commended for this.

However, I fear that concerns expressed by Directors in previous discussions of the enhanced structural adjustment arrangement for Kenya have not been fully allayed. Underlying these concerns was a general feeling that the objectives of the program were not very ambitious, and that it was within the grasp of the authorities to do more, especially in view of their proven ability over the longer term. In particular, both higher growth and reduced dependence on official assistance should be achievable. The sense of unease is compounded by the observation that arises from reading the staff paper that, while performance criteria have been met, underlying developments are less reassuring.

For example, the overall fiscal deficit reduction is not far out of line with the program's objectives, but the balance between categories of expenditure has shifted because of the inability of the authorities to cap the wage bill. Moreover, revenue performance has been less buoyant than hoped for. More generally, Table 10 of the background paper shows that the role of government in the economy has expanded. This development runs counter to the need to increase the efficient use of resources and to foster a dynamic private sector. In this context, delays to the reform and divestiture of the parastatals continue to be of special concern.

On the monetary side, the financing of the deficit is satisfactory, but the scale of the government check float continues to suggest that there has been some expediency in meeting targets. With respect to the performance criteria, compliance with the domestic credit targets has not had the desired effect on broad monetary growth, with adverse consequences for inflation. There seems here to be a phenomenon of squeezing at one point only to see a compensating expansion at another. However, the authorities have been assiduous in adjusting interest rates as seemed appropriate, and I welcome the progress made toward effectively free rates.

In the external sector, admirable progress has been made in import liberalization. Even here, however, there are disappointments: tariff protection remains high; the overall external position has been distorted by large aircraft leases; and the real level of the exchange rate is clouded by weaknesses in the data base. Overall, the performance in Kenya over the past year would seem to have been satisfactory, but short of the country's potential.

Looking at the program for 1990/91, it appears that the policies envisaged over the next year go only a limited way toward meeting this concern. The objectives for deficit reduction remain modest, as revenues are expected to recover as a proportion of GDP from the slippage in 1988/89, but will still only be in 1990/91 at the level originally programmed for the previous year. Expenditure is projected to remain within the program's limits, but the balance of recurrent expenditure retains its shift toward wages. In this connection, the intention to control further growth in the wage bill is welcome, but the recent developments reported in Mr. El Kogali's statement are cause for concern. The authorities must recognize that this is a key aspect of the program. A more encouraging development is the authorities' greater sense of realism about capital expenditure, as reflected in their change of heart over the proposed KTMT building. I urge them to place great weight on the economic viability of any planned spending.

If inflation is to be brought back in line with the original program targets, a much firmer grip on broad money growth is required. I am reassured by the staff's closing of an apparent loophole in changing the relevant performance criterion, and by the authorities' commitment to positive real interest rates. An important further step will be the introduction of market-oriented monetary control.

The parastatal sector is central to structural reform, because of its impact on the fiscal balance and because of the importance of increasing the efficient use of resources. However, progress still seems to lie very much in the future. Until now, action has been largely preparatory, even to developing a plan of action for rationalization or divestiture. I urge the authorities to achieve fully the intentions expressed at some length in the policy framework paper, with a view to accelerating the envisaged timetable.

Other structural measures have been more encouraging, particularly in the area of trade liberalization. These measures could be usefully followed up by action to reduce the high level of protection, but there is a marked contrast in the approach to trade liberalization between the 1989 policy framework paper and the one prepared for the Board today. The earlier policy framework paper talked about a timetable for reducing tariff protection, with an action program for restructuring domestic industries that were adversely affected. This year's paper, however, refers only to continuing efforts for lower and more even protection. Some reassurance that the authorities are not shying away from the efficiency implications of lower tariffs would be welcome.

Although developments in the real exchange rate are obscured by data problems, there seems to have been some depreciation; however, the projections of export growth, the developments in the terms of trade, the need for further trade liberalization, the deterioration in producer incentives, and the level of the parallel rate all suggest that there may need to be more. The interesting appendix to the staff report, which outlines the important role played by rising labor costs in the decline in producer incentives, should serve to remind the authorities of their responsibilities, both at the microeconomic level as an employer and at the macroeconomic level in maintaining an appropriately nonaccommodative stance. Indeed, exchange rate flexibility is an adjunct to--not a substitute for--a sound policy framework.

With respect to the outlook for the external position, a comparison of Tables 6 and 9 in the current staff report with the equivalent tables from the 1989 staff report suggests an improved prospect for the current account over the next few years. However, this improvement is based on expected increases in official capital inflows, as there is no evident improvement in the prospects for private inflows. This increased dependence on official inflows persists in the long-term outlook and is indeed disappointing. This demonstrates clearly, as the staff report emphasizes, that there is an urgent need for Kenya to expand its nontraditional exports. Kenya's natural advantages and the past track record of its authorities, together with a well-implemented adjustment program, should give it a sound basis to increase its economic independence. Unfortunately, achieving this objective still seems some way off.

In conclusion, I commend the authorities for complying with the enhanced structural adjustment arrangement and I support the proposed decision, including the temporary approval of exchange restrictions under the Fund's Article VIII 2(a). However, I urge the authorities to raise their sights and recognize that they are capable of fulfilling more ambitious goals.

Mr. Goos made the following statement:

I broadly agree with the thrust of the staff's analysis and policy recommendations and therefore can support the proposed decisions. I will touch on only a few issues, namely, fiscal policy, the balance of payments, and exchange rate policy.

First of all, I agree with previous speakers that the Kenyan authorities deserve to be commended for the continuation of their reform policies and the progress achieved on several fronts of adjustment in 1989. I found the strengthening of the national

savings performance particularly encouraging. Nonetheless, I share the concerns about the slippages that occurred in controlling the government wage bill, the external current account deficit, and, above all, the rate of inflation.

While it appears that much of the ground lost in those areas will be recovered under the program envisaged for this year, I have considerable sympathy for the view of our World Bank colleagues, as reported in the Managing Director's opening statement, that the Kenyan authorities should aim at a more rapid pace of adjustment. This admonition applies in particular to the area of fiscal consolidation--a topic on which I had expressed reservations at the most recent Board consideration of Kenya's adjustment program. It is clear that fiscal consolidation holds the key to a sustainable and lasting improvement in overall economic performance, most notably in the containment of domestic price and cost pressures.

In passing, I note the thorough and detailed analysis and recommendations made by the World Bank Executive Directors in regard to Kenya's economic situation. In many respects, I found that their analysis seems to surpass that in the papers before us, especially in the emphasis placed on financial sector reform, the elimination of regulations on private sector activity, and the dismantling of existing monopolies.

Recent press reports about substantial increases in civil service wages are quite worrisome, as is the rather high rate of growth for government employment--rightly deplored by the staff--that the program envisages. The comprehensive cutback in low-priority expenditures recommended by the staff could, of course, compensate for further slippages in the wage bill; however, such cutbacks should perhaps be pursued in their own right, regardless of the wage bill, which, in turn, should not be allowed to escape tight control. Moreover, the high rate of population growth offers little justification for de-emphasizing the need to contain government personnel expenditures; rather, that growth serves to highlight the urgency of adopting forceful population control policies, as we and other speakers have stressed repeatedly.

The importance of continued wage and cost discipline is also underlined by the desirability of securing a stable exchange rate and achieving the balance of payments targets. As to the latter goal, I wonder whether it would not be advisable to aim for a more ambitious reduction in the current account deficit than the 0.5 percentage point projected for the medium term. In this context, it must be realized that the projections for the overall balance of payments position depend to a considerable extent on substantial official capital inflows and quite ambitious export

targets that remain to be achieved. The uncertainties surrounding these projections and expectations, as well as the continued vulnerability of Kenya's external position, make it advisable to strictly limit nonconcessional foreign borrowing and to closely monitor the balance of payments impact of lower-priority development projects.

I especially welcome the attention and thorough analysis devoted in the staff report to exchange rate policy--an encouraging departure from the often cursory approach followed by the staff in this important policy area.

Based on the evidence presented in the paper, Kenya's external competitiveness seems to have weakened over the recent years, although it is difficult to understand why, contrary to the general trend, imported input prices were found to have risen relative to final domestic goods prices. More important, however, the staff's analysis does not address the critical issue of why the substantial decline in the nominal effective exchange rate of almost 50 percent since 1985 has failed to improve external competitiveness. This state of affairs is all the more remarkable considering that the domestic economy is still being protected by an average import tariff rate of some 20 percent. The answer, of course, is that the impact of the exchange rate corrections has been eaten up by domestic price and cost pressures in excess of those in Kenya's main trading partner countries. Unless it could be shown that Kenya has consistently pursued more expansionary financial policies than its trading partners--which would be surprising, given the Fund's close involvement in Kenya's adjustment effort over recent years--there is a rather strong presumption that the task of stabilizing domestic cost and price performance has been complicated by the policy of continuous currency depreciation. I would therefore reiterate my view--and in so doing, I side with a number of previous speakers--that the authorities should place more emphasis on exchange rate stability and try to correct problems of external competitiveness, if necessary by a one-time exchange rate correction rather than by so-called flexible exchange rate policies.

On a related topic, I am not quite sure whether I understood the formulation on page 29 of the staff report of the authorities' intention to reach an exchange rate level that can be sustained by the fiscal and monetary policies controlling domestic demand pressures and inflation. Does the staff mean that, if financial policy is unable to maintain a tight stance, nothing will be done on the exchange rate front and vice versa? It would be helpful if the staff or Mr. El Kogali could elaborate on that point.

Finally, I would like to urge the authorities to realize without delay their intention to construct a new and more meaningful price index.

Mr. Iqbal made the following statement:

Kenya has continued to pursue determined adjustment policies over the past two years. It is good to note that the performance criteria and quantitative benchmarks for 1989 have been generally met. In particular, targets with respect to the overall budget deficit have been generally adhered to, as reforms have been introduced in the tax area, and a rationalization of expenditures has been initiated. Furthermore, relative prices, including interest rates and the exchange rate, have been duly adjusted, which should help greatly in improving resource allocation; the import regime has been liberalized, and domestic price controls relaxed; and the economic restructuring has started to bear fruit, as the growth of consumption has been contained while the savings-investment gap has started to shrink.

However, despite the progress that has been made so far, Kenya's medium-term outlook remains uncertain. The inflation rate remains high, and socioeconomic factors continue to hamper a speedy correction of the public sector deficit. The instability of world commodity markets and the difficulties in penetrating markets in nontraditional exports, along with a moderation of growth in industrial countries, would hamper an early and viable economic resurgence. In this context, an evaluation of the 1990-92 policy framework paper and the adjustment program underlying the 1990 enhanced structural adjustment arrangement indicates that the process of fundamental economic restructuring will need to continue over a much longer period. The Fund's role in this process should increasingly focus on enhanced technical support to ensure the existence of an appropriate macroeconomic environment that, combined with concessional financing, would facilitate rapid economic growth with internal and external stability.

Since I generally agree with the thrust of the staff appraisal and support the proposed decisions, I will focus my comments on a few specific issues. First, the fiscal retrenchment will need to be strengthened, and a shift in the composition of expenditure toward nonwage expenditures should be vigorously pursued. In this respect, the recently announced increase in wages for the government sector may not be helpful. The process of privatization and reform of state enterprises also needs to be strengthened.

Second, the performance criterion applying to total domestic credit for 1989 was met in numerical terms, but not necessarily in spirit. By using other net items to finance a much larger expansion in demand, the authorities allowed the growth of broad money to exceed the programmed level, which led to a higher rate of inflation than targeted. In those circumstances, and to ensure an effective control over growth of liquidity, the change in the definition of the performance criterion from total domestic credit to a ceiling on net domestic assets, broadly defined, is appropriate. However, this change alone may not be enough since, for example, an expanded use of credit transactions between enterprises in the public sector could weaken the effectiveness of the ceiling on net domestic assets. I would suggest that the Fund's technical assistance, which has already been called upon to initiate a system of reserve money management, should also be used to plug all potential loopholes.

Third, it is difficult to discern from the staff report the substance of the exchange rate policy. While the need to ensure the confidentiality of the specific mechanism followed in implementing exchange rate adjustments is understandable, the staff report should at least have indicated the thrust of the policy. This omission is particularly significant because the staff has attempted to prove the existence of a fundamental disequilibrium that may not be amenable to a solution based solely on restrictive financial policies. In this context, the authorities should not mechanically target a real effective exchange rate based on the consumer price index, not only because the available consumer price index is inappropriate, but also because the act of targeting the real effective exchange rate could, in itself, produce an inflationary bias. To remedy the situation, the staff should estimate precisely the extent of overvaluation, which the authorities should then correct through a discrete change in the rate. Appendix VI to the staff report, dealing with indicators of competitiveness, provides a good starting point for such an exercise.

Finally, the program calls for export promotion initiatives as a complement to appropriate exchange rate management. I fully endorse the staff's stress on export promotion and on diversification through a more rational structure of domestic protection. Given the active role proposed for the World Bank in promoting exports, it would be helpful if either the Fund staff representative or the World Bank representative could describe these initiatives in some detail and assess their implications not only for Kenya, but also for its competitors. It would also be useful if the role of direct foreign investment in this process could be explained.

Mr. Ismael made the following statement:

The Kenyan authorities are to be commended for having implemented various adjustment and structural measures since the previous year's consultation. I note with satisfaction that all the performance criteria and most of the benchmarks under the first annual arrangement of the enhanced structural adjustment facility have been observed. These achievements have undoubtedly contributed to Kenya's broadly satisfactory economic performance during the past year, despite bad weather conditions and the sharp deterioration in Kenya's terms of trade.

Since I generally concur with the staff's assessment that Kenya's adjustment program has been broadly on track, I can endorse the program's objectives and policies for 1990-92 as outlined in the new policy framework paper. I therefore support the authorities' request for the second annual arrangement under the enhanced structural adjustment facility, as well as the proposed decision with regard to the exchange restrictions.

Given the lack of progress in reducing inflation during the past year and the continued fragility of the external position, I fully agree with the authorities that monetary policy needs to be substantially tightened this year. In light of the excessive growth in broad money during 1989, I can support the authorities' intention to place a limit on net domestic assets rather than on the previous year's target of total domestic credits. In this connection, I am encouraged by the authorities' commitment to reducing and eventually removing all legal restrictions imposed on interest rates. Finally, I welcome their intention to improve the allocation of financial resources and the functioning of monetary policy, including through an increased reliance on indirect monetary instruments.

With respect to public finance, I welcome the authorities' intention to complement their recent tax reforms with efforts to extend the coverage of user charges, with a view to financing recurrent expenditures and improving the quality of government services. In light of the relatively high ratio of revenue to GDP, however, greater effort needs to be directed toward containing recurrent expenditures, especially with regard to wages and salaries. In this connection, the authorities' efforts to improve the analysis of expenditures, especially through the development of a monthly monitoring system of wages and operating expenses, are welcome. Also welcome are their efforts to strengthen budgetary procedures for the purpose of improving the efficiency of development expenditures.

In the external area, I applaud the recent initiatives taken by a number of industrial countries to cancel their loans to Kenya. These initiatives have helped considerably to alleviate the burden of Kenya's external and fiscal positions; however, the staff has correctly pointed out that Kenya, like many other low-income countries, will still need new concessional assistance, in addition to substantial debt cancellation. Meanwhile, I join the staff in urging the authorities to develop and firmly adhere to a prudent nonconcessional borrowing policy.

In order to sustain economic adjustment and progress over the medium term, it is important that the present program also lay the groundwork for promoting nontraditional exports. Crucial for this purpose is the continuance of the authorities' flexible exchange rate policy in the context of a comprehensive policy to improve economic competitiveness. In this connection, I commend the authorities' ongoing efforts--predicated on a desire to prevent a deterioration in competitiveness arising from an underestimation of inflation--to develop a new consumer price index.

The authorities are also to be commended for their continued efforts to liberalize Kenya's international trade, especially through the import liberalization program. The reduction of non-tariff restrictions through this program to about 7 percent of the value of total imports, together with the continued efforts under the enhanced structural adjustment arrangement to improve the pricing system and the efficiency of the parastatals, will undoubtedly contribute to further diversification of the economy, and particularly the promotion of nontraditional exports.

Mr. Serre made the following statement:

The Kenyan authorities are to be commended for the progress achieved during the first annual arrangement under the enhanced structural adjustment facility. Considering the difficult economic and financial situation that prevailed three years ago, one can appreciate the ground that has been covered. This is undeniably a good example of adjustment with growth. The unfavorable developments during the second half of 1989 clearly demonstrate, however, that there is little room for maneuver in keeping up the momentum of the program. Therefore, we are pleased to note the tightening of financial policies that is envisaged in the 1990 program, since this is consistent with the need to devote more attention to both the containment of inflationary pressures and the pursuit of the diversification process within the economy.

In this context, I would like to discuss some issues that deserve very close attention for the success of this program,

dealing successively with macroeconomic policies, structural reforms, and the medium-term outlook of the economy. Above all, it cannot be overemphasized that, at this stage, macroeconomic policies remain essential for keeping the program on track. With specific reference to the management of public finances, the slippage that has been observed on the wage bill vis-à-vis other current outlays is regrettable; that trend should therefore be adequately reversed. It is a further cause for regret that the savings arising from debt forgiveness should be absorbed by higher than expected interest rates on domestic debt. In contrast, the progress already achieved in monitoring revenue measures has been encouraging; the targets set up under the program are realistic and consistent with the actual trends. However, further delays should be avoided in implementing the new value-added tax.

On the expenditure side, the ongoing streamlining of the structure of outlays and the authorities' commitment to recover user charges when affordable are welcome. We urge the authorities to take full advantage of the higher than projected external assistance to expand resolutely the fiscal scheme as a whole. It is indeed clear that reducing the budget deficit for 1990/91 to 3.8 percent of GDP will depend critically on a strict adherence to the program.

Concerning monetary policy, there is an urgent need to ensure further reduction in the growth of the money supply. As in other parts of the program, we welcome the change that has been made in establishing a more adequate money supply performance criterion for 1990. In addition, we are pleased with the streamlining of lending interest rates; that measure, as the staff has underscored, constitutes an important step toward the goal of liberalizing interest rate policy. Another positive aspect of the program is the willingness of the authorities to increase the reliance on market mechanisms for improving the allocation of financial resources and monitoring reserves within the framework of the reform supported by the World Bank.

Turning now to structural reforms, we fully concur with the staff on the need to accelerate the rate of restructuring in the public sector. In this respect, the policy framework paper should have indicated a more precise timetable for the ongoing process. Furthermore, the authorities would have been well advised to extend the conclusion of performance contracts, as had successfully been done in the case of the Kenya railroad.

In the face of an increase in population growth, the authorities must place greater emphasis on both diversifying the economy and promoting private sector activity, in order to absorb the labor force. This overall objective could be reached by the

rigorous and timely implementation of the set of measures, described in the policy framework paper, that have been supported by World Bank operations.

The medium-term outlook for Kenya's economy, compared with other countries in sub-Saharan Africa, indicates that there is a strong economic potential to be developed. In this context, we agree with the staff that the balance of payments position can improve steadily. Moreover, it is true that, despite the significant progress that has already been made, strong demand management policies and further diversification of the economy under the enhanced structural adjustment arrangement are essential to pave the way for sustainable and balanced growth. The present situation--characterized by debt forgiveness measures, such as debt cancellation by France of F 1.3 billion, as well as by strong support from the international financial community--constitutes an opportunity that should not be missed.

The effects of the ongoing external policies are, unfortunately, a cause for concern. Since an important part of the authorities' strategy relies on flexible exchange rate management, it is striking to see the uncertainties that still surround the indicators used to assess the precise impact of such a policy. The staff has candidly raised this important question on page 28 of the report as well as in Appendix VI. It should be useful, in this respect, to devote special attention to this matter during the midterm review.

To conclude, we share the generally hopeful tone of the staff report. We concur, however, with the conclusion of the Committee of the Whole of the World Bank that the Kenyan authorities should be aiming for quicker adjustment. We support the proposed decisions.

Mr. Fogelholm made the following statement:

The growth performance of the Kenyan economy has continued to be satisfactory. However, the past year's price increases were clearly higher than desirable, and the external accounts were weaker than programmed, owing largely to the costs associated with the leasing of airplanes, but also to the deterioration in the terms of trade. Overall, however, the program under the first year of the enhanced structural adjustment facility is essentially on track, and the policy framework paper and staff report give the impression that the Government is determined to continue its adjustment policies. I therefore support the proposed decisions.

In the November 1989 review, I expressed some concerns about Kenya's external position and the adequacy of its fiscal stance. As regards fiscal policy, I am pleased to note that this year's budget deficit seems to be on target, despite a substantially--and disappointingly--higher than expected wage bill. In this context, I acknowledge the increasing demand for such public services as education, but, that being the case, stronger efforts should be made to reduce other expenditures commensurately; the growth of civil service employment in general should be contained, and restraint should be exercised on the salary front, in order to check the growth in the wage bill. While welcoming the overall direction that fiscal policy has taken, I regard the program's deficit target for the coming year to be the absolute minimum for sustaining the adjustment process. Therefore, I fully agree with the staff that the authorities should, if anything, err on the conservative side in implementing the budget. With respect to the budget, I would like to support the authorities' emphasis on social and environmental aspects, although I note from the World Bank discussion on Kenya that a national environmental program still needs to be developed.

The maintenance of positive real interest rates is most welcome, as are the steps that have been taken to remove the ceilings on fees and charges, while allowing for flexibility in setting interest rates. However, this greater flexibility should also be used in practice to fight the inflationary pressures that have resulted from, inter alia, the strong monetary expansion of the past year.

With regard to the state corporations, I note the staff's assessment that these enterprises are rather inefficient. The Government should therefore be urged to strengthen and accelerate the restructuring of these corporations, including, where necessary, the initiation of a process of privatization. Furthermore, regulations that restrict private sector activity should be abolished, agricultural marketing should be opened up to private traders, and price controls should be reduced.

The external current account is expected to improve gradually in the years ahead, but, as the staff notes, the deficits are still expected to be higher than in the mid-1980s. Although the staff's projections through the 1990s show a small reduction in the current account deficit and in the debt-service ratio, this reduction will not significantly change Kenya's dependency on concessional financing in the foreseeable future. Efforts to diversify the economy and to strengthen the export sectors should therefore be the top priority of the authorities, both in the short and medium term.

To achieve such development, every effort must be made to increase the economy's responsiveness to export market opportunities. Structural rigidities must be reduced, prices further liberalized, and domestic cost pressures contained through prudent demand policies and wage moderation. It is highly questionable, given the existing degree of trade liberalization, whether it is still necessary to maintain the complex system of import restrictions and tariffs that are described in paragraphs 33-36 of the policy framework paper. More generalized import liberalization would be preferable, supported by appropriately tight fiscal and monetary policies and a stable macroeconomic framework.

Finally, with respect to exchange rate policy, Kenya, like other countries, should, of course, have an exchange rate consistent with positive developments in the external accounts. In view of the experience in recent years, however, it would seem that external competitiveness should be achieved through internal means--by removing structural rigidities, freeing prices and imports, and keeping domestic price pressures in check--rather than through a further depreciation of the currency. I refer here to the results of the study on "Exchange Rate Policy and Adjustment in Africa" by Pierre Jacquemot and Elsa Assidon, which reviews the experiences of 16 sub-Saharan and Indian Ocean countries. One of the conclusions of this study is that, owing to the specific elasticities of Kenyan exports, the country's nontraditional industrial sector was almost destroyed by the reduction in imports and the increase in raw material prices that followed the depreciations in the currency. Staff comment on this point would be appreciated .

Mr. Noonan made the following statement:

The program of economic stabilization in Kenya, which reaped such high dividends under the stand-by and structural adjustment arrangements, appears to have been no less successful during the first year under the enhanced structural adjustment arrangement. In 1989, the country continued to make satisfactory progress, as evidenced by another sizable increase in real GDP, improved public sector finances, higher national savings, and some accumulation of reserves. We believe that, despite adverse external developments, this outcome is indicative of the authorities' strong commitment to keeping Kenya on the path of sustained economic growth and development. However, there are a number of concerns that must be addressed if this goal is to become a reality.

During the most recent Board discussion on Kenya in May 1989, some Directors were disturbed by the realization that the steady GDP growth in recent years had not been accompanied by gains in

per capita income. Little had changed in this regard by end-1989, as per capita GDP--at SDR 280--was roughly the same as in 1986, despite average real GDP increases of over 5 percent a year during that period. This situation can be attributed in part to the steadily increasing dependency ratio in Kenya, which puts tremendous strains on the country's resources. We therefore welcome the higher priority that the authorities, aided by the World Bank, are giving to this problem and are encouraged by the progress noted in the policy framework paper.

However, the realization that demographic and other cultural changes may come about only in the long run should not lead the authorities to assume that more ambitious growth targets are unattainable. Indeed, the authorities' stated desire for a greater private sector role must be seen as consistent with efforts to remove constraints on more rapid economic expansion. Some important planks of such a strategy are already in place. Positive real interest rates, for example, have the potential to stimulate saving and thereby remove some of the inflationary pressure. The removal of the taxes on exports, which was accomplished late in 1989, will allow domestic goods to compete on a more level playing field. Other measures that have not yet been implemented include wide-ranging structural reforms in taxation, the tariff system, and finance, which will serve as incentives for the production of nontraditional goods. In this regard, we would suggest that measures should be introduced in a timely fashion to deal with those distortions in the pricing system that provide an incentive for imported goods at the expense of domestically produced import substitutes.

Although the authorities have succeeded in reducing the fiscal deficit to a more manageable level, there is no room for relaxation of effort on this front. At this stage, the emphasis should be on consolidating the gains that have been made so far by attending to the more qualitative aspects of fiscal management. In that vein, the intention to restructure the pattern of expenditures is welcome; a higher share of government outlays is already being channeled into badly needed infrastructural development. However, pockets of weakness could be seen during the past year in the tendency toward extrabudgetary expenditures and delays in the introduction of tax measures. We hope that the timely implementation of the system to monitor expenditures on a monthly basis, as well as the overall improvements in budgeting and management, will prevent a recurrence of these shortcomings.

The staff has characterized the state enterprise sector as a major source of inefficiency in government operations, indicating that transfers to these entities are putting undue strain on expenditures. In that context, it is somewhat surprising that,

apart from the broad statements of intent attributed to the authorities, there is no comprehensive plan of action for dealing with these entities.

The advances that were achieved on the domestic front in 1989 were not matched by any substantial progress in the external sector--and especially not with respect to the current account balance. This unhappy outcome was partly the result of exogenous factors, such as the 30 percent decline in coffee prices that facilitated a 9 percent fall in the terms of trade. However, another contributing factor was the authorities' insufficient appreciation of the fact that there is little room for maneuver in the external sector, given the extreme dependence of the program in the medium term on the viability of that area. The unprogrammed leasing of aircraft in the face of adverse external developments, as well as the absence of a strategy to deal with the uncompetitive price structure of the petroleum sector, as manifested in the rapid decline in petroleum exports, can be cited as two examples of that lack of comprehension.

The above comments notwithstanding, Kenya has made tremendous strides toward becoming a viable economy in the foreseeable future and deserves our encouragement. We therefore support the proposed decisions.

Mr. Yoshikuni said that, since the beginning of the current enhanced structural adjustment arrangement for Kenya, his chair had expressed a number of concerns about the implementation of the program, particularly with respect to the vulnerability of Kenya's balance of payments position in the medium term. The staff report reviewing the first annual arrangement indicated that generally satisfactory results had been attained with respect to program targets. However, the continued weakness of the external sector was a source of disappointment. Particularly worrisome was the unexpectedly large current account deficit in 1989--5.9 percent of GDP--as compared to the target of 4 percent. Furthermore, the inflation rate in 1989 exceeded the target, owing to the unexpected rise in broad money.

As one of the major creditors to the ESAF Trust Account, his chair was concerned about those developments, Mr. Yoshikuni continued. In his view, they must point either to the weak monitoring ability of the authorities or to the weakness of the original program itself. As the staff paper rightly put it, the increase in broad money had occurred despite the fact that the performance criterion for total domestic credit had been met; that development therefore indicated the need for more specific program design at the outset. More important, however, the lease contract of Kenya Airways--not envisaged under the program--had been primarily responsible for the deterioration in the external current account balance. Since the airline was a state-owned company, and since the contract had resulted in an increase in

government imports, that action constituted a substantial deviation from the program goal of containing nonconcessional borrowing by the public sector. It was therefore regrettable that the contract had not been discussed by the staff and the authorities at the midterm review in November 1989, just one month before the lease contract had been signed. Comments from the staff and the Kenyan authorities' views on that transaction would be helpful.

With respect to the 1990 program, Mr. Yoshikuni commented, there was a clear need to strengthen fiscal restraint on the expenditure side, despite the progress that had already been made in reducing the budget deficit. The continued large growth in the number of government employees envisaged by the authorities was particularly worrisome. A 2 percent increase in overall employment and an 8 percent increase in the number of teachers did not constitute a convincing demonstration of a significant effort to contain public employment. In his view, a more ambitious attempt to limit employment in the coming fiscal year--and preferably to effect a reduction from the previous year's level--was warranted.

In the area of monetary policy, every effort should be made to contain inflationary pressure through a reduction in domestic credit, Mr. Yoshikuni stated. In that connection, he supported the 11 percent growth target for broad money, as well as the new performance criteria on net domestic assets. In view of the large slippage that had occurred in that area during the previous year, the room for maneuver was quite limited.

Much work remained to be done in restructuring the state corporations, Mr. Yoshikuni said. The large leasing contract of Kenya Airways was a particular cause for concern. A comprehensive review of the airline's operation, including, inter alia, an analysis of the profitability of the lease contract in the medium term, should be presented by the time of the midterm review.

His chair continued to harbor reservations concerning the external viability of Kenya's balance of payments position, Mr. Yoshikuni confirmed. As the staff's medium- and long-term scenarios clearly showed, Kenya would continue to run a substantial current account deficit of about 4 percent of GDP throughout the 1990s. That implied that, even after the conclusion of the enhanced structural adjustment arrangement, the country would still be heavily dependent upon the continued flow of concessional funds from external creditors; that realization, in turn, raised doubts about the effectiveness of the facility in strengthening the adjustment process and restoring external viability. He strongly hoped that those points would be addressed by the time of the midterm review.

Ms. Hansen remarked that she broadly agreed with the thrust of the staff's analysis. On balance, Kenya's performance under its adjustment program had been satisfactory: growth was about on target; most benchmarks

had been met; and a number of structural problems were gradually being addressed. Nevertheless, the staff report highlighted some important concerns, which she shared.

The stronger than targeted monetary expansion in the second half of 1989 and accompanying inflationary pressures--which might have been greater than the measured price index showed--were regrettable, Ms. Hansen commented. It would therefore be important that the authorities adhere to the tightened financial policies agreed for 1990, in order to keep the program on track. In that connection, the most recent step toward interest rate liberalization and the commitment to remove interest rate ceilings by June 1991 were welcome.

With respect to fiscal policy, she shared the staff's concern about the rapid increase in the government wage bill, Ms. Hansen said, particularly in light of the need to alter the composition of recurrent expenditure over the medium term. Although there were undoubtedly strong reasons for increasing the number of teachers, perhaps there might be room for economizing in other parts of the wage bill by reducing staff levels in less critical areas.

The staff's concern over indications that incentives for Kenyan producers of tradable goods had deteriorated was valid, Ms. Hansen remarked. The authorities were therefore urged to redouble their efforts to contain domestic demand pressures and inflation, and to adjust the exchange rate as appropriate.

More fundamentally, however, Ms. Hansen said, the staff documents confirmed the view that, given Kenya's physical and human resource base, the gradual pace of adjustment that it was currently following fell short of its potential. As the staff report pointed out, the magnitude of Kenya's economic distortions and structural imbalances were smaller than in many other developing countries, requiring a correspondingly less demanding schedule of structural reforms and lower potential costs of adjustment. That situation would seem to suggest that Kenya should be able to set more ambitious development goals than many other developing countries. In particular, the authorities should move more aggressively to eliminate the present anti-export bias and improve export competitiveness, to revive foreign investment through improvements in the investment climate, and to rationalize and restructure the broad array of state corporations. By giving priority attention to those areas, Kenya could significantly improve its medium- and long-term prospects: it could accelerate its growth rate, strengthen its external position, and lessen its dependence on foreign borrowing.

The Kenyan authorities should be commended for the number of constructive actions that they had already taken in the course of their adjustment program, Ms. Hansen stated. She hoped that they would redouble their efforts so as to make the most of their country's considerable potential.

Mr. Hogeweg said that he appreciated the analysis in the staff paper of exchange rate developments and the competitiveness of the Kenyan economy. That analysis had probably been triggered by the interesting Board discussion on those matters in November 1989, during which he, along with other Directors, had expressed doubts about the emphasis that the staff had placed on "exchange rate flexibility." It was their concern that that phrase was being used as a euphemism for the practice of accelerating the pace of real effective depreciation, in order to strengthen a country's competitive position. On that occasion, he had characterized that advice as tantamount to advocating competitive devaluations, a procedure which was not only counter to the spirit of the Fund but also destabilizing for Kenya domestically.

In the staff report, Mr. Hogeweg observed, the argument was made that, because the consumer price index had underestimated the actual inflation rate--as shown by shortages in price-controlled commodities--the measured real effective depreciation had not actually taken place. In fact, in terms of labor costs, the exchange rate had effectively appreciated somewhat since 1987. The parallel market rate had depreciated 30 percent more than the official rate. Similarly, the need to maintain high import tariffs indicated that the present nominal exchange rate was not compatible with a viable current account position. The obvious question, therefore, was what policy advice should be offered to the authorities in those circumstances. Apparently, the staff saw those developments as confirmation of the soundness of its advice that the depreciations should continue until competitiveness was attained; however, the new findings could be seen as a cause for concern, since they essentially indicated that Kenya's inflation problem had worsened, and that the authorities would need to be more ambitious in their stabilization efforts.

In that connection, the significant tightening of monetary policy in early 1990 had been welcome, Mr. Hogeweg continued. However, that action had been in response to the completely unwarranted acceleration of monetary expansion in late 1989, which made Kenya's very gradual programmed slowdown in inflation in itself a more ambitious target. In addition, he welcomed the substitution of the more broadly defined performance criterion of net domestic assets for total domestic credit; that change might indeed facilitate attainment of the final objective of monetary policy, namely, reducing the rate of inflation. However, all those efforts were predicated on achieving the programmed pace of gradual reduction of measured inflation.

The new findings on Kenya's competitiveness only increased the importance of domestic stabilization as the primary emphasis of the efforts at strengthening competitiveness, Mr. Hogeweg commented. Moreover, the anti-export bias in the economy would have to be removed. After all, competitiveness involved more than prices alone. In that context, the exchange rate could be a useful additional instrument; however, a continuing slide in the nominal exchange rate, with seemingly no end in sight, was not appropriate.

As to state enterprises, Mr. Hogeweg said, no mention was made by the staff of possible privatization as a way to improve their continuing weak performance. He wondered whether there was any reason why that approach was not possible in Kenya.

With respect to the long-term balance of payments scenario, Mr. Hogeweg concluded, nominal GDP as expressed in SDRs was assumed to increase at an annual rate of 8 1/2 percent--a higher rate than any of the other variables in the relevant table. It was not clear what would lead to that growth and whether it could be achieved without at least a similar rate of growth in imports. He supported the proposed decisions.

Mr. Zhang made the following statement:

I am pleased to join other speakers in commending the Kenyan authorities for the satisfactory results achieved under the enhanced structural adjustment arrangement. The basic macroeconomic objectives of the 1989 program were realized, despite the negative impact of exogenous factors, and all end-September 1989 performance criteria were met, as were most of the benchmarks for the year. I am in broad agreement with the staff's appraisal and recommendations, and I have no difficulty in supporting the proposed decisions.

With regard to fiscal policy, I concur with the staff's analysis that realization of the fiscal targets is critical to the success of the adjustment effort. The overall budget deficit for 1989/90 is programmed at 4.2 percent of GDP. Revenue for 1989/90 is projected to rise to 23.7 percent of GDP from 22.9 percent in 1988/89, while the share of expenditure and net lending to GDP will increase from 29.7 percent in 1988/89 to 30.1 percent in 1989/90. According to these projections, fiscal measures need to be strengthened through raising revenue and reducing expenditures. We welcome the authorities' commitment to continue replacing the sales tax with a uniform value-added tax and to implement a tax policy reform for broadening the tax base and enhancing the elasticity, efficiency, and equity of the tax system. The measures that the authorities plan to implement in order to reduce the overall share of recurrent expenditure--as outlined in the Government's Memorandum on the Economic and Financial Policies--are crucial, given that the level of public expenditure remains high.

Regarding state corporations, it is encouraging to note that the authorities have already taken measures to monitor the budgetary impact of enterprises, and that the number of large enterprises to be monitored will increase from 10 to 20. It is important to clarify both the financial situations of state corporations and their relationship with the Government, since this sector of the economy remains a source of considerable

inefficiency. The policy framework paper for state corporations, which will be developed this year, will greatly contribute to the overall structural adjustment effort.

The authorities should be encouraged to continue their policies to broaden the growth base in the external sector. Diversification, in terms of both products and markets, has gained critical importance in light of the recent decline in coffee prices on international markets, especially given the country's historical dependence on coffee for more than one fourth of its export earnings. Because Kenya's potential for developing its nontraditional export commodities is good, we welcome the authorities' initiatives in exchange rate management and export promotion to improve Kenya's competitiveness and achieve a sustainable external position.

Kenya has an excellent record in meeting its external debt obligations on time. In addition, the authorities have shown their strong determination to adhere to a prudent foreign borrowing policy, and in particular to limit nonconcessional loans. However, in support of the objectives and policies in the program of economic and financial adjustment, the authorities will still need to rely on concessional assistance from the Fund and the international financial institutions at large. The country deserves such assistance.

Mr. Shaffrey said that, although Kenya's performance under the enhanced structural adjustment arrangement in 1989 was not quite as good as it had been under the structural adjustment arrangement in 1988, the program was basically on track, and he had no difficulty in supporting the proposed decisions.

He fully agreed with the staff on the crucial need to meet the budgetary targets under the program, and thus he shared the staff's disappointment over the continued rapid growth of government employment, Mr. Shaffrey continued. Like Mr. Fogelholm, he felt that the rapidly expanding population placed heavy demands on government services, particularly education. However, the authorities needed to ensure that public service employment remained strictly constrained, with possible reductions in employment levels and in other areas, and that the wage bill stayed within reasonable bounds. Hence, it was disappointing to note that the increase in the wage bill was expected to exceed the program targets by a substantial margin in the current financial year; the recently announced increases effective July 1, 1990 would not help the authorities in their quest to increase the share of expenditure devoted to nonwage and operating items.

Like Mr. Enoch, he was somewhat disappointed that actions to restructure parastatals had largely been of a preparatory nature, Mr. Shaffrey

remarked. He hoped that that particular part of the program could be accelerated somewhat over the coming fiscal year.

With respect to exchange rate policy, he welcomed the attention that the staff had given to the inadequacy of the real depreciation of the Kenya shilling, Mr. Shaffrey said. Given the discussion that that topic had produced at the midterm review in November 1989, he looked forward to a report on the staff's discussions during the next midterm review. It was somewhat disappointing that the Board could not have had a full discussion at the present meeting of some of the points raised by Directors in November 1989.

He greatly welcomed the authorities' indication that interest rate controls would be removed in 1991, and the recent removal of the cap on fees and charges was a substantial move in that direction, Mr. Shaffrey continued.

Finally, progress on Kenya's adjustment program remained broadly satisfactory, but reflected what the staff had referred to during the previous discussion on the country as Kenya's preference for consensus and incremental progress, Mr. Shaffrey commented. While one might wish for more emphatic action in some areas, one could be satisfied at least that Kenya was addressing its problems and making some headway, although viability remained some way off.

Mr. Hammoudi made the following statement:

In coping with the deteriorating economic and financial situation in late 1987, the authorities in Kenya embarked on a far-reaching adjustment program, which was supported by financial arrangements with the Fund. This adjustment program was further reinforced by the adoption of a three-year arrangement in early 1989 under the enhanced structural adjustment facility.

On the whole, the available information indicates that the performance of the economy during 1989 was satisfactory, and we broadly agree with the staff appraisal and support the proposed decisions. On the fiscal front, it is rather discouraging to note that much of the burden of the cut in total expenditure fell on development outlays in 1989, while wage increases were much higher than originally programmed. In this regard, we wonder whether the recent announcement of civil service wage increases, effective July 1, 1990, are within the objectives of the 1990 program. In these circumstances, the authorities' intention to begin a monthly monitoring and reporting of wages and operating charges and to increase continuously real nonwage operating and maintenance expenditure in infrastructure is encouraging. The Government's plan to reduce borrowing from the banking system from the equivalent of 1.3 percent of GDP in 1989/90 to only 0.3 percent in

1990/91 is clearly also a step in the right direction, since this policy will enhance the role of the private sector in the economy by making more financial resources available to it.

With respect to structural reforms, we welcome the undertaking of a detailed review of the public investment program in 1991/92. Furthermore, the authorities have envisaged an increase in revenues in the 1990/91 budget through a further replacement of the sales tax by a value-added tax and through the extension of user charges to more services. In this respect, while we support the importance of broadening the tax base and enhancing the efficiency and equity of the tax system, it is also important to give further consideration to the adverse impact that the increase in user charges will have on the poor segments of the population.

The authorities' program to reduce monetary growth from nearly 18 percent at the end of 1989 to lower than 11 percent by the middle of 1990 is an appropriate step to combat inflationary pressures and must be conscientiously implemented. To this end, replacing total domestic credit in the 1990 program as a performance criterion by a ceiling on net domestic assets, in order to minimize fluctuations in the "other items, net" category, is a positive step toward the realization of this year's monetary targets.

As to external sector policies, it should be noted that in 1989 official concessional borrowing exceeded the program target while official grants showed a 7 percent decline. The country's debt-service ratio also increased from 29.4 percent in 1988 to 30.8 percent in 1989. Under these conditions, and given the projection of further increases in Kenya's external financing requirement for 1990-91, the authorities should be encouraged to refrain from borrowing financial resources on a nonconcessional basis. The official donor community, and particularly the multilateral financial institutions, would obviously be expected to contribute to the country's financial needs.

Mr. Schoder made the following statement:

In 1989, the Kenyan authorities again demonstrated the seriousness of their development strategy and their unflagging commitment to the requirements of adjustment. They deserve to be highly commended for the implementation of the first annual arrangement under the enhanced structural adjustment facility, and they deserve to receive approval of the second annual arrangement. Because the Board comes in contact all too rarely with a member country that adheres so strikingly to the policy advice provided

by this institution, it is not only in Kenya's but also the Fund's best interest that Kenya's structural adjustment effort yield the targeted results.

With this background, it should come as no surprise that the staff report on Kenya reads like a textbook case of structural adjustment in a low-income African country. I therefore basically agree with the overall thrust of the policy framework paper and with the program for 1990.

The only notable slippage in 1989 happened in the field of monetary policy, which was substantially more expansionary than programmed. That slippage certainly was not the result of excessive borrowing by the government sector, which was below target, but was due to a very rapid expansion in credit to the private sector. The slippage subsequently fed through the economic system by weakening its capability to combat inflation. The size and the implications of the overshooting of the private sector credit target justified a thorough investigation of the likely causes of the phenomenon. In that context, the attribution in the staff paper of the expansion in liquidity principally to developments in "other items, net" is rather mystifying, and it would be helpful if the staff could elaborate on the driving forces behind that upswing. Against this background, I welcome the shift in the related performance criteria from total domestic credit to net domestic assets, since that shift should close the loophole responsible for the overshooting of the liquidity supply.

Excessive monetary expansion, through its impact on the domestic price level, threatens the competitive position of the export sector and thus undermines the strategy of broadening and diversifying the export base of the economy by including nontraditional products. That strategy is indeed very critical if Kenya is to reduce its dependence on some commodities, and in particular its vulnerability to the world market price fluctuations of those commodities. In that context, it is quite unfortunate that serious doubts have now arisen as to the competitive position of Kenya's economy and, specifically, the evolution of its external competitiveness. On the basis of a wide range of empirical indicators, the staff has concluded that Kenya's external competitiveness has worsened over the past several years. This outcome to the authorities' prolonged adjustment efforts is most disappointing, because it cannot be realistically expected that the process of diversifying the economy, stabilizing the financial sector, and improving the viability of the balance of payments can be achieved under these conditions. The statement on page 17 of the staff report that "merchandise exports are projected to grow faster than expected at the outset of the ESAF program, with the main thrust coming from nontraditional exports" was already somewhat suspect,

because the rationale for such an optimistic projection was not readily apparent. Naturally, the fact that Kenya's traditional export sectors have been negatively affected by external developments increases the need for increased exports in other, nontraditional fields; however, the link between recognizing that necessity and forecasting its achievement is not clear. Furthermore, the negative developments in competitiveness make me wonder whether the balance of payments forecasts for 1990 and beyond are not overly optimistic.

In these circumstances, one cannot avoid questioning the traditional "flexible exchange rate policy" recommendation offered by the staff. Kenya has consistently applied the Fund's advice with regard to its exchange rate, and it has depreciated in nominal effective terms by some 50 percent over the past several years. Despite this massive adjustment, the very interesting analyses provided in Appendix VI of the staff report point to a worsening in the competitive position. Should Kenya therefore increase the dosage of the treatment in terms of exchange rate depreciation, or should alternative policy instruments be utilized? If the competitive position proves to be inadequate, as current information suggests, exchange rate corrections will probably be unavoidable. However, even if more of the same medicine is called for, action cannot be limited to that field alone. The discovery of a weakening in the external competitive position increases the necessity of implementing tight fiscal and monetary policies so that nominal exchange rate corrections can be maintained in real terms over time. On that point, I agree fully with the comments made by Mr. Fogelholm, Mr. Goos, and Mr. Hogeweg in favor of a larger contribution by internal adjustment to the restoration of external competitiveness. These observations and questions only underscore the necessity of undertaking, at the midyear review of the program, a thorough investigation and assessment of exchange rate developments and the evolution of external competitiveness. The goal should be to develop detailed policy advice on the basis of an historical analysis of the price transmission mechanisms as they operate in the Kenyan economy, in order to detect and correct the negative movements that have appeared over time.

The staff representative from the African Department noted that, with respect to budgetary pressures, the staff shared the concern of a number of Directors about the slippages in realizing the target on wage bill growth in 1989/90. In particular, the growth in civil service employment was a cause for concern. That growth had been affected significantly by the increase in the number of teachers following the introduction of the 8-4-4 System and could not be expected to subside until the system was fully in place. However, since the staff felt that the increase in wages was a structural

problem, it had pressed the authorities on that subject, and the growth of the civil service was expected to be reduced to 2 percent in 1990/91.

The authorities had given assurances that the recent wage increases reported in the Nairobi press were consistent with the program targets, the staff representative continued. The press had not made clear that those increases affected primarily civil servants and teachers in the lowest seven salary groups, who received increases of 8-10 percent, depending on their grade. Therefore, because of its exclusion of most professional workers, the wage hike would still remain within the guidelines of the program.

In assessing other types of expenditure, one should remember that Kenya had experienced a number of border incidents during the past year, the staff representative remarked. The expenditures arising from those incidents, combined with the troops that the authorities had been maintaining in Namibia as part of an international peacekeeping effort, had made it difficult for them to realize the reductions hoped for in those nonpriority areas of expenditure.

With respect to monetary policy, the growth of net domestic assets in 1989 was undoubtedly attributable to the growth of domestic credit, the staff representative stated. That development reflected the expediency on the part of the authorities that Mr. Enoch had referred to and was precisely the reason why steps had been taken to tighten the performance criteria through the introduction of the net domestic assets measure. The use of that measure as a performance criterion, along with other steps that the authorities were committed to implementing in 1990, should help to produce a tight monetary policy.

The tightening of monetary policy was reflected in the increase in interest rates that took place in March 1990, the staff representative continued. Deposit rates and lending rates were raised by 1 percentage point at that time, with the new minimum deposit rate at 13 1/2 percent, the short-term lending rate at 16 1/2 percent, and the long-term lending rate at 19 1/2 percent. Furthermore, the elimination of restrictions on fees and charges represented a fairly important policy change insofar as it effectively liberalized interest rates, giving commercial banks the freedom to charge rates above the ceilings.

The staff, including members of the Central Banking Department, was focusing on the institutional rigidities in the monetary sector that had limited the ability of the Government to market treasury bills, the staff representative observed. Breakthroughs in that area would play an important part in strengthening Kenya's monetary policy.

In the external sector, the staff representative noted, Kenya was on the verge of an agreement with IDA on export promotion. It was expected that an appraisal mission would take place in the first week of June 1990, and that a sectoral credit agreement with the World Bank would effectively

introduce a duty exemption system parallel to the present import compensation system by the beginning of July 1990. Within 18 months, both of those systems would be replaced by a duty drawback scheme, which should significantly enhance the competitiveness of those exporters experiencing difficulties in getting rebates on tariffs on import inputs.

By working with the Government on reducing and simplifying government regulations and controls, permits, licenses, and policies for the repatriation of profits and dividends, the World Bank was also helping to enhance the role of direct foreign investment in relation to export promotion, the staff representative continued. Moreover, the program for export promotion would attempt to focus on specific sectoral markets, using World Bank expertise and technical assistance to help exporters penetrate European and regional markets for textiles, leather and leather products, processed foods, and basic middle manufactures.

With respect to the Kenya Airways' lease contract, the staff representative stated, discussions had been held in Nairobi in September 1989 with the authorities on management problems and the need for an overhaul of the fleet. At that time, the urgency of the need to upgrade the quality of the fleet had not been made clear, as the discussions had focused primarily on the size of the work force and the quality of the airline's management. However, the staff had emphasized to the authorities that any action to refurbish the fleet by engaging in lease contracts or borrowing to buy new planes should be accompanied by a serious investigation into the organization of Kenya Airways. The authorities had subsequently sought technical assistance from the World Bank and hired management consultants on their own, with the result that a management restructuring plan, including cutbacks in staffing, was expected to be introduced later in 1990. The leasing of the airplanes had taken place after those discussions and was therefore consistent with the authorities' overall efforts to deal with the management problems of the airline.

Following the completion of a relevant IDA study, a restructuring plan for the textile industry would also be formulated in the summer of 1990, the staff representative commented. Because textiles constituted an important part of the items contained in Schedule IIIC, it was expected that the completion of the study would lead to the further liberalization of many items in that category.

With respect to exchange rate policy, the thrust of the staff's efforts had been to tighten fiscal and monetary policies and, secondarily, to eliminate the factors that had been inhibiting exports and in general creating inefficiencies in the export sector, the staff representative from the African Department said. In addition to implementing fiscal and monetary policies consistent with the program, it was expected that the authorities would eliminate any overvaluation that developed in the exchange rate during the course of the year. The staff had also focused on the measure of inflation that the authorities had been using, and which, as most international

donors had observed, was inadequate. The Government was hoping to produce a new consumer price index by the end of the year that would give a better sense of the extent to which an erosion of competitiveness had taken place. Meanwhile, its own studies led the staff to believe that further exchange rate action might be necessary. From end-1989 to end-March 1990, there had been a real effective depreciation of approximately 4 percent, and it was felt that the authorities would take the appropriate measures needed to restore competitiveness during the year. It was also expected that a narrowing of the differential between the official and the parallel market exchange rates would occur during the year.

The staff representative from the Exchange and Trade Relations Department suggested that the exchange rate policy in the staff report could have usefully emphasized that an exchange rate level consistent with external viability "would be sustained" by tight fiscal and monetary policies, rather than "can be sustained" by those policies. In other words, domestic inflationary pressures should be avoided by pursuing as tight a fiscal and monetary policy stance as possible. Furthermore, once the equilibrium exchange rate was approached, fiscal and monetary policies should be used to limit those inflationary pressures that might undermine it.

Evaluating the effects of exchange rate devaluations on African countries--and particularly their effects on inflation--could sometimes present a dilemma, the staff representative continued. While large amounts of domestic expenditure on projects could generate future payoffs, they could also cause domestic absorption and inflation to rise in the short run. In that context, a country's capability of reducing quickly its inflation rate relative to partner countries might be constrained. Furthermore, the gains from cutbacks in projected expenditures should be viewed in light of the fact that inflation was not that severe a problem for Kenya: the projected rate for the current year was 7 1/2 percent, but even the 1989 rate of 10 percent was lower than the rates of Kenya's partner countries--and much lower than the inflation rate in other Fund-supported countries.

In the case of Kenya, the staff representative remarked, the objective was to tighten demand-management policies so as to eliminate any domestic feedback operating through the cost side of the inflationary process that could undermine exchange rate stability. To the extent that inflationary pressures were already in the pipeline, and that overvaluation had already developed via the cost structure, the authorities' preference--for political and other reasons--was to make a gradual adjustment over a period of six or eight months, rather than a one-time adjustment.

To reduce the inflation rate and correct exchange rate overvaluations already in the system through demand-management measures alone was a very delicate task, the staff representative from the Exchange and Trade Relations Department observed. Adding to the difficulty were the political complications that frequently surrounded the process and the impossibility of determining precisely the equilibrium exchange rate. The Fund staff did

not advocate that the authorities should depreciate immediately to correct every instance of overvaluation or small misalignments; in the real world, it was much more realistic to ask whether a sizable overvaluation existed and could be adjusted in three or six months.

Mr. Enoch said that the determination of an appropriate exchange rate policy was partially an empirical question that depended upon various linkages, including the one that Mr. Fogelholm had identified between export-import performance and the real exchange rate. Mr. Fogelholm had referred to a study demonstrating that export performance in Kenya had not responded to changes in the exchange rate, but the staff had made clear that, in fact, there had been no depreciation of the real exchange rate; if anything, the movement had been in the opposite direction. On the other hand, a recent World Bank study had pointed to the very strong, positive effects of improvements in the real exchange rate on export performance in many countries.

The relationship between the exchange rate and domestic prices and costs that Mr. Goos had referred to was another empirical question, Mr. Enoch continued. To the extent that an exchange rate change could quickly have a substantial effect on domestic prices and costs, it was less useful as a policy tool. One could argue, however, that domestic cost restraint went hand in hand with an appropriate exchange rate policy. In the case of a country using a domestic nominal anchor, for example, nominal wage price restraints could be set at a certain percentage. Actions of that type would help to reduce concern about the inflationary effects of exchange rate policies.

A very important distinction had been drawn by the staff representative from the Exchange and Trade Relations Department between a flexible exchange rate policy, which implied depreciations over time--perhaps following the movements of a parallel rate--and a one-time devaluation, Mr. Enoch noted. In that respect, there might well be common ground between the advocates of stable rates and those believing in the strength of exchange rate effects, who would prefer a single, one-step devaluation to a rate that was flexible over the long term. A comparison of the economic effects of the two approaches to devaluation would indicate that the expectational impact on domestic prices and costs could be quite different. Expectations of continued further depreciation could perhaps be managed more easily if the authorities made clear that, having enacted a one-time devaluation to correct the initial disequilibrium, they were now pledged to maintain a stable rate, than if they were to announce that only a part of the devaluation had been completed.

A detailed analysis of the differing impacts of those two approaches to devaluation could be useful and interesting, Mr. Enoch concluded. Although, as the staff representative from the Exchange and Trade Relations Department

had remarked, a once-and-for-all devaluation might be more difficult politically, that consideration should not enter into the staff's assessment of the relative merits of the two strategies.

The staff representative from the African Department remarked that the competitiveness of exports had been affected not only by the exchange rate, but also by restrictions and institutional rigidities in the market. The inadequacy of the export compensation scheme had made it difficult for exporters to recoup the cost of tariffs on their intermediate inputs and raw materials, and infrastructure-related problems had affected exports in a number of sectors, particularly horticulture. Moreover, restrictions with respect to foreign direct investment had had a negative impact on exports.

Mr. Hogeweg commented that the relaxed attitude that the staff representative from the Exchange and Trade Relations Department had seemed to take to Kenya's inflation rate was somewhat surprising. Since the current inflation rate of 10 percent and the projected rate of 7 1/2 percent had been measured using the old, inadequate index, the underlying problem--as reflected in recent effective exchange rate movements--was actually much worse. Those developments were worrisome and served to underscore the concern that the continued slide of the nominal exchange rate might undo its own intended effect by destabilizing the domestic economy.

The staff representative from the Exchange and Trade Relations Department said that, rather than advocating a more relaxed attitude to inflation, the staff had urged the implementation of the tightest possible financial and fiscal policies in Kenya. Furthermore, the staff agreed that further progress should be achieved in that direction, suggesting that Kenya should aim for an inflation rate comparable to those of its most successful noninflationary partners. It was fully expected, therefore, that the current expenditures arising from aid flows would generate positive returns in the medium term.

The staff representative from the African Department added that the financial program for 1990 had been tightly formulated on the assumption that the inflation rate would actually be held to 7 1/2 percent during the year.

Mr. El Kogali said that he had noted with interest the comments by Mr. Hogeweg, Mr. Fogelholm, and Mr. Goos on exchange rate policy. The staff should devote more attention to that area, since many of the countries in his constituency had questions about the implementation of exchange rate policy and its efficacy in correcting distortions in their countries. In Malawi, for example, there was considerable discussion on the relative merits of a one-time-only devaluation versus a flexible exchange rate policy.

Competitiveness in many African countries was not merely a function of the exchange rate, Mr. El Kogali continued. Problems in the field had to be

contended with, including the availability of workers and the seasonality of work, and the cost--as opposed to the rate--of exchange. Exchange rate devaluations and the provision of stronger incentives to farmers would not be sufficient to overcome those structural rigidities. In Sudan, for example, the preparation of the cotton crop required the migration of laborers from the western part of the country to the central regions during the summer months. Labor shortages or unusually rainy weather could therefore easily sabotage that sector of the economy. In those circumstances, therefore, a study of the structural rigidities endemic to that part of Africa--in conjunction with an analysis of exchange rate policy options--would be useful.

It was important to emphasize the connection between an export diversification program and the terms of trade, Mr. El Kogali stated. The downturn in coffee prices, for example, did not mean that a discovery of copper in Uganda would automatically lead to a large investment in an indigenous copper industry. In deciding whether to invest in copper, the investors would be guided by movements in the price of copper vis-à-vis other commodities. In that sense, therefore, the success of a country's diversification process was closely related to its terms of trade.

With respect to Kenya Airways, the immediate objective was to rationalize its structure and establish sound management techniques, Mr. El Kogali said. Beyond that relatively limited consideration, however, there was a need to work toward the integration of all the various national airlines in Africa; at present, air travel from West Africa to East Africa was quicker and more convenient via Europe than directly across the continent. The improvement of air travel in Africa should therefore be considered in the context of the cultural, as well as the economic, integration of the region. Profitability should not be the sole criterion of a successful airline.

The Acting Chairman remarked that exchange rate policy had always been a difficult aspect of adjustment efforts in Kenya. In the mid-1980s, in particular, the staff had come under great criticism from the Executive Board for not having pressed aggressively enough for exchange rate adjustment. At that time, Kenya's case had been cited as an example of the lack of cooperation between the World Bank and the Fund, as the World Bank had balked at approving export and import loans to the Government because of a perceived exchange rate misalignment. That debate had led to the inauguration of exchange rate adjustments in 1985 and 1986 to achieve competitiveness. Nonetheless, the continued existence of import rigidities and anti-export biases created the impression that the question of the exchange rate and its relation to domestic policies had somehow not been dealt with adequately. Therefore, a case study of the Fund's involvement in the Kenyan economy from the late 1970s to the present could be useful.

The Acting Chairman made the following summing up:

Directors commended the authorities for continuing to demonstrate a commitment to economic adjustment and structural reform. They noted that, under the 1989 program supported by the first annual arrangement under the enhanced structural adjustment facility, the end-September performance criteria and most of the benchmarks for the year had been met. More specifically, Directors observed that fiscal policy on the whole was on target as were interest rate and exchange rate policies. They welcomed the progress made in implementing the program's structural measures. They regretted, however, the larger than programmed increase in the Government's 1989/90 wage bill, the higher than targeted monetary expansion in the second half of 1989 that had contributed to inflationary pressures, and the slower than expected progress on some structural reforms, particularly with respect to state enterprises.

While Directors felt that Kenya's performance had been satisfactory, the view was forcefully conveyed that Kenya should adopt more ambitious objectives and adjustment policies, in order to bring down the rate of inflation and achieve a higher rate of sustained growth. There was a clear need for broader action to strengthen the competitive position of the economy, improve industrial efficiency, reduce the structure of domestic protection, and lower Kenya's reliance on foreign assistance while permitting an increase in foreign investment.

Directors observed that stronger monetary restraint and continued fiscal adjustment were called for. Directors, therefore, endorsed the tightening of the stance of financial policies. They welcomed the programmed tightening of monetary policy, including the recent increase in interest rates and the removal of the cap on fees and charges, deeming them important steps toward the interest rate liberalization scheduled for June 1991.

Directors noted that the programmed reduction in the fiscal deficit was critical to the success of the adjustment effort. The continuing high rate of growth in government employment in 1989/90 and the rate expected for 1990/91 were disappointing. They stressed that, in the event of further slippages in the wage bill, the authorities needed to make comprehensive cutbacks in low-priority expenditures. Directors welcomed the recent introduction of a value-added tax and cost sharing in health and education, and encouraged the authorities to continue efforts to broaden the tax base and to enhance its efficiency and equity.

Directors expressed concern about the slow progress made in restructuring several major state corporations, which remained a

source of considerable inefficiency in the economy. They urged the authorities to make public enterprise reform initiatives, including privatization, a more central part of the structural adjustment effort over the medium term.

Directors regarded the growth of nontraditional exports as key to sustained economic expansion. Diversification had become critical in light of the recent decline in international coffee prices and Kenya's historical dependence on coffee; indeed, the continued external vulnerability of the economy underscored the need for diversification. To that end, both exchange rate policies and specific initiatives to reduce the antiexport bias of the economy and open it further to imports, including an appropriate reform of the protective tariff structure and removal of administrative obstacles to efficient performance, should be used in a stable macroeconomic environment to improve the overall competitiveness of production.

Directors stressed that Kenya would have to adhere firmly to a prudent foreign borrowing policy, so that the projected decline in the debt-service ratio was attained. They welcomed the recent debt cancellation initiatives by several bilateral creditors, but observed that Kenya remained highly dependent on concessional assistance, and that this dependency needed to be reduced over time.

It is expected that the next Article IV consultation will be held on the standard 12-month cycle.

The Executive Board then took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision relating to Kenya's exchange measures subject to Article VIII, Section 2(a), and in concluding the 1990 Article XIV consultation with Kenya, in the light of the 1990 Article IV consultation with Kenya conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Kenya maintains the restrictions on payments and transfers for current international transactions as described in SM/90/64 in accordance with Article XIV, Section 2, except that there are restrictions subject to Fund approval under Article VIII, Section 2(a), in the form of limits for the remittances of rental income of nonresidents and of a foreign exchange budget on the basis of which import licenses for nonliberalized import items are issued. In the circumstances of Kenya, the Fund

grants approval for their retention until June 30, 1991, or the conclusion of the next Article IV consultation with Kenya, whichever is earlier.

Decision No. 9421-(90/68), adopted
April 30, 1990

Enhanced Structural Adjustment Facility - Second Annual Arrangement

1. The Government of Kenya has requested the second annual arrangement under the enhanced structural adjustment facility.

2. The Fund has appraised the progress of Kenya in implementing economic policies and achieving the objectives under the program supported by the first annual arrangement, and notes the updated policy framework paper (EBD/90/104).

3. The Fund approves the arrangement set forth in EBS/90/64, Supplement 2.

Decision No. 9422-(90/68), adopted
April 30, 1990

2. BAHRAIN - 1990 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1990 Article IV consultation with Bahrain (SM/90/58, 4/5/90). They also had before them a background paper on recent economic developments in Bahrain (SM/90/63, 4/16/90).

Mr. Finaish made the following statement:

Since the most recent Article IV consultation in 1988, the Bahrain authorities have continued to implement policies aimed at diversifying the domestic economy to reduce its dependence on the oil sector. In this task, they have made considerable progress. The authorities have encouraged the growth of a regional service and financial sector and the establishment of a manufacturing sector. The availability of natural gas has facilitated the development of energy-intensive basic industries, including aluminum and petrochemicals, while steps have also been taken to broaden the industrial base so as to utilize the output of these industries in downstream activities. The diversification effort has been supported by a well-established infrastructure, skilled manpower, and an exchange and trade system that is almost completely open.

Kenya, 1794

315

IMF OFFICIAL MESSAGE

WASHINGTON, D. C. 20431

DO NOT SOFT ROLL EXCEPT WHEN ALIGNING INTO LINE 23

START ADDRESS IN THE BOX

The Treasury
Ministry of Finance
P.O. Box 30007
Treasury Building, Harambee Avenue
Nairobi, Kenya

1990 APR 30 PM 7 54

MARK XX FOR CODE
(_______) CODE

DISTRIBUTION

CC: SEC
MD
DMD
MR. EL KOGALI
AFR
ETR
FAD
LEG
RES
TRE
MR. H. SIMPSON

START TEXT HERE

Executive Board took following decisions April 30, 1990:

quote

A. Kenya - Decision Concluding Article XIV Consultation

1. The Fund takes this decision relating to Kenya's exchange measures subject to Article VIII, Section 2(a), and in concluding the 1990 Article XIV consultation with Kenya, in the light of the 1990 Article IV consultation with Kenya conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Kenya maintains the restrictions on payments and transfers for current international transactions as described in SM/90/64 in accordance with Article XIV, Section 2, except that there are restrictions subject to Fund approval under Article VIII, Section 2(a), in the form of limits for the remittances of rental income of nonresidents and of a foreign exchange budget on the basis

DO NOT TYPE HERE

IF REQUIRED INITIAL BELOW

SPECIAL INSTRUCTIONS — TEXT MUST END HERE

TELEX NO.:

DRAFTED BY NAME (TYPE): TWalter:BJOwen:jrw EXT.: 6712 DEPT/DIV: SEC DATE: 4/30/90

AUTHORIZED BY NAME (TYPE): Leo Van Houtven AUTHORIZED BY NAME (TYPE):

TYPE ** ON LAST OR ONLY PAGE OF MESSAGE

Log A 1493

SEC. 48 (a) REV. 3 11-21-88 CONTINUOUS

SIGNATURE (PLEASE KEEP SIGNATURE IN SPACE ALLOWED) SIGNATURE

IMF OFFICIAL MESSAGE
WASHINGTON, D. C. 20431

DO NOT SOFT ROLL EXCEPT WHEN ALIGNING INTO LINE 23

MARK XX FOR CODE
(________) CODE

START ADDRESS IN THE BOX

Kenya

DO NOT TYPE HERE

DISTRIBUTION

START TEXT HERE

of which import licenses for nonliberalized import items are issued. In the circumstances of Kenya, the Fund grants approval for their retention until June 30, 1991, or the conclusion of the next Article IV consultation with Kenya, whichever is earlier.

B. Kenya - Enhanced Structural Adjustment Facility - Second Annual Arrangement

1. The Government of Kenya has requested the second annual arrangement under the enhanced structural adjustment facility.

2. The Fund has appraised the progress of Kenya in implementing economic policies and achieving the objectives of the program supported by the first annual arrangement, and notes the updated policy framework paper (EBD/90/104).

3. The Fund approves the arrangement set forth in EBS/90/64, Supplement 2. unquote

Van Houtven, Secretary, Interfund

IF REQUIRED INITIAL BELOW

SPECIAL INSTRUCTIONS

TEXT MUST END HERE

TELEX NO.:

DRAFTED BY NAME (TYPE):

EXT.:

DEPT /DIV:

DATE:

AUTHORIZED BY NAME (TYPE):

AUTHORIZED BY NAME (TYPE):

TYPE ** ON LAST OR ONLY PAGE OF MESSAGE

Log

SEC. 48 (a) REV. 3 11-21-88 CONTINUOUS

SIGNATURE (PLEASE KEEP SIGNATURE IN SPACE ALLOWED) SIGNATURE

Kenya, 1784

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR
AGENDA

CENTRAL FILES
ROOM C-532

0408

EBD/90/104

April 4, 1990

To: Members of the Executive Board

From: The Secretary

Subject: Kenya - Enhanced Structural Adjustment Facility - Policy Framework Paper, 1990-92

Attached for consideration by the Executive Directors is the policy framework paper under the enhanced structural adjustment facility for Kenya. This subject, together with the staff report for 1990 Article IV consultation with Kenya and its request for the second annual arrangement under the enhanced structural adjustment facility (EBS/90/64, 3/30/90), is tentatively scheduled for discussion on Monday, April 30, 1990.

Mr. Heller (ext. 8353) or Mr. Katz (ext. 7465) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

KENYA

Enhanced Structural Adjustment Facility Policy Framework Paper for 1990-92 1/

Prepared by the Government of Kenya in collaboration with the staffs of the IMF and the World Bank

April 2, 1990

I. Introduction

1. In 1987 there was a significant deterioration in Kenya's terms of trade compared with 1986. The current account deficit widened to 6.0 percent of GDP, and the overall balance of payments reverted to a deficit. There was a major loss of foreign exchange reserves, and the import regime was tightened. The inflation rate accelerated and real GDP growth declined, reflecting in part less favorable weather conditions. In view of the deterioration in financial and economic conditions, and in line with the objectives set out in the Government's 1986 Sessional Paper on Economic Management for Renewed Growth, the Government in late 1987 adopted a major stabilization and structural adjustment programme. The overall objectives of the programme were to revive prospects for accelerated growth and to provide productive employment for the rapidly growing labor force. The programme was supported by an 18-month stand-by arrangement from the IMF, and a three-year arrangement under the Fund's structural adjustment facility, both of were approved on February 1, 1988. The programme was also supported by IDA sectoral adjustment lending for the agricultural and industrial sectors, with cofinancing from other donors. Under the structural adjustment programme, the Government set out to improve the economy's growth performance, reduce the rate of inflation, and progressively narrow the current account deficit to a sustainable level through financial stabilization policies and a phased introduction of structural reforms over the programme period in agriculture, industry, government expenditure, the financial sector, and state corporations.

2. Performance under the 1988 programme was on the whole positive. The major elements of the adjustment programme were successfully implemented and, as a consequence, the objectives of the programme with regard to growth, financial stability, and the external sector were to a

---

1/ This paper updates and extends the policy framework paper of April 26, 1989, (EBD/89/123) and has been prepared in conjunction with the second year of the Enhanced Structural Adjustment Facility (ESAF).

large extent achieved. In early 1989 the Government requested support under a three-year arrangement under the ESAF for its 1989-91 programme, which was designed to broaden and reinforce the adjustment process and set the stage for a sustained export-led growth. The programme aims to achieve a real GDP growth higher than the population growth rate, to reduce the rate of inflation to the average of Kenya's main trading partners, to curtail substantially the external current account deficit, and to build up Kenya's net official international reserves. To attain these objectives, the programme for 1990-92 stresses the further tightening of the fiscal stance; tackling structural issues related to the budget and state corporations; implementing structural reforms in the financial, trade and industrial sectors, and pursuing flexible exchange and interest rate policies; as well as other market-oriented domestic policies. The reforms in the financial and industrial sectors are also being supported by IDA through sector adjustment credits and cofinancing by other donors.

II. Performance Under the 1989 Adjustment Programme

3. For 1989--the first annual programme supported under the ESAF arrangement-- the rate of real GDP growth was targeted at 5.1 percent, CPI inflation was set to decelerate to 8.0 percent (from 10.4 percent in 1988), and the external current account deficit (including official transfers) to be reduced from the equivalent of 5.3 percent of GDP in 1989 (8.3 percent excluding official transfers) to 4.0 percent in 1989 (7.0 percent excluding official transfers). To support the stabilization effort, the programme provided for a tightening of the fiscal stance, with the 1988/89 budget deficit to be contained at 4.5 percent of GDP (6.9 percent excluding grants). A tight monetary stance was to be maintained, supported by a flexible exchange rate policy to achieve competitiveness. In the context of overall medium-term objectives, the programme also addressed key structural areas in the budget, state corporations, the industrial sector and external trade, and the financial system.

4. With the implementation of these policies, performance under the 1989 programme was on the whole encouraging. The real GDP growth rate is estimated at 5.0 percent--virtually on target, despite less favorable weather conditions at the beginning of 1989, and lower-than-anticipated coffee production. The inflation rate of 10.1 percent, while representing a slight deceleration from the 10.4 percent rate of 1988, was higher than the 8.0 percent programmed, largely reflecting greater-than-targeted growth in broad money. The overall budget deficit on a commitment basis in 1988/89 was 4.6 percent of GDP (6.9 percent excluding grants), only slightly above the programme target of 4.5 percent of GDP. This fiscal outcome reflected both lower expenditure and revenue in relation to the budget targets. The financing of the 1988/89 deficit was largely from external and domestic nonbank sources, with bank financing confined to 0.1 percent of GDP, compared with the programmed 1.4 percent of GDP (1.3 percent of revised GDP), owing to a substantial

increase in unpresented cheques; adjusting for the liquidation of these cheques in early July 1989 results in a cash deficit of about 4.6 percent of GDP and domestic bank financing equivalent to about 1.3 percent of GDP. During the second half of 1989, the Government pursued a fiscal policy that was broadly in line with the targeted fiscal deficit of 4.2 percent of GDP (6.8 percent excluding grants) for 1989/90. During the same period the Government utilized domestic bank resources as programmed to finance the deficit, and interest rates on deposits and lending were raised so as to tighten the stance of monetary policy. The increase of broad money was 17.8 percent compared with the 11.6 percent target, following an expansion of 8.3 percent in 1988.

5. External sector developments during 1989 were consistent with the programme. The current account deficit decreased to 4.5 percent of GDP (including official transfers and excluding leases) compared with a programmed share of 4.0 percent, and 5.3 percent in 1988. A higher trade deficit--which was mainly to lower international coffee prices--was virtually offset by a larger capital account surplus than anticipated. The overall balance of payments surplus at SDR 52 million ($67 million), was some SDR 6 million ($8 million) below the programmed level. Consequently, gross foreign reserves rose by SDR 33 million ($42 million), compared with the programme target of SDR 40 million ($51 million). External policies were pursued as programmed. The exchange rate continued to be flexibly managed, depreciating by 7.2 percent in real effective terms compared with 2.2 percent during 1988 to restore competitiveness, while the liberalization of imports proceeded. The limits on the contracting or guaranteeing of government external borrowing on nonconcessional terms were observed and external debt service obligations were met on time.

6. Progress continued to be made in 1989 in implementing the structural policy measures of the programme. In the agricultural sector, the annual review of producer prices was undertaken and producer prices for beans, maize, and wheat were raised to improve production incentives; the monopoly procurement of cotton by the Cotton Board was removed; and a study of the sugar industry was completed. With a view to improving agricultural input supply, a fertilizer policy paper was approved and steps were taken to implement its recommendations. The financial restructuring of the National Cereals and Produce Board (NCPB) was virtually completed and progress was made in its organizational restructuring. Maize trade was opened up to cooperatives and private traders.

7. Other initial steps were also taken to restructure state corporations and to monitor and define their financial relations with the Central Government. These included allowing Kenya Railways to begin to operate on commercial principles, financial restructuring of Kenya Railways and South Nyanza Company (SONY), monitoring the financial performance and flow of funds of ten nonfinancial state corporations, charging market rates of interest on direct government loans to public enterprises, categorizing the government portfolio of state corpora-

tions' loans to clarify the Government's net creditor position, and adopting guidelines and initiating the financial and organizational restructuring of two development finance institutions (DFIs)--the Industrial Development Bank (IDB) and the Industrial and Commercial Development Corporation (ICDC).

8. As part of an effort to enhance the effectiveness of fiscal policy, fiscal structural reforms involving discretionary tax measures, user charges, and expenditure rationalization, were introduced in the context of the 1989/90 budget. In particular, on the revenue side, the export tax on coffee and tea was eliminated, the effective corporate tax rate and the top rate of the personal income tax were lowered, personal income tax brackets were widened, income tax personal exemptions were increased, a presumptive tax on the value of gross sales of agricultural produce was adopted, a bill to replace the manufacturing sales tax with a value-added tax (VAT) and to extend it to business services was presented, and cost-sharing in health and education was introduced and extended in other public services. On the recurrent expenditure side, a number of measures were adopted to curtail the growth of civil service employment and thereby to help contain the growth of the wage bill in 1989/90 at 11 percent. Moreover, capital expenditures were restricted to a smaller number of high priority projects and provisions were made for real increases in operations and maintenance expenditures in such priority sectors as agriculture, livestock, health, roads, and water supply.

9. As part of the financial sector adjustment programme, various structural reforms were introduced. Thus, with a view to maintaining positive real interest rates and eventually attaining market-determined interest rates, in April 1989 the minimum savings deposit rate for commercial banks was raised 2 percentage points to 12 percent and the maximum commercial bank lending rate for loans with maturities greater than four years was raised by 3 percentage points to 18 percent. Subsequently in November 1989, the commercial banks' minimum savings deposit rate was raised further to 12.5 percent and their maximum lending rate for maturities of three years or less was raised to 15.5 percent from 15.0 percent. The maximum lending rate of 18 percent was made applicable for loans of more than three years. Moreover, during the year a new Banking Act was adopted, the supervisory capability of the Central Bank was enhanced, a restructuring programme for eight financial institutions and two building societies was prepared, and an act to establish the Capital Markets Authority was passed.

10. In the industrial sector, the implementation of the industrial sector adjustment programme, geared toward, expanding exports and investment, proceeded as scheduled. Quantitative restrictions were removed on additional import items (thereby raising the value of imports licensed without restrictions to about 93 percent of the value of total 1986/87 imports) and replaced by tariffs. For items that compete with domestic production the import licensing system was streamlined, a system to monitor import licensing was introduced, and the number of

tariff categories was cut from 17 to 12. Moreover, four additional manufacturing-in-bond facilities were approved. In order to foster foreign investment, a high level Cabinet Sub-Committee on Investment was established and investment guidelines were published. Also, with the decontrol of prices for fertilizer, animal feed, and soft drinks the number of items under the Price Control (General) Order was reduced to 18.

III. Objectives and Policies for 1990-92

11. As indicated in the policy framework paper covering the period 1989-91, Kenya's development strategy for the remainder of this century is contained in the Government's 1986 Sessional Paper on Economic Management for Renewed Growth. The paper stresses the dominant role of the private sector in revitalizing the economy and the need for the Government to establish market-based incentives to promote private sector activity. Emphasis is being placed on increased productivity in agriculture and in rural nonfarm activity, a dynamic informal sector, and the restructuring of industrial incentives to eliminate the existing anti-export bias and to improve export competitiveness.

12. During the period 1990-92, in line with the Sessional Paper, the Government's overall objective will be to provide a favorable and balanced macroeconomic environment while addressing the structural problems constraining growth. Despite the higher-than-anticipated inflation, the Government aims at reducing the rate of inflation from 10.1 percent in 1989 to the level expected for Kenya's trading partners by 1992 (about 5.0 percent), strengthening the balance of payments, and progressively reducing the current account deficit excluding official transfers to a sustainable level (5.2 percent of GDP by 1992). In addition, the Government intends to implement sector-specific measures to ensure the attainment of a more ambitious real GDP growth, above 5 percent per annum. Agricultural value added, which grew by an annual average of 4.3 percent in 1987 and 1988 is expected to maintain the high growth achieved, owing to increased yields primarily on smallholdings. Manufacturing value added, which expanded by 5.9 percent annually during 1987 and 1988, is anticipated to grow by an annual average of 6.4 percent over 1989-92, reflecting the processing of agricultural products, a gradual recovery in manufacturing exports, and a revival of manufacturing investment. High economic growth is expected to come mainly from improvement in the efficiency of investment, particularly in the agricultural and industrial sectors, while the savings rate is expected to rise during the programme period, mainly reflecting the improved performance of state corporations, the reform of the financial sector, as well as a gradual reduction in the budget deficit. The behavior of exports will be strongly influenced by the prospects for coffee and tea as well as tourism, and evolution of nontraditional exports. Merchandise export volume is expected to increase on average by about 6 percent annually in the 1990-92 period, with manufactured exports increasing by about 7 percent annually in real terms.

13. In order to achieve these objectives, the Government intends to take action in a number of areas, including:

(a) Structural reduction of the budget deficit, to levels that can be sustained by foreign and noninflationary domestic financing, and that will not crowd out the private sector;

(b) Budget rationalization through: containment of public sector employment to enhance the quality of government services and of maintenance, in an environment of expenditure restraint; and a better prioritization of public investment to ensure a focused implementation of high-quality projects consistent with the capacity to operate and maintain the stock of projects;

(c) Limited use of new nonconcessional sources of external finance, together with increased mobilization of concessional finance from official sources, consistent with the macroeconomic framework;

(d) Greater reliance on market forces to allocate financial resources and the development of money and capital markets under the programme supported by IDA and technical assistance from the IMF;

(e) Reorientation of trade and other industrial incentives to eliminate the anti-export bias, encourage efficiency, promote the growth of nontraditional exports, and encourage domestic and foreign industrial investment;

(f) Maintenance of an appropriate exchange rate policy, to support liberalization in the trade regime, allow the timely and competitive supply of imports, and promote sustained export-led growth;

(g) Further improvement in farmer incentives, agricultural input supply, and agricultural services, particularly for smallholders; and

(h) Restructuring and revitalizing financial and nonfinancial state corporations, including better loan recovery by the Government from these corporations and changes in the mandates and modes of operation of DFIs.

Budgetary policies

14. The Government's objective of having the private sector play the dominant role in revitalizing Kenya's economy has implications for the share of available resources claimed by government expenditure. Whereas the 1986 Sessional Paper envisaged maintaining government expenditure at

about 28 percent of GDP (the ratio achieved in 1984/85), total central government expenditure has steadily increased to more than 30 percent of GDP in recent years.

15. The Central Government's overall cash deficit will be steadily reduced from 4.2 percent of GDP in 1989/90 (6.5 percent excluding grants) to 3.8 percent of GDP in 1990/91 (5.6 percent excluding grants) and to a more sustainable level, presently estimated at about 3.4 percent of GDP, by 1991/92 (5.1 percent excluding grants). The Government aims at sharply reducing domestic bank financing of the deficit by 1991/92, with almost all additional domestic bank credit being channelled to the private sector. In addition, the Government intends to monitor a broader consolidated public sector deficit and ensure that the trend of lower central government deficits is mirrored in the overall public sector financial position (see paragraph 26 below).

16. To accomplish the central government deficit reduction objective, revenue collection will be increased from 22.9 percent of GDP in 1988/89 to 24.0 percent of GDP by 1991/92. In 1989/90, tax revenue will increase, owing to the introduction and revision of existing regulations on sales tax and excise duties, tariffs, and miscellaneous other measures. Revenue from the introduction of a presumptive tax of 5 percent on the value of gross sales of agricultural produce is expected to offset the projected loss in receipts from the elimination of the export tax on coffee and tea. These measures are anticipated to raise revenue by 0.4 percent of GDP. Additional structural revenue measures involving user charges, fees, and taxation are being implemented. Regarding user charges, substantial progress has already been made in agriculture, livestock, and transport (roads). During 1989, the Government also introduced new user charges in health and cost-sharing in education that are anticipated to raise revenue equivalent to about 0.4 percent of GDP. The Government envisages that a rising share of recurrent expenditures will be financed through user charges for health, education, and other public services and that user charges will help to finance improved quality of government services. Structural reforms in taxation policy will also continue to be implemented to broaden the tax base and increase the elasticity of the tax system. In particular, the Government replaced the sales tax with a VAT, which retains the multiple rate structure and introduces a uniform 17 percent VAT on business services on January 1, 1990. The institutional capacity for tax policy analysis in the Treasury will also be strengthened, and computerization and other administrative improvements will be introduced beginning in 1990. These programmes are supported by UNDP, IDA, and ODA.

17. On the expenditure side, the Government will reduce the share of available resources claimed by government expenditure to 29.1 percent of GDP by 1991/92, restructure the composition of expenditure to make it more efficient, and contain the size of unprocessed payment orders and unpresented cheques and eliminate excess votes. In order to enhance the expenditure rationalization effort, the Government has started a system of economic classification of expenditure (personnel expenditure; non-

wage operating and maintenance expenditure; interest payments; expenditure on central government capital formation; and transfers to state corporations, local authorities, and nongovernmental organizations) in the 1990/91 Annual Estimates and 1990/91-1992/93 Forward Budget processes, for programmes (sub-votes), ministries, and the Central Government as a whole.

18. In order to help correct the prevailing imbalance between wage and nonwage current expenditure, the Government aims over the medium term (1990-92) to limit the average wage increases in the Central Government and the Teachers' Service Commission (TSC) combined to about 4 percent annually (taking into account normal annual increments, promotions, and retirements, but excluding salary revisions for particular jobs where necessary to restore or maintain competitiveness with the private sector). Furthermore, the Government will decelerate the growth of central government employment to 2 percent and the growth of TSC employment to 8 percent, in 1990/91. For the remainder of the three-year period, the growth of central government employment will continue to be contained at no more than 2 percent annually, while the growth of TSC employment will be decelerated further. During 1989 the Government has already undertaken measures to restrain government employment, including the freezing of posts that have been vacant for more than six months, a ban on further upgrading or creation of posts during 1989/90 except with specific authority from the Treasury, control over recruitment at lower grades (A-F), the withdrawal of guaranteed government employment for trainees from government training institutions, and a reduction in the number of untrained teachers. In the period ahead, the Government intends to review pre-service training allowances, reorient training gradually toward in-service training, and rationalize housing benefits. Additionally, over the next three years, the Government will steadily increase, in real terms, nonwage operating and maintenance expenditures in priority sectors, including health, agricultural services, road maintenance, and water supply, and develop sectoral norms for defining appropriate staffing and nonwage inputs for different types of public services in priority areas. These policies will gradually reduce the share of the budget going to personnel expenditure while improving the efficiency of the public service. Monthly monitoring systems of wage bill developments and operations and maintenance outlays will also be implemented and operational in 1990.

19. Recent experience has demonstrated that the ranking and selection of donor-assisted activities--whether their economic nature is capital, current, or mixed--and also the ranking and selection of purely locally funded capital expenditures, has considerably improved the quality of expenditure allocation. The Government will strengthen its activity in this area. The Government is concerned that donor-assisted activities should be consistent with overall government priorities, and that the pace of government capital formation should be consistent with the Government's financial capacity to subsequently operate and maintain the capital stock. With these concerns in mind, the Government will shift emphasis toward a shorter, less extensive project list with focus on

completing unfinished projects. Thus, ministries will be required to prepare lists of ongoing and proposed projects (donor-assisted activities plus purely locally funded capital expenditures), with the projects corresponding to identifiable heads or subheads in the budget, costed out on the assumption that they will be implemented expeditiously, and ranked into groups on the basis of sectoral priorities. Priorities will be considered in consultation with the Ministry of Planning and Development. In the Annual Estimates and Forward Budget processes, financial ceilings are currently being applied, enabling the Government to include only the number of projects that it can afford at any point in time to implement expeditiously. Those projects selected for implementation in the Annual Estimates and Forward Budget will be documented as a public sector project list. In addition, the Government will prepare, with the assistance of IDA, a public investment programme consisting of the capital expenditures of the Central Government and gradually increasing its coverage to a larger number of major nonfinancial state corporations.

20. Most of Kenya's external capital comes from multilateral and bilateral sources in the form of highly concessional loans. Kenya's debt service ratio has been about 30 percent during the last five years. Between 1990 and 1992, the Government will continue to limit nonconcessional borrowing that is contracted or guaranteed by the public sector in order to reduce the ratio of debt service payments (inclusive of lease payments) to exports of goods, nonfactor services and private transfers, to below 25 percent in 1992, contributing to a stronger medium-term external payments position.

State corporations

21. In recent years, the Government has begun to take steps to clarify the financial situation of state corporations and the Government's relationships with them. The particular measures have included: formalizing the terms of past government loans to state corporations, enactment of the State Corporations Act, inclusion of 42 enterprises in the State Corporations Forward Budget exercise, implementation of restructuring plans for various state corporations, and requiring state corporations to pay market-equivalent interest rates to the Government, making any subsidies explicit.

22. Over the next three years, the Government will accelerate its efforts to strengthen the economic efficiency and financial performance of state corporations. Building upon the largely case-by-case approach that has been applied thus far to state corporation reform in Kenya, as well as the experience of other developing countries that have initiated comprehensive public enterprise reform programmes, the Government will develop criteria on the basis of which it will designate some state corporations as strategic and others as potential candidates for restructuring. On the basis of this designation, the Government will

review the application of the State Corporations Act with the aim of reducing the level of administrative and other controls over the operations of commercially oriented state corporations.

23. As part of its overall strategy, the Government will assess the scope for developing an overall model of performance agreements with state corporations based upon the experience of Kenya Railways as well as review present policies relating to salary scales, debt restructuring, and debt management. The Government intends to undertake a reform of the present categorization of state corporations' salary scales in commercially oriented enterprises with a view towards reducing the degree of rigidity in the present system and increasing management autonomy. Policies relating to capital and debt restructuring will be formulated, especially for those strategic state corporations that are identified as undercapitalized and faced with excessive debt levels.

24. The Government intends to implement an information system and develop a data bank with technical assistance from UNDP as a basis for assessing policies relating to restructuring and monitoring of budgetary and monetary flows. Beginning in mid-1990, a set of quarterly and annual indicators will be developed for about 20 selected state corporations that are considered to be of strategic budgetary importance. Financial and physical indicators will be used to address the issue of capital restructuring as well as to monitor the overall performance of selected state corporations. Over the programme period, the indicators and data base will be further refined and extended to allow a more comprehensive coverage of the state corporation sector, to enable measurement of the consolidated public sector deficit and an assessment of overall performance in the sector.

25. To further its efforts toward developing an information system, the Government intends to strengthen the existing institutional framework for data collection on state corporations. The Government Investments Division (GID) will devise ways in which this information can be collected on a regular basis and consolidated. It will establish channels of information-sharing with other relevant data centers, including the parent ministries, state corporations, and the Central Bank, and also strengthen coordination efforts with other monitoring agencies, including the Auditor-General Corporations and the Inspectorate of State Corporations. The Ministry of Finance will review the present staffing, training and computerization needs of GID in order to strengthen its analytical and data collection capacity.

26. In order to achieve a better appreciation of the impact of state corporation financing operations on the economy, the Government will begin in 1990 to record the aggregated flow of funds for certain non-financial state corporations, with a view toward developing a limited consolidation of the public sector deficit. The Government will also clarify its position as a creditor of state corporations by completing the process of defining loan terms for past undefined lending, by strictly enforcing collection, and by systematically monitoring its

portfolio of loans to state corporations, including classifying these loans as performing or nonperforming.

27. Kenya Airways has experienced some financial and organizational difficulties in recent years, including deficiencies in management and operations and excess staffing. Based on a forthcoming study financed by IDA, the Government will formulate and implement an action plan for its restructuring.

Monetary and financial sector policies

28. With the aim of reinforcing its overall adjustment efforts, the Government adopted a financial sector adjustment programme in 1989, supported by a financial sector adjustment credit from IDA, and technical assistance from the IMF. In order to further enhance the mobilization of domestic resources and to improve the allocation of such resources, while increasing the flexibility and effectiveness of monetary management, the Government is continuing its efforts to implement the financial sector adjustment programme. The principal objective is increased reliance on market mechanisms to allocate financial resources and implement monetary policy. In particular, indirect monetary policy instruments, such as open market operations, will be used to control liquidity. To enhance the soundness and stability of Kenya's financial system, the regulatory framework and the supervisory capacity of the Central Bank are being strengthened, and weak financial institutions will be restructured. Steps will also be taken to help stimulate capital market activity.

29. In the period ahead, monetary programming and, in particular, reserve money management will be adopted to make daily liquidity management consistent with longer-run monetary policy objectives. At the same time, the Government will broaden the spectrum of available monetary policy instruments and will increase their use, while gradually phasing out the use of direct credit controls to attain monetary policy targets. A Monetary Policy Committee established in 1988 will be responsible for selecting the appropriate instruments and interventions to achieve monetary policy objectives. In tandem with these developments, interest rates will be maintained positive in real terms. During 1990, the Government will review the experience with a broader set of monetary policy instruments and agree with IDA and the IMF on appropriate steps to establish a more market-driven interest rate structure. By June 1991 interest rate ceilings will be removed.

30. To help remove inefficiencies in the financial system, a revised Banking Act was passed by Parliament in 1989, which among other things enables the Central Bank to intervene in institutions prior to insolvency, to restructure, effect mergers, or liquidate as appropriate. The Act also limits advances to insiders and defines exposure and capital adequacy requirements. By June 1990, regulations will be issued, which link capital adequacy requirements to assets and require banks and Near-Bank Financial Institutions (NBFIs) to maintain a prescribed capital/-

assets ratio. The Central Bank will continue to strengthen its capacity to supervise the large number of depository institutions and to intervene and restructure troubled institutions.

31. To facilitate financial reforms, steps will be taken to encourage the development of both short-term money markets, and long-term debt and equity markets. In short-term money markets, secondary trading in Treasury securities will be encouraged through the removal of inappropriate interest rate differentials that are due largely to remaining administrative controls. To complement the market in Treasury Bills, consideration will be given to the creation of private money instruments. Therefore, during 1990 the Government will allow commercial banks that meet prescribed criteria to issue bearer-negotiable certificates of deposit as a first step in introducing private instruments. Other private sector instruments, such as bankers' acceptances and commercial paper, will be introduced more gradually. To stimulate the development of long-term debt and equity markets, the Capital Markets Authority (CMA) has been established in 1990 to promote, develop, and regulate the corporate securities market. CMA will promote capital markets by encouraging public issues and demand for securities as well as encouraging financial intermediaries to develop and participate in underwriting, securities brokerage, and related activities. It will help identify and remove impediments to the supply of securities, demand, and intermediation. CMA will also propose a regulatory system to maintain investor confidence. In line with these objectives, by July 1990 CMA and the Government will propose measures to reduce disincentives to holding and issuing securities, encourage greater participation of insurance companies and other institutional investors in private securities markets, and enhance investor protection. At the time that CMA becomes fully operational, the role of the Capital Issues Committee in setting share prices in respect of domestic companies will be discontinued.

Medium- and long-term development objectives

32. Because of its high rate of population growth, Kenya must pursue a strategy of rapid economic growth. In order to sustain high economic growth, medium-term development priorities will be to: expand and diversify the export base, while improving the enabling environment for the private sector; intensify agricultural production and increase the efficiency of marketing arrangements; and, rehabilitate and improve maintenance of infrastructure. Over the longer term, emphasis will be placed on: reducing population growth; improving the access and equity of social services, especially education and health; and, strengthening environmental management, especially in arid and semi-arid areas and in the wildlife sector.

External trade and industrial policies

33. Medium-term policies in the external sector are conceived as part of a broad strategy to eliminate anti-export bias in the economy and to revitalize the productive sectors. Macroeconomic policies, such as flexible exchange rate management (see paragraph 39), and specific sectoral reforms are to be pursued to establish a diversified basis for growth and to reduce the country's dependence on coffee and tea as its major exports. The thrust of these initiatives is consistent with the Government's recent efforts to promote industrial sector growth, which have aimed at increasing its outward orientation, efficiency, and the share of private investment in the sector.

34. Specific incentives on the external side to promote the efficiency of the industrial sector mainly concentrate on consolidating the reform of the trade system by completing the second phase of the import liberalization programme. In mid-1989, quantitative restrictions were lifted on items in import Schedule IIIB, which consists of about 10 percent of all items and almost 5 percent of 1986/87 import values. Since Schedules I, II, and IIIA were liberalized in 1988, almost 70 percent of all items and 93 percent of 1986/87 import values are now unrestricted. The liberalized imports are mainly raw materials and intermediate and capital goods, including bulk items such as fertilizer and petroleum, priority goods not available in the domestic market, and some goods that compete with domestic production. The import licensing system, which was modified in February 1989 in order to streamline the granting of licenses and to monitor the efficiency of the process, is functioning effectively and the monitoring system shows that the time between the application for a license and the approval of the foreign exchange allocation has been considerably shortened, from over six months to about three weeks.

35. To maintain the momentum of trade reform, the Government intends to liberalize most of the goods that are still subject to quantitative restrictions--those in Schedule IIIC, which are mainly items that compete with domestic production and luxury goods--over the next two years by shifting items from IIIC to IIIB. Schedule IIIC contains 827 items accounting for about 7 percent of the value of imports in 1986/87. A few goods will continue to be restricted for health or national security reasons. There are 25 of these goods and they are estimated to represent 24 percent of the value of goods in Schedule IIIC. They include such items as ivory, game skins, and some military equipment. Unrestricted licensing will be introduced for nonexempt items in Schedule IIIC (except textiles) in two stages in July 1990 and July 1991, with quantitative restrictions being replaced by tariffs in providing protection. Accordingly, 210 items constituting 55 percent of import items in Schedule IIIC will be liberalized by June 1990. These represent a third of the 1986/87 import values of the goods to be liberalized. Another 173 items accounting for 70 percent of the value of eligible imports will be liberalized by June 1991. In addition, unrestricted licensing of textile imports in Schedule IIIC will be

introduced once the comprehensive textile restructuring programme, to be formulated with the assistance of IDA in 1990, has been implemented.

36. An important part of the reorientation of the productive sectors toward more efficient activities has been the replacement of quantitative import restrictions with equivalent tariffs. Tariffs are both more transparent, allowing firms to anticipate the effective costs of importing, and more uniform across goods, resulting in a more even effective protection of domestic activities and leading to more efficient allocation of resources. The quantitative restrictions that were removed on imports in Schedule IIIB in 1989 were replaced by tariffs, as were the import restrictions that were lifted in 1988. At the same time, the combined import-weighted average tariff for goods in Schedules I, II, and IIIA was reduced slightly. Efforts to establish a more even and lower rate of protection will continue.

37. An increasing share of Kenya's future industrial growth and export receipts will have to come from nontraditional exports. The Government intends to complete and submit legislation for the establishment of port processing zones for new manufacturing production by January 1991. The zones will allow firms with a minimum of 50 percent of production going to identified export markets to import inputs free of duty and to operate under streamlined administrative arrangements. In order to reduce anti-export bias for existing export activities, the Government plans to establish a duty drawback/exemption scheme so that exporters of nontraditional goods will pay international prices for their imported inputs. The scheme will be set up in 1990, with assistance from IDA, and the Government intends to have it fully functioning by mid-1991. Access to credit for working capital will also be facilitated by implementing a preshipment export-financing scheme. The Government also plans more decisive action on specific initiatives already taken to increase exports to countries outside the region. Until the duty drawback/exemption system is fully operational the Government is committed to making the export compensation scheme more readily available to more exporting firms. During 1989 the Government reduced its processing time for application for compensation by one third to 22 days and intends to take additional steps during 1990 to further reduce this time, by implementing legislation to enable commercial banks to pay compensation to exporters within 90 days, upon evidence of shipment of goods through customs. Procedures for the manufacturing-in-bond scheme, which has begun operations with 19 facilities licensed and 3 operating in 1989, will be streamlined to encourage more exporters to make use of this facility.

38. To encourage foreign investment, the Government has taken several measures to strengthen the functioning of the investment approval process, which can also play an important role in enhancing export prospects through foreign participation in, for example, manufacturing-in-bond and export processing zones. A Cabinet Sub-Committee on Investment, chaired by the Vice-President and Minister for Finance, has been established to remove some of the bottlenecks in the investment project

approval process. It is expected that project approval delays will be significantly reduced. With regard to price controls, during August-December 1989 the prices of animal feed, soft drinks and fertilizer were decontrolled, reducing the number of controlled items to 18 under the General Order. Further progress will be made in this direction.

39. The Government's aim for industrial state corporations and DFIs is to improve their efficiency through restructuring and improved monitoring and supervision. With the assistance of IDA, the Government has initiated studies to redefine the role of the development banks and has developed a plan for their financial and organizational restructuring. In October 1989, the Government agreed with IDA on an action programme for the rationalization of major DFIs in the industrial sector, IDB and ICDC. The objectives of the programme are to: emphasize profitability and financial sustainability; enhance their role as providers of venture capital and financial advisory services; and ensure that their lending activities are fully integrated within the financial system. Changes in mandates, operating practices, portfolio composition, internal organization, and relationships with official agencies will be required to achieve these objectives. The Government intends to restructure IDB and ICDC over a period of 18-24 months. The Development Finance Corporation of Kenya, which is 70 percent foreign-owned, will be encouraged to undertake a similar set of reforms. The restructuring programme will be implemented beginning in 1990. In addition to improving liability management, adopting new organizational structures, and establishing appropriate information, control, and reporting systems, the programme will develop a mechanism to isolate noncommercial government-directed projects from their portfolios, and design and initiate implementation of a detailed divestiture plan for equity holdings in the DFI portfolios. With respect to the latter, as Kenya's capital market is relatively underdeveloped, a phased combination of public and private placements of loans and equity will be required for the orderly divestiture of DFI assets.

Exchange rate policy

40. To ensure Kenya's external competitiveness, support the import liberalization programme, and strengthen the overall macroeconomic policy framework, the Government is determined to continue pursuing an appropriate exchange rate policy. The Kenya shilling, which is pegged to a basket of currencies, depreciated in real effective terms by 7.2 percent between end-December 1988 and end-December 1989. This flexible approach to exchange rate policy will be continued during the period 1990-92.

Agricultural policies

41. Agriculture accounts for about 32 percent of wage employment, and within that, modern agriculture accounts for some 20 percent of employment. Coffee and tea are responsible for roughly 27 percent and 21 percent, respectively, of merchandise exports. Considerable emphasis is therefore being placed on maintaining strong support for agriculture,

and exploiting linkages with tourism, industry, food security, and poverty alleviation. During 1986-88 Kenya implemented an agricultural sector adjustment programme that had the twin objectives of stimulating agricultural growth through intensification and contributing to fiscal stabilization. Steps were taken toward improving the timeliness, availability, and application of key inputs (fertilizers and seed); increasing the access of smallholders to credit; maintaining price incentives for agricultural producers; deregulating some commodity markets; rationalizing budgetary allocations and expenditures; restructuring designated agricultural state corporations; and raising user charges for livestock services, notably dipping and artificial insemination. As a result of these measures, earlier policy reforms, and favorable weather, agricultural value added increased by about 4 percent a year during 1986-88.

42. The Government remains committed to creating an enabling environment for accelerated agricultural growth and for increasing employment, exports, and food security. As in the recent past, these goals will be pursued through more selective public sector expenditures and interventions, and increased private sector involvement, particularly in output marketing and input supply. Improved extension services also will increasingly take into account the special needs of women farmers. A more comprehensive food security study (in draft since 1988) will be completed following review at the inter-ministerial level. During 1990-92, private sector participation and competition in input supply, pricing, and marketing will be deepened. Farmers will also receive more timely payments from marketing boards, which are undergoing restructuring. The following specific actions will be taken with respect to individual commodities:

(a) Floor producer prices for grains (maize, wheat, and rice), which take into account import and export parity prices and domestic costs of production, will continue to be set and announced by the Government in a timely manner. With respect to maize marketing, two thirds of NCPB's buying centers were closed in 1987/88 while licenses to purchase maize were granted to buying agents, small traders, cooperatives, and millers in 1988/89 and 1989/90. NCPB will continue to reduce its participation in the maize market and move toward a new role as buyer and seller of last resort. Concurrently, the Government will seek to eliminate constraints that have stifled private sector response to the emerging opportunities to market grains. They include a fixed pricing system, which suppresses the efficient functioning of markets; restrictions in issuing licenses to buying agents; delays in developing mechanisms for monitoring the impact of market reform and ensuring orderly deregulation of marketing arrangements; and uncertainty over the Government's cereal sector reform programme. The Government is reviewing the results of a grain pricing study, which aims to provide an improved and more flexible pricing system. Also, a comprehensive transport and

storage study was initiated in 1989. The study, which is scheduled for completion in March 1990, will form the basis for the rationalization of stores, the construction of bulk facilities and increased deregulation of grain transportation across districts.

(b) Producer prices of Kenya's major export crops, coffee and tea, will continue to be based on export auctions. The subsidy on domestically consumed coffee was eliminated when domestic prices were raised on January 12, 1990. In early 1990, the Government will begin implementing an improved system that ensures that farmers are paid a significant proportion of the total price for coffee cherry within one month after delivery. The Government will obtain financial assistance for implementing this system under the IDA-supported Coffee II Project. Meanwhile, by June 1990, the Coffee Board will be enabled through the recruitment of specialized personnel and acquisition of information services to develop a strategy for storage, international marketing, and financing of coffee stocks.

(c) Implementation of the financial restructuring plan for SONY is ongoing and includes conversion of about K Sh 1.0 billion in loans to equity through provisions in the Government's 1988/89 budget; revaluation of assets and strengthening of capital reserves; and offsetting accumulated losses against capital reserve and equity. This financial restructuring will enable SONY to borrow commercially (and independently of the Central Government) starting in 1990 for the full rehabilitation of plant and equipment. Further, an ongoing ODA-financed study is looking into ways of encouraging self-sufficiency in sugar while reducing subsidies on production.

(d) The Cotton Lint and Seed Marketing Board has lost its legal monopoly on purchasing seed cotton and initial steps are being taken to divest its ginneries. In support of these reforms, the Government has approved the adoption of a new cotton pricing system which is based on auctions and which reflects differentials in quality and variety.

(e) The Government is developing a master plan for the milk industry, which will redefine the role of Kenya Cooperative Creameries (KCC) and outline a strategy and policies for increased competition in milk processing and retailing, supported by reforms in milk pricing and marketing. Meanwhile, more timely payments will be made to farmers.

43. Fertilizer prices were decontrolled in December 1990. A fertilizer import plan will continue to be drafted by June each year. Deregulation will be complemented by further increases in the number of distributors, measures to simplify licensing procedures for private importers, and dialogues with donors about monetizing and untying fertilizer aid. User

charges for livestock dipping and artificial insemination have been increased substantially since late 1987, and by 1992 the subsidies on these services will be completely eliminated. The Government will also clarify the future role of the Tractor Hire Service and adjust its service charges to market rates by June 1990.

44. In concert with budget rationalization, overall allocation to the agricultural sector has continued to increase for nonwage expenditure, especially for adaptive research, animal health services, and extension. Several agricultural state corporations are also being restructured into more viable operations that are less dependent on government resources. They include NCPB, Kenya Meat Commission, the Agricultural Finance Corporation, the Cotton Board, and KCC.

Infrastructure

45. Kenya has relatively well-developed infrastructure. During the next three years, increased expenditure will be directed at maintenance and at generally meeting the growing demand from economic and population growth. Particular emphasis will be placed on improving infrastructure in secondary towns, planned as centers of rapid growth in employment, and on upgrading infrastructure for exports. An important thrust of energy policy is to identify and exploit alternative domestic energy sources for both urban and rural consumption. At present, the power sector is meeting urban residential and commercial demand. Nationally, however, only about 6 percent of the population has access to electricity, mainly in Central, Coast, Eastern, Western, and Rift Valley Provinces. A study of rural electrification will be carried out to supplement the 1987 National Power Development Plan, which concentrated mainly on generation. The rural electrification study will focus on long-term rural and urban power requirements; potential supply from hydroelectric, geothermal, and nonconventional sources; linkages between various sources of energy, agriculture, and the environment; and issues pertaining to the economic and financial viability of future urban and rural power investments. A separate study of the related issue of energy pricing will be completed in parallel so that its results can be fed into the rural electrification study. Power projects under way include Turkwel Gorge (106 MW), which will be completed in 1991, increasing the grid generating capacity to 775 MW. Kenya is also developing geothermal energy, which is expected to add 280 MW to the national grid by 2005. In the water supply sector, the Government has a target to provide water near every home by 2000. Currently, the Government is working on a Nairobi Water Supply III Project, construction of which began in 1989, and is continuing to implement the Rural Water Supply Programme with the support of a number of donors.

46. Transport services have not been provided at the lowest possible cost to the economy because of inadequate maintenance and suboptimal rail/road distribution. Necessary resealing of existing bitumen roads, regraveling of existing gravel roads, and upgrading of farm-to-market rural access roads will be given priority nationally over investments in

new roads. An urban transport rehabilitation and expansion programme will be developed, with emphasis on improved maintenance capacity, traffic management, travel conditions for public transport passengers, and parking control and revenues. In January 1990, road-user charges were doubled to reflect the costs of maintenance. Kenya Railways will continue to benefit from a recovery programme that has included additional training and institutional restructuring.

Population and human resource development

47. Although Kenya's fertility and population growth rates remain high, there are encouraging signs of progress in the effectiveness of the Government's population programme. Data from the 1989 Kenya Demographic and Health Survey suggest that there has recently been a significant decline in the desired family size and an increase in the proportion of married women who wish to have fewer children. Moreover, the total fertility rate fell from 7.7 in 1984 to 6.7. Contraceptive use increased from 17 to 27 percent over the same period. Demand for contraceptives, especially modern methods, has been rising much faster than the Government and donors expected. In order to prevent the emergence of contraceptive shortages and to further strengthen recent progress, the Government has requested IDA and cofinancing donors to accelerate processing of the Population IV Project.

48. In line with the Sessional Paper No. 6 of 1988 on Education and Manpower Training for the Next Decade and Beyond, the Government has identified a number of steps toward greater cost-sharing and rationalization of expenditures in the education sector. With effect from the academic year 1989/90, all university students are required to pay for a large part of the cost of their food, accommodation, and tuition. To assist them in these payments, the Government has made changes to the student loans scheme, which is administered through commercial banks. Although loans are not contingent on collateral, parents are required to co-sign the loan application. Over the coming years the Government plans to evaluate implementation of the system, especially its recovery rate, which hitherto has been low (28 percent). In accordance with the policies articulated in the Sessional Paper, the Government is making efforts to consolidate secondary schools and to reduce the number of uneconomic schools. In several districts small schools have been closed and students have been absorbed in neighboring schools. A national census of primary school teachers has recently been completed to verify the number of teachers and eliminate payroll anomalies. Government-assisted secondary schools that have boarding facilities receive a per capita grant from the Ministry of Education to help meet the cost of student accommodation and food. These grants have been decreasing over the years and parents are being asked to make up the difference. Further establishment of boarding schools is being discouraged by the Government in favor of day schools. The Government has also discontinued student allowances at teachers' colleges.

49. With effect from December 1, 1989 the Ministry of Health has adopted a system of user charges in the public health system. The fee structure has been designed so as to avoid a negative impact on low-income groups and to encourage the more efficient provision of health services in government facilities. Dispensaries and various types of patients are exempt from these charges (e.g., children under five years of age, pre- and post-natal care, family planning, and AIDS patients). Revenues generated through user charges will be used to improve services. Of this revenue, 75 percent will be spent to improve services in the generating institution, and the remaining 25 percent will be used to finance preventive/primary health care services in the district. During 1990, the National Hospital Insurance Fund will also be revised to make contributions more progressive and benefits more realistic. Over the coming years, the Government will monitor the system to ensure effective implementation, taking into account its impact on low-income groups, and introduce changes as appropriate.

Environment

50. Kenya's environmental problems stem largely from population pressures on its limited land resources. These environmental pressures are imposing severe constraints on production in the country's agricultural and livestock sectors and contributing to the destruction of wildlife and natural habitats. Environmental problems affecting agriculture include degradation of arable land through reduced fertility and water-holding capacity, coupled with a reduction of dry-season water resources. Soil erosion is the main cause of arable land degradation. Increased upstream offtake of water and reduced replenishment of ground water are the direct consequence of changes in forestry cover. Kenya's forest lands, in both the highlands and the lower semi-arid areas, are being reduced through encroachment by farmers and pastoralists, and indiscriminate harvesting. Despite widespread tree planting, the standing stock of wood is being depleted by about one percent annually. In view of these developments, the Government has renewed its efforts to strengthen its forestry and reforestation programme. The programme aims to strengthen forest legislation, conduct an inventory of natural and plantation forests, increased resources for forest protection, and promote farm and social forestry as well as peri-urban fuelwood plantations. With the support of IDA and FINNIDA, the Government will formulate a comprehensive, long-term master plan for forestry that defines the development and investment programme to 2010. The master plan and related projects will be completed by 1994. The Government is fully committed to policies and strategies of sound environmental management and human settlements. There is now a need to translate broad environmental concerns into specific action plans, which can better define concrete policy measures and investment priorities, to support the rehabilitation and preservation of Kenya's fragile environment. To this end, the Government intends to prepare a National Environmental Action Programme, to be completed over the next two years. While this work gets under way, however, in addition to the forestry sector there are two environmental priority areas where policy and investment needs are

particularly urgent and should not be delayed: arid and semi-arid lands (ASALs) and the wildlife sector.

51. In recent years considerable work has been undertaken by the Government and donors to identify environmental issues and problems of sustainable development in Kenya's ASAL areas--which constitute more than four fifths of the country's total land surface, and carry over 25 percent of total human population and slightly more than one half of the livestock. Rapid population growth and migration from high-potential lands are undermining the fragile ecology of these areas. Population pressure is leading to economic activities that are not only unsustainable over time, and hence have a high social cost, but also threaten to cause rapid environmental degradation. Past efforts to develop ASAL areas failed in part because they did not focus sufficiently on the need to reestablish and sustain the environmental base of economic activity. There is therefore an urgent need to put in place a set of policies and investments that can both halt the environmental deterioration and assure the means for sustainable livelihoods. With the assistance of IDA, the Government will prepare during 1990 an ASAL Environmental Action Plan to: formulate a strategy for the rehabilitation of ASAL ecosystems; assess the infrastructure needs for environmental rehabilitation and environmentally sound economic development; and define an action plan showing investment and policy reform priorities. The Government has recently taken major steps to address the critical situation of Kenya's wildlife sector. In addition to strengthening anti-poaching efforts and banning the export of ivory, the Government has reconstituted the Wildlife Department as a separate agency, Kenya Wildlife Services (KWS), to increase its effectiveness in policy formulation and the management and protection of Kenya's valuable wildlife resources. With the assistance of IDA and other donors, KWS has begun to prepare a long-term strategy and action plan for the development of the wildlife sector in Kenya. In addition to developing a set of investment priorities, the strategy will address a number of key policy issues, including: revenue generation to make KWS self-financing; measures to expand the role of the private sector and local communities in the conservation and management of wildlife; greater sharing of wildlife-generated income with local communities to give them a stake in wildlife conservation; improved land-use policies in dispersal areas; and measures to improve training and extension.

IV. Social Impact

52. Since the magnitude of economic distortions and structural imbalance is less in Kenya than in most other adjusting African countries, the structural reforms required and their potential social impact are correspondingly smaller. Moreover, many of the reforms being implemented will directly benefit lower-income groups such as agricultural smallholders. Nevertheless, the Government recognizes that there may be adverse effects on some groups. In order to minimize possible social costs of the adjustment programme, the Government's reform measures are

being applied in a gradual manner and are aimed at encouraging supply responses, which can reduce the impact of price increases and generate additional economic activity and employment. Overall, the programme is designed to sustain the economy's recent growth momentum and to permit a gradual increase in per capita consumption.

53. The potential adverse effects arise primarily from four sources: exchange rate policy, pricing policy, industrial restructuring, and cost recovery. Since low-income urban families spend about 40 percent of their income on food, they are likely to be adversely affected by the ongoing reduction in consumer subsidies implicit in the evolution of the domestic price structure. For a number of food items, however, the margin between producer and consumer prices is partly attributable to inefficiencies in the marketing system. To the extent that these inefficiencies are reduced, the impact of lower consumer subsidies would be mitigated. Moreover, most of Kenya's poor are agricultural producers and will therefore reap the benefits of higher producer prices while being relatively unaffected by increases in urban food prices.

54. For a number of reasons, the impact of price decontrol for manufactured products on consumers is expected to be relatively moderate. First, supply responses combined with consumer resistance can effectively limit the extent of price increases, as demonstrated by the recent experience with decontrol of meat prices. Second, increased availability of competing imports for many of the decontrolled items would tend to dampen possible inflationary pressures. Third, over the longer term, price decontrol is expected to promote increased capacity utilization and encourage new investment, which would further reduce pressures for price increases while generating additional employment.

55. Aided by appropriate restructuring, much of Kenya's import-substituting industry is sufficiently efficient to withstand increased import competition. Moreover, the envisaged measures in this sector would be sequenced in such a way that expansion in newly favored activities will take place before or simultaneously with contraction of activities affected by reduced incentives and protection. In particular, measures to increase the level and efficiency of investment (price decontrol, import liberalization, export promotion, capital market development) are being implemented early in the programme period, whereas the lowering of tariff protection will take place in later years.

56. In the area of cost recovery, the introduction of user charges for health services includes provisions for the complete exemption of those who cannot afford to pay and for those services that must be encouraged for social reasons, such as child health, family planning, and AIDS treatment. In addition, no charges will be levied for treatment in specialized hospitals (e.g., for spinal injury, leprosy) and mental hospitals. Also, accident victims will not be denied treatment in government hospitals because of nonpayment of fees. The Government has also decided that the entire revenues collected from health user charges

will be automatically used by the health sector for improving and expanding services, and that these revenues will not go to the Exchequer. Moreover, 25 percent of total user charges collected in a district will be used for financing primary health care in that district while the balance will be used by the institutions concerned for improving the quality of services. In the education sector, increased cost recovery is being targeted at the university and the secondary education levels, where mostly high- and middle-income groups tend to benefit from government-subsidized education. Even at these levels, the Government will ensure that children of poor families are not denied access to government education facilities and has for this purpose established the Presidential National Bursary Scheme, which provides financial assistance to meritorious students for access to higher educational facilities. As part of the planned education sector adjustment programme and in consultation with IDA, the Government will also review the costs already being borne by parents at the secondary and primary education levels and identify appropriate policy measures to ensure greater access by the poorer sections of society. A serious constraint on the Government's ability to design and implement targeted interventions to mitigate the social costs of adjustment has been the lack of an appropriate data base and monitoring system. As part of the IDA-supported Rural Services Design Project, the Ministry of Planning is developing a Monitoring and Evaluation System to evaluate the economic and social effects of programmes and strategies in rural areas. Although the major focus of this pilot effort on agricultural policies and projects, the Government is interested in expanding the system to permit a more comprehensive and regular evaluation of household welfare and social conditions. To this end, discussions have been initiated with IDA and other interested donors to support an expanded welfare monitoring system.

V. External Financing Requirements, 1990-92

57. The adjustment policies to be pursued during the programme period are expected to progressively reduce the current account deficit, excluding official transfers, from 8.6 percent of GDP in 1989 to 5.2 percent of GDP by 1992. During the same period, gross international reserves are targeted to increase steadily from 2.2 months of non-government imports to 3.0 months. Kenya's gross external financial requirements during 1990-92, consisting of the current account deficit (excluding official transfers), debt amortization, and necessary increases in reserves, are expected to be about $3.3 billion. In mobilizing these resources, in order to achieve a progressive decline in the debt service ratio (defined in terms of exports of goods, nonfactor services, and private transfers) from 31 percent in 1989 to below 25 percent in 1992, the Government intends to exercise restraint in the contracting or guaranteeing of new nonconcessional loans.

58. Disbursements from existing grant and loan commitments are expected to be $1.0 billion. New grants and loan commitments from official

sources are expected to yield disbursements amounting to $2.0 billion over the 1990-92 period. The proposed ESAF arrangement contributes $211 million of the new commitments. This leaves an additional financing need of $268 million over the three-year period. The Government expects to fill this need with cofinancing on the Financial Sector Adjustment Credit, disbursements from other quick-disbursing IDA credits, and by mobilizing additional balance of payments financing from bilateral sources.

59. For the second year of the programme, 1990, Kenya's gross external financing requirement is expected to be about $1.2 billion. Grant and loan commitments are expected to yield disbursements amounting to some $887 million, of which about one fifth is in the form of grants. Of disbursements in the form of loans, about $84 million relates to programme lending, mostly from IDA. Commercial borrowing accounts for $45 million, while the remainder is taken up by various project loans. With the addition of the proposed ESAF arrangement, and anticipated disbursements from other private sources, total disbursements in 1990 are projected at $1.0 billion. This leaves an additional financing need of $129 million, which the Government expects to fill with the first tranches of the Agricultural Sector and Export Promotion Credits from IDA, cofinancing for the Financial Sector Adjustment Credit, and some balance of payments financing from bilateral sources.

Kenya: Summary and Time Frame for Macroeconomic and Structural Adjustment Policies, 1990-92

	Objectives and Targets	Strategies and Measures	Timing of measures
I. External policies			
a. Exchange rate	Medium-term external viability.	Adjust exchange rate to expand production and diversification, and assure competitiveness in domestic and external markets.	Continuous.
b. Imports	Make protection more transparent and uniform.	See section IIb below.	
c. Exports	Increase nontraditional exports.	See section IIb below.	
d. External debt	Improve information on external debt and reduce the overall external debt service ratio.	Limit public sector external borrowing on nonconcessional terms.	Continuous.
		Establish computerized data base for public and private external debt.	June 1990.
II. Sectoral policies			
a. Agriculture	Maintain and improve producer incentives.	Determine prices for grains (maize, wheat, rice) on basis of import and export parity and domestic costs of production.	Announce floor prices every February.
		Adopt more timely coffee payments system.	June 1990.
		Recruit specialized personnel and acquire management information system for use in developing a strategy for storage, international marketing, and financing of coffee stocks.	June 1990.
		Introduce cotton pricing system that reflects differentials in quality and variety.	June 1990.
		Accelerate payments to farmers by KCC.	Continuous.
		Outline strategy for increased competition in milk processing and retailing.	December 1990.
	Improve efficiency in sugar production and processing.	Restructure South Nyanza Sugar Company.	1990/91.
	Improve efficiency of grain marketing.	Improve marketing arrangements and efficiency, especially of NCPB. Reduce financial burden of grain marketing operations.	1990-92.
		Limit role of NCPB to stock management for market stability, food security, and buyer of last resort.	Continuous.
		Gradually expand the role of private traders, first in primary markets (i.e., farmers), then in secondary markets (i.e., millers).	1990-92.
	Promote the timely delivery and efficient allocation of agricultural produce, inputs, and services.	Continue to provide appropriate budgetary resources for agricultural services research and extension.	1990-92.
		Continue preparation of fertilizer import plan.	Continuous.
		Complete phased removal of subsidy in livestock dipping and artificial insemination.	1992.
		Clarify the role of the Tractor Hire Service and pursue full cost recovery for services provided.	June 1990.
		Restructure the Agricultural Finance Corporation.	1992.

Kenya: Summary and Time Frame for Macroeconomic and Structural Adjustment Policies, 1990-92 (continued)

	Objectives and Targets	Strategies and Measures	Timing of measures
b. Industry and trade	Export promotion.	Strengthen the administration of the export compensation scheme to make payments prompt and more reliable.	Continuous.
		Increase coverage and predictability of the export compensation scheme.	1990.
		Establish and implement a duty drawback/exemption scheme.	June 1991.
		Design and implement a comprehensive firm-level support scheme for small scale exporters.	1990-92.
		Complete prefeasibility study of export processing zones.	August 1990.
		Formulate program including preparation and submission of legislation for export processing zones.	January 1991.
	Import liberalization.	Remove quantitative restrictions currently under Schedule III(C) by moving items to Schedule III(B) (except for items restricted for reasons of health and public safety, and textiles); replacing quantitative restrictions with equivalent tariff rates.	June 1990-June 1991.
		Monitor import liberalization by maintaining system that provides accurate and timely data on approvals of import license applications and corresponding foreign exchange allocations.	Continuous.
		Implement restructuring plan for textile industry, based on findings of technical study to be completed by July 1990.	1990-93.
III. Fiscal policies			
	Adjust fiscal position.	Reduce central government budget deficit to levels that are sustainable by foreign and noninflationary domestic financing.	Continuous.
		Begin to measure public sector consolidated deficit.	1990.
		Limit amount of unpresented cheques to level of end-June 1988.	Each year.
	Increase the effectiveness of expenditure in achieving its objectives, while lowering the level of central government expenditure in terms of GDP.	Continue to measure the economic composition of expenditure in the Annual Estimates and Forward Budget processes, for programmes (sub-votes), ministries, and the Central Government as a whole.	Continuous.
		Formulate training, recruitment, and employment policies with the objective of reducing the growth of government employment, and gradually reducing the share of the budget claimed by personnel expenditure. Reduce intake into civil service of preservice trainees and reorient training institutions to more in-service training; review preservice training allowance.	Starting in 1990.
		Limit growth of personnel expenditure in the 1990/91 budget to 9 percent.	1990/91 budget.
		Set and enforce ceilings for salaries for each operational Ministry and Teachers' Service Commission.	Starting in 1990.
		Introduce monthly monitoring system of government wage bill and operations and maintenance in priority sectors.	1990.

Kenya: Summary and Time Frame for Macroeconomic and Structural Adjustment Policies, 1990-92 (continued)

	Objectives and Targets	Strategies and Measures	Timing of measures
		Have ministries plan staffing levels as part of Forward Budget processes.	Continuous.
		Set targets for increases in real nonwage operating and maintenance expenditures in priority sectors, including road maintenance, agricultural services, health, and water supply.	Continuous.
		Prepare, with IDA assistance, the public investment programme for 1991/92 budget.	1991/92.
		Extend public sector project list to cover capital expenditures of selected nonfinancial state corporations.	Start by 1990/91.
		Maintain and expand user charges for education, health, and roads, and extend to other direct service providing sectors.	Continuous.
IV. State Corporations			
	Establish government objectives; improve financial performance and monitoring; and reduce transfers from Central Government.	Formulate a policy framework paper for state corporations.	August 1990.
		Agree to criteria for classifying state corporations. Designate those that are strategic.	December 1990.
		Review and initiate steps to modify categorization of salary scales in commercially oriented state corporations.	June 1990.
		Review the State Corporations Act to reduce government controls over commercially oriented state corporations.	August 1990.
		Extend from 10 to 20 the number of state corporations for which budgetary impact is monitored; provide a measure of consolidated public sector deficit.	Begin 1990, end 1991.
		Clarify the Government's position as a creditor of state corporations by quantifying on a quarterly basis the level of commitments and payments of debt service by state corporations; categorizing the Government's portfolio of loans to state corporations as performing or nonperforming and strictly enforcing collection of loans.	June 1990.
		Establish an information system and data base for state corporation for a core group of 20 enterprises; devise a set of quarterly and annual indicators of economic and financial performance.	Begin in June 1990, end in June 1991.
		Formulate an action plan for the restructuring of Kenya Airways.	September 1990.

Kenya: Summary and Time Frame for Macroeconomic and Structural Adjustment Policies, 1990-92 (continued)

	Objectives and Targets	Strategies and Measures	Timing of measures
V. Monetary and financial policies			
	Greater market orientation in mobilizing and allocation of financial resources.	*Maintain positive real interest rates for saving and lending.	Continuous.
		*Manage reserve money using available generalized monetary policy instruments through the Monetary Policy Committee; refine the design of monetary policy instruments; maintain improvements in the tendering system for treasury bills and bonds.	Continuous.
		*Review experience with generalized monetary policy instruments and agree with IDA on appropriate steps to establish a more market-driven interest rate structure while maintaining positive real savings deposit rates.	June 1990.
		*Allow interest rates to be market-determined.	June 1991.
	Reduce inefficiencies in the financial system.	*Adopt the revised Banking Act, which among other things should: (i) strengthen the Central Bank's ability to intervene expeditiously in troubled financial institutions; (ii) set out appropriate prudential supervision and reporting requirements; and (iii) enable the Central Bank to impose penalties on financial institutions that do not meet the requirements of the Banking Act.	Continuous.
		Develop and implement suitable training programme for Central Bank supervision staff.	Continuous.
		*Issue regulations that link capital adequacy requirement to assets (net of provisions, depreciation, and write-offs) and require banks and NBFIs to maintain capital of 7.5 percent of assets, including off-balance-sheet items.	June 1990.
		*Agree with IDA on further action to restructure or strengthen marginal financial institutions.	June 1990.
	Broaden and deepen capital and money markets; encourage the development of secondary markets and private capital issues.	*Agree with IDA on the appropriate form of taxation on financial instruments.	June 1990.
		*Begin implementing measures to reduce disincentives to holding and issuing securities.	July 1990.
		*Implement appropriate investor protection measures.	June 1990.
VI. Pricing policy			
	Eliminate price distortions and stimulate private investment.	Remove price controls on a significant number of items under the general and specific orders.	1990-91.
VII. Social sectors			
a. Health	Improve cost recovery, increase allocations for preventive/primary health care, and protect lower-income groups.	Evaluate the effectiveness of user charges, taking into account impact on the poor, and introduce changes as appropriate.	Continuous, beginning in 1990.
	Improve functioning of the National Hospital Insurance Fund (NHIF).	Modify NHIF to make contributions more progressive and realistic.	1990.

* Supported under ongoing IDA Policy Credit (2049).

Kenya: Summary and Time Frame for Macroeconomic and Structural Adjustment Policies, 1990-92 (concluded)

	Objectives and Targets	Strategies and Measures	Timing of measures
b. Education	Increase cost-sharing; improve operation of the student loan scheme and consolidate number of secondary schools.	Evaluate impact of cost-sharing measures and effectiveness of student loan scheme. Introduce changes as appropriate.	Continuous, beginning in 1990.
c. Social impact	Develop and implement an appropriate data base and welfare monitoring system to evaluate social impact of policy reforms.	Develop a survey-based welfare monitoring system.	Beginning in 1990.
VIII. Environment			
a. ASAL	Develop an environmental strategy for ASAL areas.	Prepare an ASAL Environmental Action Plan.	June 1990.
b. Wildlife	Establish Kenya Wildlife Services (KWS).	Ensure that KWS becomes operational and begins implementing its new mandate.	June 1990.
	Develop a long-term strategy for the management of wildlife resources.	Complete a strategy and action plan for the wildlife sector, including investment priorities, policy reforms, and resource mobilization for KWS.	August 1990.
c. Environmental management	Improve environmental management.	Formulate a comprehensive National Environmental Action Programme.	By 1992.
IX. Infrastructure			
	Strengthen policies and investment planning in the energy and urban transport sectors.	Prepare a study of rural electrification to supplement the National Power Development Plan; conduct parallel study of energy pricing.	February 1991.
		Develop urban transport rehabilitation and expansion program.	1991.

Table 1. Kenya: External Financing Requirements, 1989-92

(In millions of U.S. dollars)

	1989 Program	1989 Actual	1990	1991	1992
Total financing requirements	1,081	1,191	1,162	1,095	1,038
Current account, excluding net official transfers	609	727	671	587	537
Amortization 1/	282	296	325	348	349
Of which: World Bank/IDA	(97)	(88)	(96)	(101)	(102)
IMF repurchases	135	126	100	40	81
Change in reserves	55	42	66	120	70
Disbursements from existing commitments	1,081	1,191	393	386	237
Grants	258	228	53	20	8
Loans	790	847	340	366	229
Bilateral creditors 2/	232	226	90	97	61
Multilateral creditors 2/	458 3/	582 3/	215	249	148
Of which: World Bank/IDA	(115)	(236)	(115)	(126)	(70)
Of which: adjustment lending	(157)	(182)	(41)	(41)	(—)
Private creditors	100	39	35	20	20
Other capital (net)	33	116	—	—	—
Disbursements from expected new commitments	—	—	640	613	758
Grants	—	—	125	142	152
Loans	—	—	369	343	574
Bilateral creditors 2/	—	—	98	90	142
Multilateral creditors 2/	—	—	261	202	353
Of which: IDA 4/	—	—	(43)	(47)	(55)
Private creditors	—	—	10	51	79
IMF - ESAF	—	—	105	105	—
Other capital (net)	—	—	41	22	32
Total identified financing	1,081	1,191	1,033	999	995
Initial financing gap	—	—	129	96	43
Disbursements from expected IDA adjustment lending 5/	—	--	55	55	20
Cofinancing and additional multilateral assistance	—	—	74	41	23

Sources: Data provided by the Kenyan authorities; the World Bank; and Fund staff estimates.

1/ Public medium- and long-term debt.
2/ Including SPA.
3/ Includes SDR 80 million in disbursements under IMF/ESAF arrangement.
4/ New lending less expected disbursements noted in footnote 5.
5/ Agricultural sector adjustment credit and export promotion credits in 1990/1991, and education sector credit in 1992.

Table 2. Kenya: Key Indicators, 1986-92

	1986	1987	1988	1989	1990	1991	1992
		Actual		Est.		Projections	
GDP at market prices (growth rate)	7.0	5.8	6.1	5.0	5.2	5.4	5.5
GDY growth rate 1/	9.4	2.4	6.7	3.3	4.8	5.7	5.6
GDP/per capita growth rate	3.0	1.9	2.2	1.1	1.6	1.8	1.9
GDY/per capita growth rate 1/	5.3	-1.4	2.8	1.5	1.2	2.1	2.0
Consumption/per capita growth rate	--	3.1	4.0	-0.3	-0.8	1.7	0.5
Inflation rate (end period) 2/	4.3	6.6	10.4	10.1	...	...	...
Real effective exchange rate depreciation (end period)	-4.8	-14.0	-2.2	-7.2	...	...	...
Total domestic credit (growth rate) 3/	29.0	20.5	7.2	9.7	14.9	7.9	4.8
Net credit to Government (growth rate) 3/	53.7	29.7	-6.7	-5.6	0.6	0.8	0.9
Credit to other sectors (growth rate) 3/	17.7	14.9	16.7	17.9	9.8	11.3	13.4
Broad money (growth rate) 3/	27.6	12.4	8.3	17.8	10.9	10.7	10.6
Debt service (in U.S. dollars)	573	608	587	642	650	653	708
Debt service/Exports 4/	28.7	33.0	29.3	30.6	27.2	24.1	23.1
Debt service/GDP	8.0	7.6	6.8	7.6	7.1	6.7	6.8
Gross investment/GDP	18.8	24.8	23.6	25.3	25.4	25.0	25.0
Domestic savings/GDP	18.9	19.7	18.5	19.4	20.0	21.0	22.5
National savings/GDP	17.8	17.0	15.6	16.2	17.5	18.2	20.0
Marginal national savings rate	-0.5	-0.2	-0.1	0.4	0.3	0.3	0.3
Public investment/GDP 5/	8.1	7.1	8.1	8.4	7.7	7.1	6.3
Government savings/GDP	3.1	3.9	1.7	0.4	1.2	1.7	1.9
Private investment/GDP	11.6	12.5	11.5	13.9	14.6	14.9	15.7
Private savings/GDP	14.7	13.2	13.9	16.3	16.3	16.5	18.1
Public/Private investment ratio	70.2	57.1	70.1	60.3	52.8	47.3	39.9
Government revenue/GDP 3/	22.5	23.1	22.9	23.7	24.1	24.0	24.2
Grants/GDP 3/	1.0	2.2	2.3	2.3	1.8	1.7	1.6
Government expenditure/GDP 3/	30.2	28.0	29.7	30.1	29.7	29.1	29.0
Deficit/GDP 3/ 6/	6.6	4.2	4.6	4.2	3.8	3.4	3.2
Deficit/GDP 3/ 6/ 7/	7.8	6.4	6.9	6.5	5.6	5.1	4.8
Export growth rate 8/	4.1	-19.2	6.2	9.0	11.3	12.1	11.3
Exports/GDP 8/	26.5	21.3	21.8	23.0	24.3	25.9	27.4
Import growth rate 8/	1.4	1.3	5.8	9.5	6.8	5.6	8.0
Imports/GDP 8/	-26.5	-26.8	-27.3	-28.9	-29.3	-29.4	-30.2
Current account (in millions of U.S. dollars) 7/	-183	-643	-716	-727	-671	-587	-537
Current account/GDP 7/	-2.5	-8.1	-8.3	-8.6	-7.3	-6.0	-5.2
Current account (in millions of U.S. dollars) 9/	-34	-500	-460	-499	-493	-425	-377
Current account/GDP 9/	-0.5	-6.3	-5.3	-5.9	-5.4	-4.4	-3.6
Gross official reserves (months of nongovernment imports)	4.0	2.1	2.1	2.2	2.5	3.0	3.0

Sources: Data provided by the Kenyan authorities; and staff estimates.

1/ GDP at constant prices adjusted by gains and losses from changes in terms of trade.
2/ Nairobi consumer price index.
3/ Year beginning July 1. The growth rate of net credit to Government in 1990 was adjusted (see paragraph 4 of PFP).
4/ Ratio of public debt to exports of goods, all services, and private transfer receipts.
5/ Public includes central government, municipalities, councils, and parastatals.
6/ Figures do not add up because of adjustment to cash basis.
7/ Excludes grants.
8/ Exports and imports defined as including nonfactor services. Growth rates in terms of SDRs.
9/ Includes grants.

Kenya, 1794

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

EBS/90/64

CONFIDENTIAL

March 30, 1990

To: Members of the Executive Board

From: The Secretary

Subject: Kenya - Staff Report for the 1990 Article IV Consultation and Request for the Second Annual Arrangement Under the Enhanced Structural Adjustment Facility

Attached for consideration by the Executive Directors is the staff report for the 1990 Article IV consultation with Kenya, and its request for the second annual arrangement under the enhanced structural adjustment facility, which is tentatively scheduled for discussion on Monday, April 30, 1990. Draft decisions appear on pages 35 and 36.

Mr. Heller (ext. 8353) or Mr. Katz (ext. 7465) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

KENYA

Staff Report for the 1990 Article IV Consultation and Request for the Second Annual Arrangement Under the Enhanced Structural Adjustment Facility

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 Mamoudou Touré and A. Basu

March 28, 1990

Contents

Page

I. Introduction 1

II. Recent Developments and Performance Under the Program 2

III. Objectives and Policy Framework for 1990-92 12
1. Fiscal policy and structural reforms in the budget 13
2. Reform of state corporations 14
3. Monetary policy and financial sector reform 14
4. External policies 15
5. Balance of payments outlook 16
6. Long-term prospects and capacity to repay the Fund 19
7. Social and environmental impact of the program 22

IV. The Program for 1990 24
1. Fiscal policy 25
2. State corporations 26
3. Monetary and financial sector policies 27
4. External policies 28
5. Benchmarks and performance criteria 31

V. Staff Appraisal 31

Text Tables

1. Use of Fund Credit, December 1989-December 1991 3
2. Performance During the First Annual Arrangement Under the ESAF 4
3. Selected Economic Indicators, 1986-92 5
4. Government Finances, 1986/87-1992/93 7
5. Monetary Survey, June 1986-December 1990 8
6. Medium-Term Balance of Payments, 1985-92 10
7. Medium-Term Scenarios, 1989-93 18
8. External Public Debt Operations, 1985-92 20
9. Long-Term Balance of Payments Scenario, 1993-2001 21
10. Indicators of Fund Credit, 1990-2002 23

Appendix I. Second Annual Arrangement Under the Enhanced Structural Adjustment Facility 37
Attachment: Letter of Request 40
Attachment: Memorandum on the Economic and Financial Policies of Kenya 42

Appendix II. Relations with the Fund 57

Appendix III. Relations with the World Bank Group 61

Appendix IV. Statistical Issues 66

Appendix V. Basic Data 67

Appendix VI. Indicators of Competitiveness 70

Charts

1. Nominal and Real Effective Exchange Rates, January 1985-December 1989 12a
2. Economic Growth Indicators, 1986-92 12b
3. Central Government Operations, 1984/85-1991/92 14a
4. Balance of Payments, 1985-92 16a

I. Introduction

The 1990 Article IV consultation discussions with Kenya, together with discussions on an updated medium-term policy framework paper (PFP) and an economic and financial program that could be supported by the second annual arrangement under the enhanced structural adjustment facility (ESAF), were held in Nairobi between January 26 and February 15, 1990. The Kenyan representatives included Professor George Saitoti, Vice President and Minister of Finance; Mr. Eric C. Kotut, Governor of the Central Bank; and other senior officials. The staff representatives were Mr. P. S. Heller (head-AFR), Mr. M. Katz (AFR), Mrs. J. Landell-Mills (ETR), Mr. O. Liviatan (FAD), Ms. M. Rose (EP-AFR), and Mrs. H. Corbett (Administrative Assistant, TRE). Messrs. I. Bannon and C. Bruce from the World Bank's Eastern Africa Department, and Mr. T. Allen, from the World Bank's resident mission in Nairobi, participated in the discussions on the medium-term PFP.

Kenya is on the standard 12-month cycle for Article IV consultations, and the last consultation was concluded on May 15, 1989. At that time, Executive Directors observed that the authorities' three-year program for 1989-91 under the ESAF would broaden and reinforce the adjustment process. Directors endorsed the further tightening of the fiscal stance, the continuation of flexible interest and exchange rate policies, and the implementation of structural reforms in the budget, the financial sector, and the trade and industrial sectors, and welcomed the pursuit of market-oriented pricing policies. Directors emphasized the need to limit the growth of the government wage bill, to implement the trade liberalization and export promotion measures, to limit non-concessional loans, and to ensure timely inflows of external assistance for Kenya's adjustment efforts.

In the attached letter to the Managing Director from the Minister of Finance and the Governor of the Central Bank dated March 28, 1990 (Appendix I), the Government of Kenya requests the second annual arrangement under the ESAF 1/; this arrangement is in an amount equivalent to SDR 80.5 million (56.7 percent of quota) in support of a program for the period January-December 1990. The program is described in the memorandum on economic and financial policies attached to the authorities' letter.

In developing Kenya's medium-term strategy, the authorities have prepared, in close collaboration with the staffs of the Fund and the World Bank, an updated PFP setting forth the Government's economic objectives for 1990-92 and the macroeconomic and structural adjustment

---

1/ The three-year ESAF arrangement for SDR 241.4 million became effective on May 15, 1989. Purchases of SDR 40.23 million each were made on May 31, 1989 and November 30, 1989, respectively.

policies designed to achieve these objectives (forthcoming). 1/ The document is expected to be considered by the World Bank's Executive Directors at a meeting of the Committee of the Whole on April 26, 1990. Requests for a sectoral adjustment credit for export promotion and a second agricultural adjustment credit, in a combined amount equivalent to US$175 million, are expected to be presented to the World Bank's Executive Board in August 1990.

As of February 28, 1990 the total of the Fund's holdings of Kenya shillings subject to repurchase and the outstanding loans to Kenya were the equivalent of SDR 326.40 million, or 229.85 percent of quota (Table 1). Taking account of scheduled repurchases and four semiannual disbursements under the prospective ESAF arrangements, net Fund credit would amount to SDR 318.7 million (224.4 percent of quota) at end-December 1990, and SDR 370.0 million (260.6 percent of quota) by end-December 1991.

The second annual ESAF arrangement and the Minister's letter to the Managing Director, with the accompanying memorandum on economic and financial policies, are presented in Appendix I. Summaries of Kenya's relations with the Fund and the World Bank Group and outstanding statistical issues appear in Appendices II, III, and IV, respectively; basic data (including social and demographic indicators) are presented in Appendix V; and indicators of competitiveness appear in Appendix VI.

Kenya continues to avail itself of the transitional arrangements under the provisions of Article XIV.

II. Recent Developments and Performance Under the Program

The basic macroeconomic objectives of the 1989 program were largely realized despite a deterioration in the external terms of trade; and all end-September performance criteria were met as were most of the benchmarks for the year (Table 2). Preliminary data indicate that the real GDP growth rate was on target at about 5 percent--despite less favorable weather conditions at the beginning of 1989 and lower-than-anticipated coffee production. Output growth in agriculture and manufacturing was slightly lower than in 1988, whereas activity in construction and trade is estimated to have been slightly more buoyant. The end-period inflation rate of 10.1 percent, while representing a marginal deceleration from 10.4 percent in 1988, was higher than the 8 percent programmed, largely because of greater-than-targeted growth in broad money (Table 3). Gross domestic expenditure is estimated to have increased from 105.1 percent in 1988 to 105.9 percent of GDP in 1989, reflecting an increase of 1.7 percentage points in gross domestic investment, to the equivalent of 25.3 percent of GDP in 1989, largely on account of the

---

1/ This paper updates and extends the PFP for January 1989-December 1991 of April 25, 1989 (EBD/89/123).

Table 1. Kenya: Use of Fund Credit, December 1989–December 1991

	Outstanding Dec. 31, 1989	1990 Jan.-March	1990 April-June	1990 July-Sept.	1990 Oct.-Dec.	1991 Jan.-March	1991 April-June	1991 July-Sept.	1991 Oct.-Dec.
					(In millions of SDRs)				
Total transactions (net)		-19.25	15.12	28.61	-20.26	35.48	-8.29	31.56	-7.38
Transactions under tranche policies (net)		-14.51	-20.38	-6.89	-15.52	-4.76	-8.29	-8.67	-7.38
Repurchases		14.51	20.38	6.89	15.52	4.76	8.29	8.67	7.38
Ordinary resources		(5.33)	(3.46)	(2.13)	(2.13)	(—)	(1.96)	(3.91)	(3.91)
Borrowed resources		(9.19)	(16.91)	(4.76)	(13.39)	(4.76)	(6.34)	(4.76)	(3.46)
Transactions under special facilities (net)		-4.74	-4.74	-4.74	-4.74	—	—	—	—
CFF (net)		(-4.74)	(-4.74)	(-4.74)	(-4.74)	(—)	(—)	(—)	(—)
ESAF loans		—	40.23	40.23	—	40.23	—	40.23	—
Total Fund credit outstanding 1/	314.48	295.23	310.35	338.96	318.70	354.18	345.89	377.45	370.07
Under tranche policies	(146.66)	(132.15)	(111.77)	(104.88)	(89.36)	(84.60)	(76.31)	(67.64)	(60.27)
Under special facilities	(58.95)	(54.21)	(49.48)	(44.74)	(40.00)	(40.00)	(40.00)	(40.00)	(40.00)
Under SAF	(28.40)	(28.40)	(28.40)	(28.40)	(28.40)	(28.40)	(28.40)	(28.40)	(28.40)
Under ESAF 1/	(80.47)	(80.47)	(120.70)	(160.93)	(160.93)	(201.17)	(201.17)	(241.40)	(241.40)
					(As percent of quota)				
Total Fund credit outstanding 1/	221.46	207.91	218.56	238.70	224.44	249.42	243.58	265.81	260.62
Under tranche policies	(103.28)	(93.06)	(78.71)	(73.86)	(62.93)	(59.58)	(53.74)	(47.63)	(42.44)
Under special facilities	(41.51)	(38.18)	(34.85)	(31.51)	(28.17)	(28.17)	(28.17)	(28.17)	(28.17)
Under SAF	(20.00)	(20.00)	(20.00)	(20.00)	(20.00)	(20.00)	(20.00)	(20.00)	(20.00)
Under ESAF 1/	(56.67)	(56.67)	(85.00)	(113.33)	(113.33)	(141.67)	(141.67)	(170.00)	(170.00)

Sources: IMF, Treasurer's Department; and staff estimates.

1/ Includes use of ESAF Trust resources.

Table 2. Kenya: Performance During the First Annual Arrangement Under the Enhanced Structural Adjustment Facility

	June 1989	September 1989		December 1989	
	Actual	Program 1/	Actual	Program 2/	Actual
Quantitative performance criteria		(In millions of Kenya shillings)			
Total domestic credit 3/	52,422	56,897	55,632	58,080	57,750
Net bank credit to the Government 4/	13,670	17,420	14,639	17,270	12,671
Banking system	(17,510)	(21,891)	(20,019)	(21,741)	(17,481)
CSFC	(-3,840)	(-3,701)	(-4,610)	(-3,701)	(-4,040)
Debt assumed from parastatals	(—)	(-770)	(-770)	(-770)	(-770)
		(In millions of U.S. dollars)			
New nonconcessional external loans contracted or guaranteed by the Government (cumulative per calendar year) 5/					
a. 1-12 years' maturity	56.4	100.0	69.5	100.0	69.5
b. Short-term credits of less than one year's maturity 6/	—	—	—	—	—
Quantitative benchmark		(In millions of SDRs)			
Minimum cumulative increase in net official international reserves from end-December 1988 7/	80	37	27.4	58	52

Nonquantitative performance criteria	Status
Review: A midterm review will be completed by end-October 1989.	Done.
Trade and payments restrictions: The Government of Kenya will continue to maintain a liberal exchange and trade system and will not introduce any new, or intensify existing, restrictions.	Done.
Structural performance criterion	**Target Date**
Implement the import liberalization program and provide on monthly basis data on import license applications, approvals, and corresponding foreign exchange allocation by end-September 1989.	Implemented ahead of schedule.
Structural benchmarks	
Maintain positive real interest rates throughout 1989.	On target.
Confine the growth of the Government's personnel wage bill to 7.5 percent by end-June 1990.	Likely to be exceeded.
Adopt fiscal measures including user charges in health, education, and other sectors beginning July 1989.	Implemented.

Source: Memorandum attached to the letter of request of Kenyan authorities of April 18, 1989; and the letter of intent dated September 26, 1989.

1/ Performance criteria.
2/ Quantitative benchmarks.
3/ Total domestic credit of the banking system is the sum of net credit to the Government, other public sector credit, and private sector credit. It includes bank credit utilized by the Cereals and Sugar Finance Corporation (CSFC). Not adjusted for the monetization of the buildup on the stock of unpresented checks by the Government during 1988/89 of K Sh 1.8 billion.
4/ Net credit to the Government is net credit to the Government from the banking sector. The ceiling excludes the operations of the CSFC, and the amount of public enterprise debt assumed by the Government and reclassified from outstanding private sector credit. Not adjusted for the unpresented checks mentioned in footnote 3. If adjustments were made for this buildup in unpresented checks, the quantitative benchmark on net bank credit to the Government for end-June and end-December and the performance criterion for end-September would still be met.
5/ In conformity with existing regulations, no public enterprise has borrowed on nonconcessional terms without government guarantee. For purposes of converting new nonconcessional external loans into U.S. dollars, the U.S. dollar exchange rates cabled to the Central Bank of Kenya from the Federal Reserve Bank of New York for January 3, 1989, has been used.
6/ Other than related to imports.
7/ Net official international reserves are defined as the Central Bank of Kenya's net foreign reserve assets (SDRs, gold, and foreign exchange holdings) minus its short-term deposit liabilities to foreigners; plus the Central Government's net foreign reserve assets (excluding those related to Fund transactions); plus Kenya's reserve position in the Fund; minus Kenya's net use of Fund credit.

Table 3. Kenya: Selected Economic and Financial Indicators, 1986-92 1/

	1986	1987	1988	1989 Prog. 2/	1989 Est.	1990 Prog. 2/	1990 Rev. prog.	1991 Prog. 2/	1991 Rev. prog.	1992 Proj.
	(Annual percent changes, unless otherwise specified)									
National income and prices										
GDP at constant prices (factor cost)	5.5	4.8	5.2	5.1	5.0	5.2	5.2	5.4	5.4	5.5
GDP deflator	9.3	6.1	9.7	7.2	8.9	6.5	6.5	5.5	5.0	5.0
Consumer prices	4.3	6.6	10.4	8.0	10.1	7.5	7.5	5.5	5.5	5.0
External sector (on the basis of SDRs)										
Exports, f.o.b.	7.5	-29.7	7.8	8.8	5.7	5.5	11.3	9.7	13.3	13.5
Imports, c.i.f.	-0.8	1.5	6.9	4.1	9.2	4.7	7.2	5.9	5.5	7.5
Non-oil imports, c.i.f.	18.7	0.8	13.1	2.8	7.6	4.4	7.2	5.8	5.7	8.0
Export volume	15.2	-3.5	5.5	5.7	9.1	4.5	9.6	5.6	8.6	8.9
Import volume	17.4	5.0	12.3	—	2.8	1.8	3.1	2.9	1.7	3.7
Terms of trade (deterioration -)	12.0	-17.5	3.5	-1.1	-8.9	-1.9	-2.4	0.9	0.5	0.5
Nominal effective exchange rate (depreciation -) 3/	-6.7	-15.8	-7.3	...	-11.1	...	...	...	...	...
Real effective exchange rate (depreciation -) 3/	-4.4	-13.0	-2.2	...	-7.2	...	...	...	...	...
Government budget 4/										
Revenue and grants	15.1	22.9	14.4	13.8	17.4	12.5	11.9	11.2	10.2	14.2
Total expenditure	17.2	6.3	22.1	12.6	15.4	10.5	10.6	9.4	8.7	13.4
Money and credit										
Net domestic assets 5/	36.9	18.1	10.7	8.7	14.1	9.0	9.2	9.1	8.2	4.7
Government	53.7	29.7	-6.7	13.3	-5.6	-6.6	26.6 6/	0.7	0.8	0.9
Other sectors	17.7	14.9	16.7	8.7	17.9	12.4	9.8	11.3	11.4	6.5
Money and quasi-money (M2)	27.6	12.4	8.3	11.6	17.8	8.4	10.9	10.7	10.7	10.6
Velocity (GDP relative to M2) 7/	3.2	3.2	3.5	3.4	3.4	3.6	3.4	3.6	3.5	3.5
Interest rate (annual rate) 7/										
Savings deposit (minimum)	11.0	11.0	10.0	...	12.5	...	...	...	...	...
Average time deposit	11.5	9.8	12.4	...	...	...	...	...	...	...
Maximum lending rate	14.0	14.0	15.0	...	18.0	...	...	...	...	...
	(In percent of GDP)									
Government budget 4/										
Revenue and grants	23.6	25.3	25.1	26.6	25.9	26.9	25.9	27.0	25.7	25.8
Total expenditure	30.2	28.0	29.7	30.8	30.1	30.6	29.7	30.2	29.1	29.0
Overall cash deficit 8/										
Including grants	6.6	4.2	4.6	4.2	4.2	3.7	3.8	3.2	3.4	3.2
Excluding grants	7.8	6.4	6.9	6.7	6.5	6.3	5.6	5.7	5.1	4.8
Domestic bank financing	4.1	-0.1	1.3	0.6	0.5	0.4	0.3	—	0.1	-0.1
Nonbank financing	2.5	3.3	0.9	0.5	0.3	0.6	0.5	1.0	0.5	0.5
Foreign financing	—	1.0	2.4	3.1	3.4	2.0	2.9	2.2	2.8	2.8
Gross domestic investment	18.8	24.8	23.6	24.3	25.3	25.7	25.4	24.7	25.0	25.0
Gross domestic savings	18.9	19.7	18.5	20.1	19.4	21.4	20.0	22.8	21.0	22.5
External current account deficit										
Including grants	0.5	6.3	5.3	4.0	5.9	4.1	5.4	2.7	4.4	3.6
Excluding grants	2.5	8.1	8.3	7.0	8.6	7.4	7.3	5.7	6.0	5.2
External debt										
External debt inclusive of Fund credit	54	56	59	58	59	62	61	63	63	63
Debt service ratio 9/	29	34	29	30	31	28	28	24	24	23
Interest payments 9/	11	12	12	11	11	10	10	10	10	9
	(In millions of SDRs, unless otherwise specified)									
Overall balance of payments	76	-76	-45	8	52	-38	46	-34	38	100
Gross official reserves (months of imports) 10/	3.7	2.1	2.1	2.3	2.2	2.6	2.5	3.0	3.0	3.0
External payments arrears	—	—	—	—	—	—	—	—	—	—

Sources: Data provided by the Kenyan authorities; and staff estimates.

1/ The data reflect revised GDP figures starting with 1985. The revisions had the impact of changing nominal GDP at market prices by +1.6 percent in 1985, +0.2 percent in 1986, -0.8 percent in 1987, +1.9 percent in 1988, and +2.6 percent each in 1989 and 1990.
2/ As shown in EBS/89/84.
3/ December-to-December variations.
4/ Fiscal year beginning July 1.
5/ Net domestic assets were not explicitly used before 1990.
6/ Not adjusted for the K Sh 2.7 billion of Treasury securities sold at end-December 1989 and redeemed in early January 1990, and the K Sh 1.8 billion monetization of unpresented checks at end-June 1989. (If adjustments were made, the percent change would be 0.6 percent rather than 26.6 percent)
7/ Level in percent.
8/ Figures do not add up from above totals because of adjustment to cash basis. The cash deficit in 1988/89 reflects the adjustment cited in footnote 3 of Table 4.
9/ In percent of exports of goods, nonfactor services, and private transfers.
10/ In months of nongovernment imports.

leasing of aircraft by Kenya Airways, and higher private sector gross fixed capital formation. Consumption is estimated to have declined by 0.9 percentage point to 80.6 percent of GDP on account of both lower private and government consumption. Accordingly, national saving is estimated to have risen from 15.4 percent of GDP in 1988 to 16.3 percent in 1989.

The overall budget deficit on a commitment basis in 1988/89 (July-June) was 4.6 percent of GDP, marginally above the program target of 4.5 percent (Table 4). Excluding grants, the deficit at 6.9 percent of GDP was equal to the program target. In relation to GDP, both revenue and expenditure were lower than originally estimated. The revenue shortfall largely reflects lower than expected collection of import duties. Expenditure and net lending was lower than programmed, primarily because of a lower than anticipated rate of project implementation. For recurrent expenditure, a larger than budgeted wage bill reflected a higher-than-programmed increase, but this was more than offset by lower spending on operations and maintenance. The cash deficit at the close of the fiscal year, at 3.5 percent of GDP, was substantially below the commitment deficit, almost wholly reflecting a buildup in the stock of unpresented checks by about K Sh 1.8 billion (about 1.1 percent of GDP), which was monetized in early July 1989. Adjusting for the liquidation of these checks results in a cash deficit of about 4.6 percent of GDP. About half of the adjusted cash deficit was financed from external sources. Domestic bank financing (inclusive of the liquidation of unpresented checks) was about 1.3 percent of GDP, with absorption of treasury bonds by the nonbank sector accounting for the remainder.

Monetary policy during the second half of 1989 was more expansionary than programmed. Broad money at end-December 1989 was 17.8 percent higher than in the preceding December, compared with the program target of 11.6 percent (Table 5). This rate of expansion of liquidity was largely a result of a 14.1 percent increase on net domestic assets, which principally reflected developments in "other items net." These were considerably higher than anticipated in the program, in June, September, and December. The rise in net domestic assets accounted for a 15.2 percent rise in relation to the stock of broad money at end-1988. Net credit to the Government declined by 5.6 percent (unadjusted for the sale of over K Sh 2.7 billion of treasury bills at end-December) far below the targeted 17.4 percent rate of growth. Adjusting the December figure for the unpresented checks, domestic credit to the Government would have been 4.2 percent, still below the target. Credit to the nongovernment sectors grew by 17.9 percent (6.4 percent in the program) with private sector credit rising by 22.1 percent. In an attempt to tighten monetary policy, the commercial banks' minimum saving deposit rate and the maximum lending rate for loans of three years or less were raised in November 1989 by 0.5 percentage point to 12.5 percent and 15.5 percent, respectively, following substantial increases in lending and deposit rates in April; and the maximum lending rate of

Table 4. Kenya: Government Finances, 1986/87-1992/93

	1986/87	1987/88	1988/89		1989/90		1990/91	1991/92	1992/93
			Program 1/	Prelim. actuals	Program 1/	Revised	Projections		
	(In millions of Kenya shillings)								
Revenue and grants	29,224	35,926	41,816	41,114	49,118	48,263	54,008	59,520	67,984
Revenue	27,968	32,738	37,980	37,381	44,219	44,076	50,293	55,583	63,768
Grants	1,256	3,188	3,836	3,733	4,899	4,187	3,715	3,937	4,216
Expenditure and net lending	37,439	39,815	48,967	48,595	56,765	56,095	62,024	67,394	76,416
Recurrent expenditure	27,551	30,646	37,040	37,110	42,719	42,891	46,912	50,719	57,707
Development expenditure and net lending	9,888	9,169	11,927	11,485	14,046	13,204	15,112	16,675	18,709
Overall deficit (treasury accounts), commitment basis	-8,215	-3,889	-7,151	-7,481	-7,647	-7,832	-8,016	-7,874	-8,432
Adjustment to cash basis 2/	59	-2,057	—	-104	—	—	—	—	—
Overall cash deficit 3/	-8,156	-5,946	-7,151	-7,585	-7,647	-7,832	-8,016	-7,874	-8,432
(Excluding grants)	-9,412	-9,134	-10,987	-11,318	-12,546	-12,019	-11,731	-11,811	-12,648
Financing	8,156	5,946	7,151	7,585	7,647	7,824	8,041	7,874	8,432
Foreign financing	29	1,429	3,893	4,000	5,626	6,322	6,120	6,485	7,378
Domestic financing	8,127	4,517	3,258	3,585	2,021	1,502	1,921	1,390	1,054
Nonbank financing	(3,102)	(4,637)	(1,058)	(3,359)	(919)	(602)	(1,271)	(1,158)	(1,318)
Banking system	(5,025)	(-120)	(2,200)	(226)	(1,102)	(900)	(650)	(232)	(-264)
Of which: adjustment for increase in unpresented checks 3/	(—)	(—)	(—)	(1,825)	(—)	(—)	(—)	(—)	(—)
	(In percent of GDP)								
Memorandum items:									
Revenue and grants	23.6	25.3	26.2	25.1	26.7	25.9	25.9	25.7	25.8
Revenue	22.5	23.1	23.8	22.9	24.1	23.7	24.1	24.0	24.2
Grants	1.0	2.2	2.4	2.3	2.7	2.3	1.8	1.7	1.6
Expenditure and net lending	30.2	28.0	30.7	29.7	30.9	30.1	29.7	29.1	29.0
Recurrent expenditure	22.2	21.6	23.2	22.7	23.2	23.1	22.5	21.9	21.9
Development expenditure and net lending	8.0	6.5	7.5	7.0	7.6	7.1	7.2	7.2	7.1
Overall deficit (commitment basis)	-6.6	-2.7	-4.5	-4.6	-4.2	-4.2	-3.8	-3.4	-3.2
Overall cash deficit	-6.6	-4.2	-4.5	-4.6	-4.2	-4.2	-3.8	-3.4	-3.2
(Excluding grants)	-7.6	-6.4	-6.9	-6.9	-6.8	-6.5	-5.6	-5.1	-4.8
Foreign financing	—	1.0	2.4	2.4	3.1	3.4	2.9	2.8	2.8
Domestic financing	6.6	3.2	2.0	2.2	1.1	0.8	0.9	0.6	0.4
Of which: banking system and adjustment for increase in unpresented checks	(4.1)	(-0.1)	(1.4)	(1.3)	(0.6)	(0.5)	(0.3)	(0.1)	(-0.1)

Sources: Data provided by the Kenyan authorities; and staff estimates.

1/ As presented in EBS/89/196 (10/16/89).

2/ The adjustment factor arises partly because financing data are derived from sources other than revenue and expenditure data. It also includes a float element resulting from differences between checks issued and checks cashed, statistical discrepancies, and, in 1987/88, and 1988/89, differences between payment orders issued and checks issued.

3/ The cash deficit for 1988/89 has been adjusted upward by K Sh 1.8 billion to reflect the increase in the stock of unpresented checks on June 30, 1989, which was largely liquidated by bank financing in early July 1989. This corresponds to the higher bank financing shown in the monetary survey for June 1989 (adjusted). Bank financing in 1989/90 is thus shown net of this liquidation, which is attributed to fiscal year 1988/89. Bank financing for 1989/90 does not reflect the classification of K Sh 770 million of parastatal debt from the private to the government sector (as shown in the Monetary Survey).

Table 5. Kenya: Monetary Survey, June 1986-December 1990 1/

	1986		1987		1988				1989							1990			
	June	Dec.	June	Dec.	March	June	Sept.	Dec.	March	June		September		December		March	June	Sept.	Dec.
	Actual								Actual	Actual	Adj. 2/	Prog. 3/	Actual	Prog. 3/	Actual	Program 4/			
	(In millions of Kenya shillings)																		
Net foreign assets	-408	-255	-759	-2,367	-2,590	-3,143	-3,327	-3,627	-2,517	-2,162	-2,162	-3,132	-3,346	-2,691	-2,499	-2,865	-2,761	-3,099	-1,847
Net domestic assets 5/	31,069	36,485	39,005	43,101	43,227	42,932	43,817	47,722	48,295	49,037	50,837	51,314	52,202	51,883	54,428	54,346	56,513	58,610	59,450
Total domestic credit	34,259	40,775	43,916	49,114	48,063	48,401	49,337	52,666	51,636	52,422	54,223	56,897	55,631	58,080	57,750	61,246	63,588	65,600	66,350
Government (net)	10,728	15,301	17,109	19,846	17,717	17,121	16,889	18,512	17,775	17,510	19,310	21,891	20,019	21,741	17,481	19,839	21,180	21,920	22,123
Other	23,532	25,474	26,807	29,268	30,346	31,280	32,448	34,154	33,861	34,912	34,913	35,006	35,612	36,339	40,269	41,407	42,408	43,680	44,227
Other items (net) 6/	-2,374	-4,289	-4,911	-6,013	-4,836	-5,469	-5,520	-4,944	-3,341	-3,386	-3,386	-5,583	-3,429	-6,197	-3,322	-6,900	-7,075	-6,990	-6,900
Money and quasi-money	31,477	36,230	38,246	40,734	40,637	39,788	40,489	44,095	45,778	46,875	48,675	48,132	48,856	49,192	51,929	51,481	53,752	55,511	57,603
	(Annual change in percent) 7/																		
Net domestic assets	18.3	36.9	25.5	18.1	15.4	10.1	4.0	10.7	11.7	14.2	18.4	17.1	19.1	8.7	14.1	12.5	11.2	12.3	9.2
Total domestic credit	21.9	29.0	28.2	20.5	11.2	10.2	2.7	7.2	7.4	8.3	12.0	15.3	12.8	10.3	9.7	18.6	17.3	17.9	14.9
Government (net)	32.3	53.7	59.5	29.7	6.0	0.1	-15.3	-6.7	0.3	2.3	12.8	29.6	18.5	17.4	-5.6	11.6	9.7	9.5	26.6 8/
Other	17.6	17.7	13.9	14.9	14.5	16.7	15.6	16.7	11.6	11.6	11.6	7.9	9.8	6.4	17.9	22.3	21.5	22.7	9.8
Money and quasi-money	21.8	27.6	21.5	12.4	7.3	4.0	2.2	8.3	12.7	17.8	22.3	19.0	20.7	11.6	17.3	12.5	10.4	13.6	10.9
Velocity	3.44	3.23	3.24	3.22	3.36	3.57	3.64	3.46	3.45	3.48	3.36	3.49	3.46	3.52	3.36	3.50	3.46	3.46	3.43

Sources: Central Bank of Kenya; and staff estimates.

1/ The claims of the National Bank of Kenya on the public entities and credit to the private sector guaranteed by the Government are shown beginning in June 1988 as part of credit to the nongovernment sector. Before that date they were shown as part of credit to the Government. Beginning September 1989, net credit to Government includes K Sh 770 million debt of public enterprises that was assumed by the Government; previously this debt was classified under outstanding credit of the nongovernment sector.

2/ Adjusted for the monetization of unpresented checks of K Sh 1,800 million.

3/ As presented in EBS/89/84 with the exceptions that the distribution of credit between the Government and the nongovernment sectors has been revised to reflect the change introduced in September 1989 described in footnote 1, and also the revised GDP figures.

4/ For March 1990, indicative targets.

5/ Prior to 1990 program ceilings were set on total domestic credit.

6/ The levels of other items net in 1990 are consistent with the level prevailing during the second half of 1989, except for June, September, and December.

7/ The annual change in percent for end-June 1990 is in relation to the adjusted end-June 1989 column.

8/ Not adjusted for the K Sh 2.7 billion of treasury securities sold at end-December 1989 and redeemed in early January 1990, and the K Sh 1.8 billion monetization of unpresented checks at early-July. With these adjustments, the increase at end-December 1990 is 0.6 percent.

18 percent was made applicable for loans of more than three years. Domestic interest rates were substantially positive in real terms during 1989.

External performance during 1989 recorded an overall surplus of some SDR 52 million after overall deficits in the previous two years (Table 6). With a gross official reserve accumulation of SDR 33 million, the ratio of reserves to nongovernment imports rose to 2.2 months from 2.1 months. This was achieved despite a 30 percent decline in the price of coffee--which contributes about a third of Kenya's export earnings--and an overall terms of trade deterioration (in SDR terms) of 9 percent. The current account deficit, including grants, was 5.9 percent of GDP compared with 5.3 percent in 1988, and 4 percent anticipated in the program. (Excluding the lease of two jet aircraft contracted by Kenya Airways (KA) in December, the ratio was 4.5 percent of GDP.) 1/ Export growth slowed to about 6 percent, down from 8 percent in the previous year, mainly because of a 17 percent decline in coffee earnings, but also because Kenya's oil exports to neighboring countries fell by some 9 percent, reflecting the lack of competitiveness of its refineries. Tea exports partially offset these declines; earnings rose by about 30 percent, responding to buoyant international prices and favorable supply conditions. Imports grew faster--by some 2 percentage points--in 1989 than in 1988, mainly because of substantially higher prices, particularly for oil, and the KA leases.

Despite the cancellation of some debt by the Federal Republic of Germany and the United States, net service earnings were somewhat lower than had been anticipated, reflecting lower travel receipts in late 1989 (see explanation in Section III 5). Official grants also fell in 1989, by some 7 percent, as the realization rate of grant-assisted projects slowed. The capital account continued to be strong. Capital inflows rose by almost 50 percent over their 1988 levels; excluding the counterpart for the KA leases, the increase was some 29 percent. Kenya has benefited from debt cancellations in the last two years from several of the major donor countries. In particular, in 1987-88, Canada canceled debt of almost SDR 79 million, the Federal Republic of Germany canceled debt equivalent to SDR 285 million in 1989, and France has announced a debt cancellation of SDR 175 million in 1990. In addition, debt canceled by the Netherlands reduced annual principal outlays by approximately SDR 2 million during 1988-90. The United States has announced that it will cancel debt during 1990-92 of approximately SDR 133 million. In 1990, these cancellations should yield savings in interest and amortization of at least SDR 20 million.

1/ The leasing of these airplanes had not been anticipated under the program. Inclusion of the airplanes in the balance of payments (at their full value according to accounting conventions) increased imports by about 1.4 percent of GDP.

Table 6. Kenya: Medium-Term Balance of Payments, 1985-92

	1985	1986	1987	1988	1989 Prog. 1/	1989 Revised estimates	1990	1991	1992
							Projections		
	(In millions of SDRs)								
Current account	-89	-29	-387	-342	-254	-389	-376	-320	-280
Exports, f.o.b.	928	998	702	757	825	800	890	1,008	1,144
Coffee	277	408	183	205	210	170	167	187	210
Tea	230	182	154	155	175	201	239	271	308
Oil products 2/	117	78	59	63	70	57	59	61	64
Other	305	330	306	334	370	372	425	489	562
Imports, c.i.f.	-1,447	-1,435	-1,458	-1,559	-1,601	-1,703	-1,825	-1,925	-2,070
Government 3/	-92	-247	-282	-266	-238	-340	-344	-320	-316
Oil	-454	-256	-270	-215	-260	-259	-276	-288	-302
Other	-900	-932	-906	-1,077	-1,103	-1,105	-1,205	-1,317	-1,452
Trade balance	-520	-438	-755	-802	-776	-903	-935	-918	-926
Services (net) 4/	242	232	202	203	272	264	341	381	418
Private transfers (net)	80	50	56	66	63	72	82	95	109
Official transfers	108	127	110	191	188	178	136	122	119
Capital account	-2	106	311	297	262	442	422	358	389
Long-term (net)	-77	109	185	235	247	435	397	366	391
Official	-55	73	192	249	237	429	390	344	368
Inflows 5/	(162)	(289)	(406)	(443)	(442)	(661)	(639)	(606)	(626)
Outflows	(-217)	(-217)	(-214)	(-194)	(-205)	(-231)	(-248)	(-262)	(-259)
Private	22	36	-8	-15	10	5	6	22	23
Short-term (net) 6/	75	-4	126	62	15	7	25	-8	-2
Overall balance	-91	76	-76	-45	58	52	46	38	109
Financing	91	-76	76	45	-58	-52	-46	-38	-109
Gross reserves	36	18	161	-20	-40	-33	-50	-90	-50
IMF credit (net)	53	-90	-84	64	-18	-18	4	51	-59
Other assets (net)	1	-5	--	-1	--	-1	--	--	--
Memorandum items:									
Gross reserves (end of period)	381	362	202	222	262	255	305	395	445
Gross reserves									
In months of non-government imports	3.4	3.7	2.1	2.1	2.3	2.2	2.5	3.0	3.0
In months of total imports	3.2	3.0	1.7	1.7	2.0	1.8	2.0	2.5	2.5
	(In percent of GDP)								
Current account deficit									
Including official transfers 7/	1.5	0.5	6.3	5.3	4.0	5.9	5.4	4.4	3.6
Excluding official transfers	3.3	2.5	8.1	8.3	7.0	8.6	7.3	6.0	5.2
Net official capital inflows plus official transfers	0.9	3.2	4.9	6.9	6.7	9.2	7.6	6.4	6.3

Sources: Data provided by the Kenyan authorities; and staff estimates.

1/ EBS/89/84 (4/27/89). Original program estimates showed the cancellation of government debt owed to the Federal Republic of Germany of DM 696 million (SDR 285 million) as an official transfer with an offsetting entry under capital outflows in 1989. Interest and amortization payments have now been adjusted for the cancellation in the relevant years.

2/ Prior to 1987, customs data included bunkering fees collected on transit shipments destined to neighboring countries. The data for 1986 were adjusted, and the counterpart was included in errors and omissions.

3/ Beginning in 1986, data include special imports of defense-related equipment and civilian aircraft. They amounted to SDR 117 million in 1986, SDR 39 million in 1987, SDR 73 million in 1988, an estimated SDR 156 million in 1989, and are projected to amount to SDR 180 million in 1990, SDR 88 million in 1991, and SDR 76 million in 1992. These imports include the KA leases given in footnote 6.

4/ Includes reduction in flows for debt cancellations described in footnote 1 to Table 8.

5/ Includes loans financing imports of defense-related equipment described in footnote 3 and in 1987 and in 1988 the counterpart (SDR 43 million in each year) for imports of defense-related equipment purchased in earlier years but shipped in those years. Also includes the counterpart to the KA leases described in footnote 6. Anticipated inflows for 1990 and 1991 include two IDA credits for export promotion and the agricultural sector and new cofinancing for these and the ongoing Financial Sector Adjustment Credit. These are expected to total some SDR 98 million in 1990 and some SDR 75 million in 1991.

6/ Includes errors and omissions and valuation adjustments.

7/ Kenya Airways leases are SDR 91 million in 1989, SDR 70 million in 1990, and SDR 35 million in 1991; excluding the capital value of these leases, the ratio would be 4.5 in 1989, 4.4 in 1990, and 3.9 in 1991.

The exchange rate continued to be flexibly managed during 1989, and depreciated by some 7 percent in real effective terms between December 1988 and December 1989. This may, however, be an overestimate, since the official consumer price index may underestimate actual inflation. (The authorities are currently developing a new price index.) A real effective index based on labor costs in manufacturing suggests a slight appreciation since 1987 (Chart 1). 1/ The accumulation of net official reserves in 1989, at SDR 52 million, was SDR 6 million short of the quantitative benchmark. The program's limits on nonconcessional foreign loans contracted or guaranteed by the Government were observed, and Kenya accumulated no arrears.

In the course of 1989, substantial progress was made in implementing the program's structural measures. In the agricultural sector, producer prices for grain were raised; progress was made in developing a food security plan; the financial restructuring of the National Cereals and Produce Board (NCPB) was virtually completed; and a cotton pricing system based on auctioning is being implemented. Initial steps were also taken to restructure other state corporations. Important structural measures in the fiscal area in 1989/90 included the adoption of a presumptive tax on the value of gross sales of agricultural produce to replace the export tax on coffee and tea, and the lowering of the effective corporate tax rate, as well as the top rate of personal income tax, the introduction of user charges in the health sector and cost sharing in education, the adoption of a bank loan scheme for university students, and the passage of legislation substituting a value-added tax (VAT) for the manufacturing sales tax at the beginning of 1990.

The ongoing reform of the trade system focused in 1989 on the second phase of the import liberalization program. In mid-1989, quantitative restrictions were lifted on import items in Schedule IIIB, which accounts for about 11 percent of all import items and about 5 percent of 1986/87 import values. Since Schedules I, II, and IIIA had been liberalized in 1988, almost 70 percent of all items and 93 percent of import values are now unrestricted and carry tariffs as the sole form of protection. 2/ The combined import-weighted average tariff for goods in Schedules I and II has been slightly reduced and the number of tariff categories cut from 17 to 12. Consequently, the structural performance criterion relating to the implementation of the import liberalization program and the development of an effective system for monthly monitoring of its operations was met before end-September. With the decontrol of prices for fertilizer, animal feed, and soft drinks, the number of

---

1/ Appendix VI provides a further analysis.

2/ The import items classified in the different schedules are raw materials, intermediate goods, and capital goods in Schedule I; bulk items, such as fertilizer, in Schedule II; high priority items not available domestically in Schedule IIIA; and items that compete with domestic output and lower priority items in Schedule IIIB.

categories under the Price Control (General) Order was reduced from 20 to 18. In the financial sector, an action plan was approved for restructuring development finance institutions; a revised Banking Act was passed by Parliament, and in late 1989 the Capital Markets Authority (CMA) was established.

III. Objectives and Policy Framework for 1990-92

The Government's overall macroeconomic objectives over the medium term (as indicated in the PFP) are (a) to achieve an annual growth rate of real GDP of more than 5 percent and to provide productive employment for the country's rapidly growing labor force (Chart 2)); (b) to reduce the rate of inflation by 1992 to about 5 percent, the level expected for Kenya's major trading partners; (c) to maintain balance of payments viability by reducing the external current account deficit from the equivalent of 5.9 percent of GDP in 1989 (8.6 percent of GDP, excluding grants) to about 3.6 percent of GDP in 1992 (5.2 percent of GDP, excluding grants); (d) to build up gross reserves from the equivalent of 2.2 months of nongovernment imports in 1989 to 3.0 months of nongovernment imports in 1992; and (e) to lower the debt service ratio from 31 percent in 1989 to below 25 percent in 1992. The Government's strategy stresses the important role of the private sector in revitalizing the economy, and the need to develop market-based incentives for stimulating private sector activity.

Consistent with these macroeconomic objectives, the investment-saving gap would be narrowed. Gross domestic investment would stabilize at about 25 percent of GDP, with an increasing share of private sector fixed capital formation, and a higher efficiency of investment, as distortions are eliminated. Gross domestic saving would increase by some 3 percentage points to 22.5 percent of GDP; national saving would increase by some 2.5 percentage points to 19 percent of GDP in 1992 with about equal increases in both private sector and government saving.

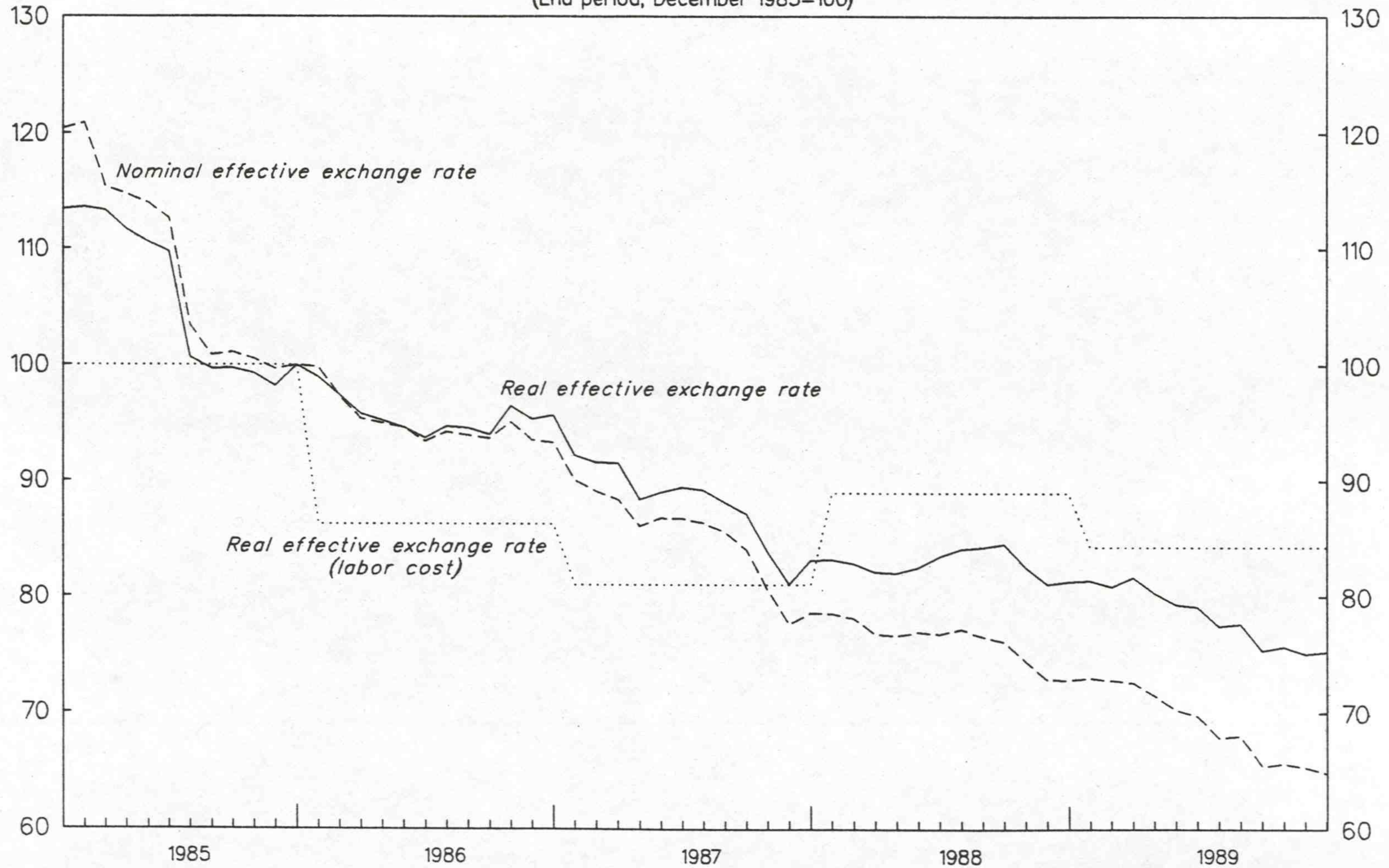
To achieve these objectives, the mix of financial policies will emphasize fiscal restraint and increasing productivity in the public sector, a monetary policy stance consistent with the inflation and external targets, and an exchange rate policy that seeks to maintain competitiveness. The structural reforms for 1990-92 will emphasize the reduction of antiexport bias and new initiatives in the promotion of exports; continuation of the liberalization of imports; the restructuring of government expenditure by restraining the growth of personnel expenditure, and an increasing share of nonwage operations and maintenance; the extension of the VAT; the restructuring and revitalizing of financial and nonfinancial public enterprises; continued financial sector reform; price decontrol; and increased productivity in agriculture.

CHART 1

KENYA

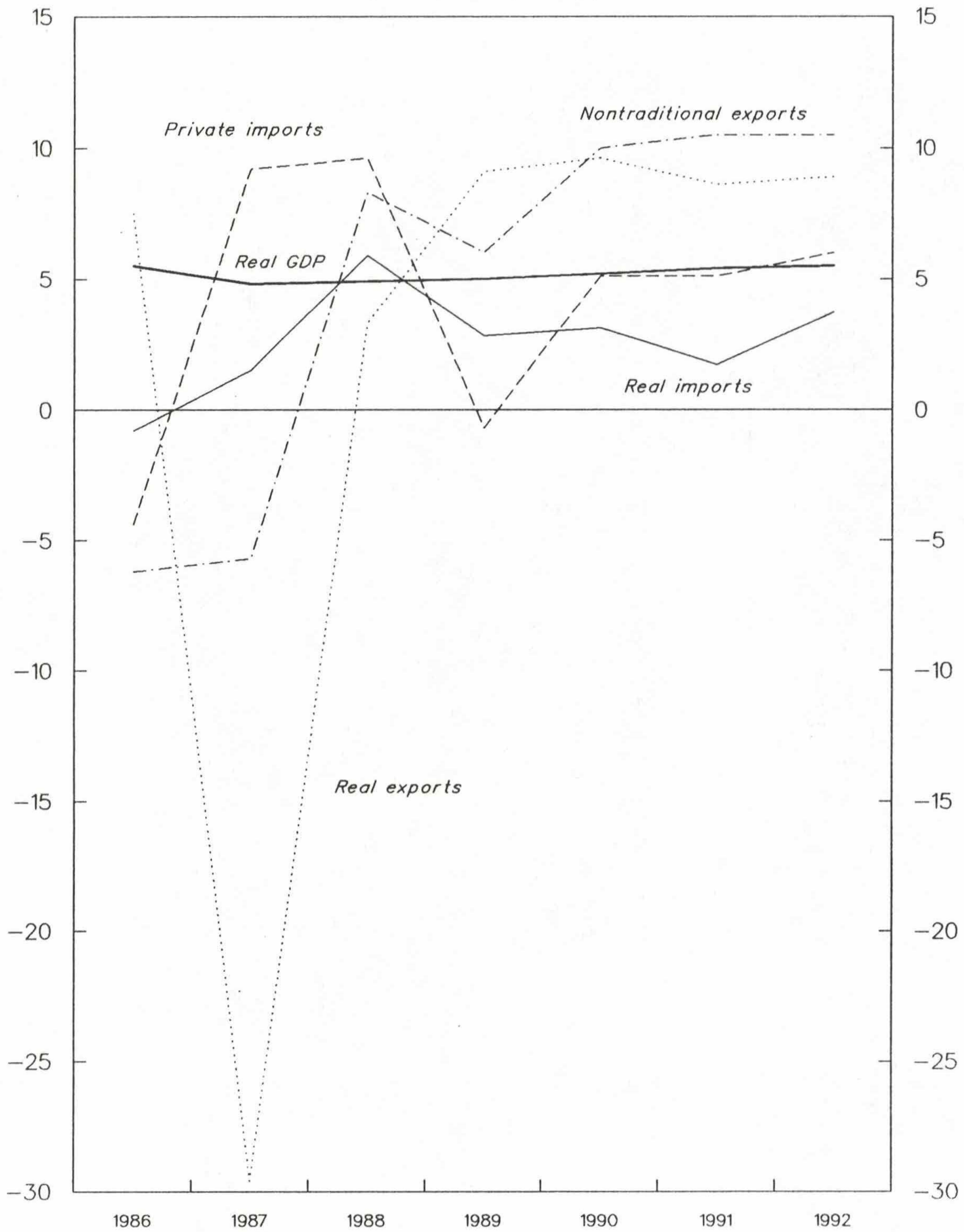
NOMINAL AND REAL EFFECTIVE EXCAHGE RATES, JANUARY 1985–DECEMBER 1989

(End period; December 1985=100)



Sources: IMF, EIS; and staff estimates.

CHART 2
KENYA
ECONOMIC GROWTH INDICATORS, 1986–92
(Annual percentage change)



Sources: IMF, EIS; and staff estimates.

1. Fiscal policy and structural reforms in the budget

Fiscal reform will be directed at reducing the structural budget deficit to levels that can be sustained by foreign and noninflationary domestic financing that will not crowd out the private sector. Accordingly, it is estimated that the central government overall cash deficit will be steadily reduced from 4.2 percent of GDP in 1989/90 (6.5 percent of GDP, excluding grants) to 3.8 percent of GDP in 1990/91 (5.6 percent of GDP, excluding grants) and to 3.4 percent of GDP by 1991/92 (5.1 percent, excluding grants) (Chart 3). Concurrently, the Government aims at reducing sharply the domestic bank financing of the deficit from 0.5 percent of GDP in 1989/90 to an estimated 0.1 percent by 1991/92, with almost all additional domestic bank credit being channeled to the private sector (details on the 1989/90 and 1990/91 budgets are provided in Section IV.1). In addition, the Government intends to monitor a broader consolidated public sector deficit and ensure that the trend of lower central government deficits is mirrored in the overall public sector financial position. The achievement of the Government's medium-term budget deficit reduction requires the implementation of structural measures that would raise total revenue by 1.1 percentage points, from 22.9 percent of GDP in 1988/89 to 24.0 percent in 1991/92, and achieve a sustained reduction in the expenditure to GDP ratio, which would drop by of 0.6 percentage point to 29.1 percent of GDP. Tax policy will focus on broadening the tax base and enhancing the elasticity, efficiency, and equity of the tax system. In particular, the Government will continue replacing the sales tax with a uniform VAT and reduce reliance on trade taxes for revenue. The Government envisages that a rising share of recurrent expenditure will be covered by user charges for health, education, and economic services in order to help finance improvements in the quality of government services.

In terms of expenditure, the Government will reduce the share of available resources claimed by government spending and restructure the composition of expenditure to make it more efficient. To help correct the prevailing imbalance between wage and nonwage operating and maintenance expenditure, the Government will decelerate the growth of central government employment to 2 percent per annum, while Teachers Service Commission (TSC) employment growth will be decelerated to 8 percent in 1990/91 and further in the following two years. It will also seek to restrain and delay any distribution of salary awards to compensate for past inflation until 1991/92 at the earliest. At the same time, the Government will steadily increase real nonwage operating and maintenance expenditure in the priority economic and social sectors of health, agricultural services, road maintenance, and water supply. Sectoral norms will be developed for defining appropriate staffing and nonwage inputs for different types of public services in priority areas. To achieve greater rationalization of the capital expenditure program in 1990/91, the Government has prepared a comprehensive project list for the Central Government with emphasis on containing its size and completing unfinished projects. A comparable list has been prepared for the major nonfinancial state corporations. During the next year, and in connection

with the 1991/92 budget, the Government will prepare, with the assistance of IDA, a public investment program and will undertake a detailed review and assessment of the relative economic merits of the major projects.

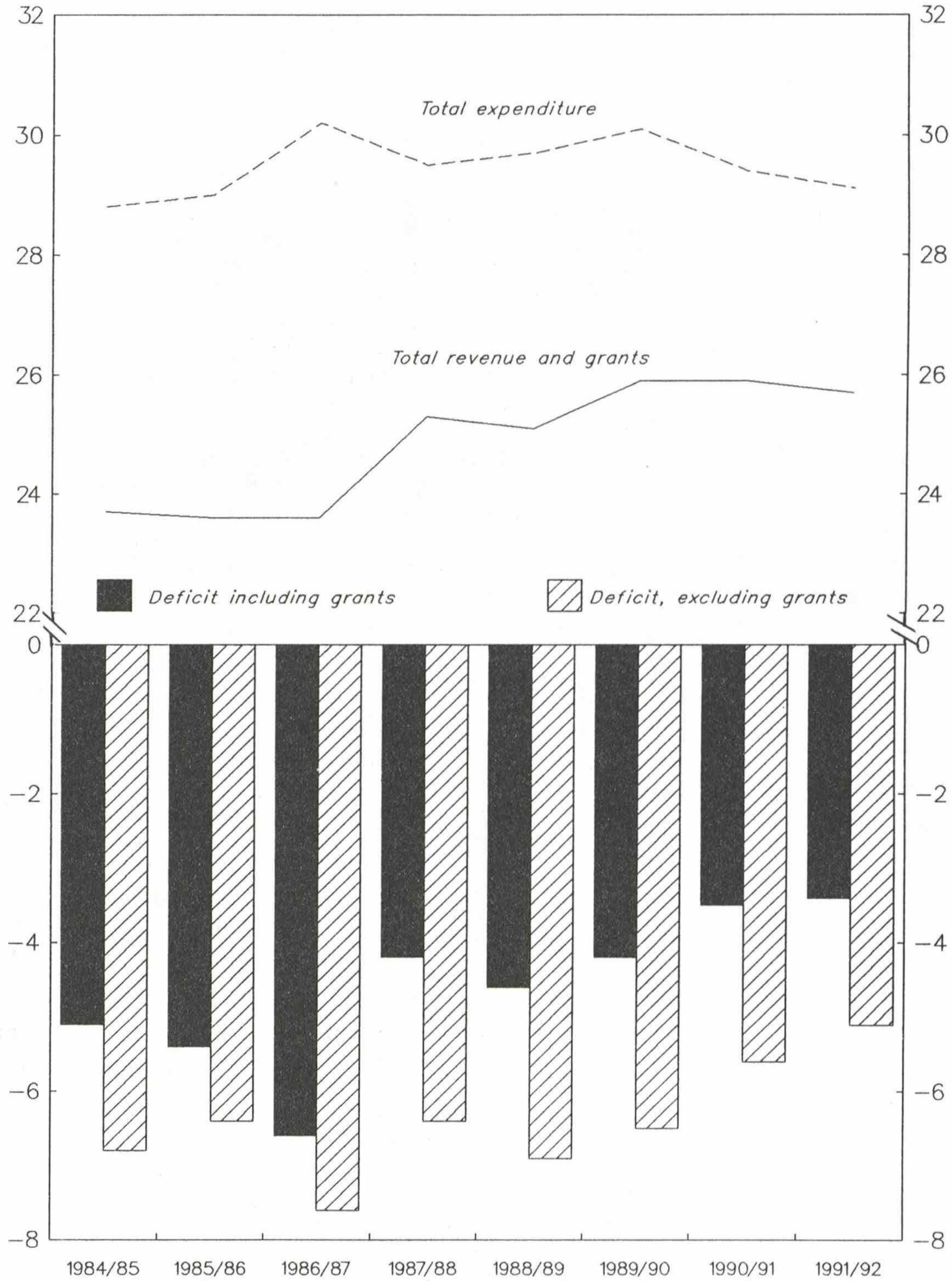
2. Reform of state corporations

Over the next three years the Government will accelerate its efforts to strengthen the economic efficiency and financial performance of state corporations. Building upon the case-by-case approach that has been applied thus far to state corporation reform in Kenya, the Government will develop criteria on the basis of which it will designate some state corporations as strategic and others as potential candidates for privatization. Steps will be taken to formalize the terms of past government loans to state corporations and require them to pay market-equivalent interest rates to the Government. Moreover, any subsidies will be made explicit. Consideration will be given to reducing the level of administrative and other controls over the operations of commercially oriented state corporations. In particular, the Government intends to undertake a reform of the present categorization of the state corporations' salary scale in commercially oriented enterprises with a view toward reducing the degree of rigidity in the present system and increasing management autonomy. Finally, the data base and the capacity for monitoring the financial and economic performance of state corporations will be significantly strengthened.

3. Monetary policy and financial sector reform

In view of the rapid expansion of liquidity in the second half of 1989, the stance of monetary policy has been tightened considerably (details of the 1990 monetary program are provided in Section IV.3). In order to enhance further the mobilization and allocation of domestic resources, while increasing the flexibility and effectiveness of monetary management, the Government will continue to implement the financial sector adjustment program with support from by IDA and technical assistance from the Fund. In particular, indirect monetary policy instruments will replace credit controls as the means of targeting liquidity; and monetary programming--primarily vis-à-vis reserve money management will be adopted to make daily liquidity operations consistent with longer-run policy objectives. In tandem with these developments, positive real interest rates will be maintained and appropriate steps will be taken to remove interest rate ceilings by June 1991. To facilitate financial reform, the development of both short-term money markets and long-term debt and equity markets will be encouraged. In the short-term money markets, secondary trading in treasury securities will be facilitated, and commercial banks will be allowed to issue certificates of deposit and commercial paper. To stimulate the growth of long-term debt and equity markets, the Capital Markets Authority (CMA), which has recently been established, will encourage public issues

CHART 3
KENYA
CENTRAL GOVERNMENT OPERATIONS, 1984/85–1991/92
(In percent of GDP)



Sources: IMF, EIS; and staff estimates.

and demand for securities as well as encourage financial intermediaries to develop and participate in underwriting, securities brokerage, and related activities.

4. External policies

Over the medium term, Kenya's external policies aim to broaden the basis for export growth by removing constraints on the export sector while maintaining a macroeconomic environment supportive of external viability. Kenya has good potential for increasing a range of non-traditional exports, including horticulture and manufactured goods, and diversification of exports into new products and markets has become critically important in light of the recent sharp decline in coffee prices and Kenya's continued dependence on commodity exports for about 50 percent of its export earnings. The authorities intend to pursue an exchange rate policy compatible with a sustainable external position and consistent with the need to diversify export production. Appropriate fiscal and monetary policies are to support this level. Since 1988, Kenya has been implementing a phased liberalization of imports aimed at increasing the openness and efficiency of the industrial sector. This reform has substantially increased the sector's access to foreign intermediate goods and has reduced their cost. The last stage of the liberalization is to be completed by mid-1991. Meanwhile the authorities intend to place greater emphasis on specific incentives to encourage exports, by allowing exporters access to imported inputs at international prices.

Efforts to promote the efficiency of the industrial sector in 1989 concentrated on consolidating the reform of the trade system by the completion of the second phase of the import liberalization program (see Section II above). In 1990 and 1991, the Government intends to remove quantitative restrictions on all nonexempt imports--primarily final consumer goods--still subject to control (except textiles). These goods, currently in Schedule IIIC, will be shifted to the now unrestricted Schedule IIIB. The items to be shifted, which account for about 46 percent of import items in Schedule IIIC, and 5 percent of 1986/87 import values, will be liberalized in two installments in July 1990 and July 1991 and replaced by equivalent tariffs. Controls on at least 55 percent of the import items to be liberalized will be removed in 1990. These represent a third of the 1986/87 import values of the goods to be liberalized. A timetable for unrestricted licensing of textile imports in Schedule IIIC, which form a large part of imports of final goods, will be formulated when the IDA study of the sector is completed in July 1990. This timetable, and the replacement of controls on textile imports with equivalent tariffs, will be discussed with the Government at the time of the midterm review of the second annual arrangement under the ESAF.

The Government is developing, in conjunction with IDA, a strategy that would substantially improve access by exporters to raw materials and intermediate inputs at international prices. Although the import

liberalization program has removed quantitative controls on most of these goods and reduced average tariffs, tariff rates still average over 20 percent. The new measures, which are being formulated in the context of an IDA credit, are expected to be implemented by early 1991 and to include a duty exemption scheme for reimbursing exporters of manufactured goods for duties on imported inputs, as well as measures to facilitate exporters' access to credit. Until the new initiatives are in place, the current export compensation scheme will be extended and made more transparent; eligible items were increased from 743 to 1,241 in June 1989 and will be increased further in July 1990, and the criteria for eligibility for the scheme will be published. The lags in disbursing payments by the Customs Office and Central Bank were considerably shortened from an average of 20 weeks in 1985/86 to 6 weeks in 1988/89, and by end-April 1990 the Government will begin to implement a system to reduce delays further and increase transparency by channeling compensation payments through commercial banks. Continuing its policy to encourage new manufacturing investment, the Government will prepare and submit legislation for export processing zones by January 1991.

5. Balance of payments outlook

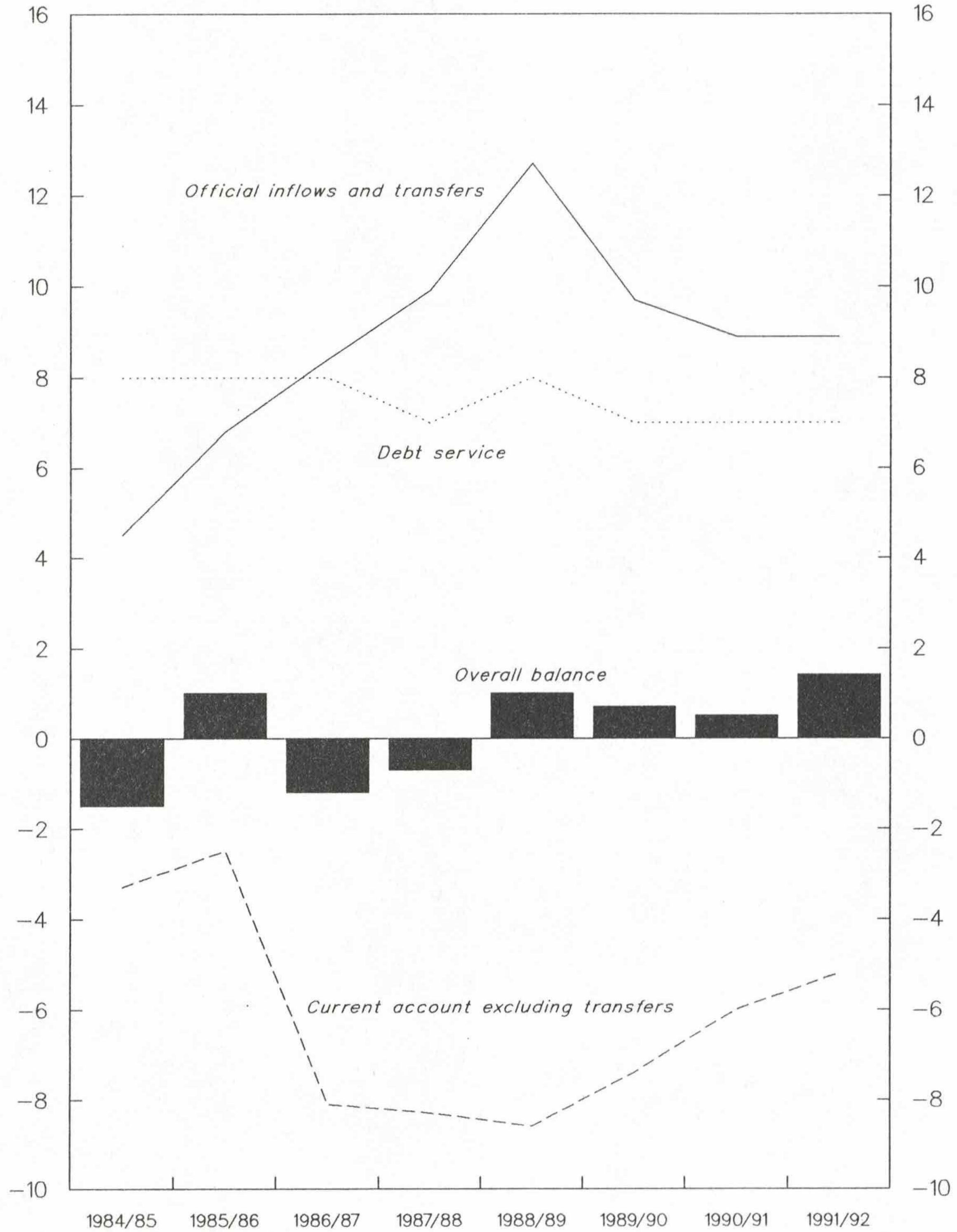
The medium-term balance of payments projections in Table 6 above have been discussed with the authorities and reflect the most recent World Economic Outlook assumptions regarding macroeconomic developments in trading partners and commodity prices. Estimated financing requirements in 1990 and 1991 are larger than anticipated when the first-year ESAF arrangement was approved, but the staff believes that they can be met mostly from identified credits currently being considered by the World Bank and other donors. 1/ Based on the experience of the past two years, it is expected that most of the financing of the external current account deficit will be available on concessional terms. (The Government intends to keep nonconcessional borrowing by the public sector within strict limits.) While the current account deficit as a ratio of GDP is forecast to be substantially higher in 1992 than it had been in the mid-1980s, it reflects a steady decline from its peak of 6.3 percent in 1987 as policies strengthen the external position (Chart 4).

Consistent with the Government's strategy to pursue prudent financial policies and encourage greater private sector participation in the economy, the share of non-oil nongovernment imports in the total is expected to increase from about 60 percent in 1987--the year before the import liberalization program began--to 70 percent in 1992. Intermediate goods will be a significant part of these higher imports, which will contribute to the more vigorous growth anticipated for nontraditional exports. Total merchandise imports are now expected to be higher

---

1/ Additional financing requirements anticipated in EBS/89/84 for 1990, 1991, and 1992 were SDR 83 million, SDR 32 million and SDR 23 million, respectively. Revised figures are SDR 98 million, SDR 75 million, and SDR 30 million, respectively.

CHART 4
KENYA
BALANCE OF PAYMENTS, 1985–92
(In percent of GDP)



Sources: IMF, EIS; and staff estimates.

over the medium term, in part because in December 1989 Kenya Airways signed leases for four airplanes, to be delivered in 1989, 1990, and 1991. These will increase government imports by some SDR 91 million in 1989, some SDR 70 million in 1990, and half of that amount in the following year. Despite the leases, however, Government import volumes fall steadily over the medium term, with lower imports anticipated for the Turkwell power project and defense. The growth in imports comes primarily from higher private imports that will sustain overall GDP growth at about 5 percent in real terms, and include some allowance for a further upward shift after 1991 as the import liberalization program is completed and higher exports of manufactured goods increase private demand for imported inputs.

Merchandise exports are projected to grow faster than expected at the outset of the ESAF program, with the main thrust coming from the nontraditional exports targeted by the Government's trade policies. Given recent downward revisions in coffee prices and on the assumption of no conclusion of the International Coffee Agreement (ICA) in 1990, coffee earnings are expected to remain well below earlier assumptions for 1990 and 1991, with volumes growing by 5 percent by 1992 compared with 19 percent in 1989. Weaker coffee earnings are forecast to be offset by a stronger performance by tea. For the first time, tea earnings surpassed those of coffee in 1989, and are expected to be some 45 percent higher by 1992, with volumes growing by 9-10 percent a year as favorable international supply and better price conditions are expected to continue. Oil exports to neighboring countries have, however, been revised downward. Lack of price competitiveness--which led to a 20 percent decline in petroleum export volumes in 1989--is expected to continue with no restructuring of the sector in prospect, and volumes are expected to remain low, at 2 percent growth a year. Net service earnings are expected to perform somewhat better, as the initial slowdown in tourist receipts toward the end of 1989 (associated with highly publicized incidents in the game parks) is offset by higher receipts on trade-related services and higher earnings from Kenya Airways.

These projections are subject to a number of uncertainties; in particular, commodity prices are likely to differ from current forecasts if the ICA is reinstated and if supply conditions in the coffee and tea markets change. Moreover, it is not clear whether the Government's policies will elicit the anticipated response in trade volumes--particularly for nontraditional exports and private imports.

If factors underlying the projections turn out to be somewhat different from the assumptions, external performance may be significantly altered (Table 7). If, for example, demand policies are such that volume growth of nongovernment, non-oil imports is 10 percent (similar to the growth in 1987 and 1988) instead of 5 percent in 1990, or double the growth rate in real GDP, the balance of payments would deteriorate sharply. Instead of the baseline overall surplus of SDR 46 million in 1990, there would be a deficit of SDR 12 million, which would more than double in 1991; the current account deficit to GDP

Table 7. Kenya: Medium-Term Scenarios, 1989-93

(In percent, unless otherwise specified)

	1989 Actual	1990 Projections	1991	1992	1993
			Baseline scenario 1/		
Coffee export price	-30.3	-13.3	6.5	7.0	7.5
Nontraditional export volume growth 2/	6.0	10.0	10.5	10.5	11.0
Other import volume growth 3/	-0.7	5.1	5.1	6.0	6.3
Current account deficit/GDP	5.9	5.4	4.4	3.6	2.6
Debt service ratio 4/	30.8	27.5	24.4	23.4	20.4
Overall balance 5/	52.0	46.0	38.0	109.0	112.0
			Scenario A: Higher import volume growth 6/		
Coffee export price	-30.3	-13.3	6.5	7.0	7.5
Nontraditional export volume growth	6.0	10.0	10.5	10.5	11.0
Other import volume growth	-0.7	10.1	5.1	6.0	6.3
Current account deficit/GDP	5.9	6.2	5.2	4.5	3.6
Debt service ratio	30.8	27.5	24.4	23.4	20.4
Overall balance	52.0	-12.0	-25.0	39.0	34.0
			Scenario B: Higher export volume growth 7/		
Coffee export price	-30.3	-13.3	6.5	7.0	7.5
Nontraditional export volume growth	6.0	15.0	10.5	10.5	11.0
Other import volume growth	-0.7	5.1	5.1	6.0	6.3
Current account deficit/GDP	5.9	5.1	4.1	3.3	2.3
Debt service ratio	30.8	27.2	24.2	23.2	20.1
Overall balance	52.0	65.0	60.0	134.0	141.0
			Scenario C: Higher coffee export price 8/		
Coffee export price	-30.3	5.0	6.5	7.0	7.5
Nontraditional export volume growth	6.0	10.0	10.5	10.5	11.0
Other import volume growth	-0.7	5.1	5.1	6.0	6.3
Current account deficit/GDP	5.9	4.9	3.8	3.1	2.0
Debt service ratio	30.8	26.9	24.0	23.0	20.0
Overall balance	52.0	81.0	78.0	153.0	162.0

Sources: Data provided by the Kenyan authorities; and staff estimates and projections. Sensitivity reflects direct effects of changes only.

1/ Based on the scenario presented in Table 6.
2/ Noncoffee, nontea exports.
3/ Non-oil and nongovernment imports.
4/ Including the IMF; in percent of exports of goods and services.
5/ In millions of SDRs.
6/ Assumes that non-oil nongovernment import volume growth is 5 percentage points higher than in the baseline scenario in 1990.
7/ Assumes that noncoffee/nontea export volume growth is 5 percentage points higher than in the baseline scenario in 1990.
8/ Assumes that coffee prices rise by 5 percent in 1990.

ratio would worsen by nearly a full percentage point of GDP annually over 1990-93. Given the high rate of monetary expansion in late 1989, combined with the 40 percent increase in approvals for import licenses in 1989 over 1988, there is a possibility that imports could well grow faster than assumed in 1990. The sharp impact on the balance of payments demonstrates the need to maintain a nonexpansionary policy stance.

On the export side, the projections assume that policies to promote nontraditional exports such as horticulture and manufacturing will take time to have an effect. However, should these exports grow by 15 percent in volume terms in 1990 instead of by 10 percent, Kenya's reliance on foreign borrowing could, ceteris paribus, be significantly lower; the overall surplus would be some 40 percent higher in the same year, and some 60 percent higher in 1991. The cumulative increase in the surplus owing to higher export earnings in 1990-93 would be 80 percent of Kenya's nonconcessional borrowing limit for 1990. Finally, commodity prices, particularly for coffee, have been fluctuating widely and can have a large impact on Kenya's export earnings. The assumption of a continued decline of some 13 percent in 1990 is based on the Fund's forecasts, with some upward revision for historical experience reflecting the buoyant demand for Kenyan coffee. However, international prices for coffee have recently shown signs of firming in light of the downward revision in Brazil's export forecasts for the crop year 1990/91. If prices rise by 5 percent instead of declining by 13 percent in 1990, Kenya's overall balance would improve by some SDR 35 million in 1991 and by a similar amount in the following year. The ratio of the current account deficit to GDP would improve by 2.2 percentage points in cumulative terms over 1990-93.

The larger current account deficits that emerge in the new baseline forecasts are expected to be financed by substantially higher concessional capital inflows than earlier projected. With gross reserves targeted, as before, to reach three months of nongovernment imports in 1991, the larger financing needs are expected to be met by quick-disbursing funds from the World Bank in both 1990 and 1991, under a second agricultural sector adjustment credit and a credit to support export development. Some cofinancing is anticipated from bilateral sources for these credits and for the ongoing financial sector adjustment credit. The authorities intend to limit strictly the contracting of nonconcessional borrowing, including leases, by the public sector. The implementation of this policy is expected to reduce Kenya's debt service ratio (including payments to the Fund) from nearly 31 percent in 1989 to about 23 percent in 1992 (Table 8). Debt as a percentage of GDP will continue to rise in the medium term, but will fall steadily after 1993.

6. Long-term prospects and capacity to repay the Fund

Estimates of Kenya's long-term external performance show that the balance of payments position can improve steadily by the turn of the century (Table 9). The ratio of the current account deficit to GDP

Table 8. Kenya: External Public Debt Operations, 1985-92

	1985	1986	1987	1988	1989	1990	1991	1992
	(In millions of SDRs)							
A. External debt outstanding 1/	3,070	3,331	3,439	3,753	3,870	4,231	4,585	4,853
Non-IMF 2/3/	2,628	2,979	3,170	3,421	3,556	3,912	4,215	4,542
Pre-1988 4/	2,628	2,979	3,170	3,421	2,909	2,643	2,375	2,119
Post-1988	—	—	—	—	647	1,269	1,840	2,423
IMF credit	442	352	269	332	314	319	370	311
B. Debt service payments (C+D)	470	488	470	437	501	496	491	526
C. Principal payments 5/	287	307	298	262	329	325	292	318
Non-IMF 3/	217	217	214	194	231	248	262	259
IMF	70	90	84	67	98	76	30	59
D. Interest/charges	183	181	172	175	171	172	200	208
Non-IMF 3/	148	145	145	155	147	153	186	199
IMF	35	36	27	21	24	18	13	9
	(In percent of exports of goods, nonfactor services, and private transfers)							
Memorandum items:								
Debt service ratios								
Including IMF	28.7	29.2	33.7	29.4	30.8	27.5	24.4	23.4
Of which: interest	(11.2)	(10.8)	(12.3)	(11.8)	(10.5)	(9.5)	(9.9)	(9.3)
Excluding IMF	22.3	21.6	25.7	23.5	23.3	22.2	22.3	20.4
	(In percent of GDP)							
Total external public debt								
Including IMF	51.3	54.3	55.8	58.6	58.5	60.8	62.6	63.0
Excluding IMF	43.9	48.5	51.4	53.5	53.8	57.6	59.9	61.4

Sources: Data provided by the Kenyan authorities; and staff estimates.

1/ Outstanding debt adjusted for the cancellation of debt owed to Canada and the Netherlands in 1987-90, to the Federal Republic of Germany in 1989, and to France and the United States in 1990.
2/ Government and government-guaranteed debt; end of period.
3/ Includes IMF Trust Fund.
4/ As of end-1988.
5/ Amortization payments on medium- and long-term debt.

Table 9. Kenya: Long-Term Balance of Payments Scenario, 1993-2001

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Current account (as a percent of GDP) 1/	-4.1	-4.0	-4.1	-3.9	-3.7	-3.8	-3.7	-3.7	-3.6
Overall balance of payments (in millions of SDRs)	111	18	106	124	145	151	155	158	99
Gross reserves in months of nongovernment imports	3.2	3.0	3.2	3.4	3.6	3.8	4.0	4.2	4.2
In months of total imports	2.7	2.6	2.8	2.9	3.1	3.3	3.4	3.6	3.6
Net use of Fund credit (in millions of SDRs) 2/	-44	-10	-26	-42	-54	-51	-44	-28	-12
					(In percent)				
Memorandum items:									
Assumed nominal growth rates:									
Traditional exports 3/	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0
Nontraditional exports	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0
Imports, excluding private non-oil 4/	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0
Private non-oil imports 5/	7.3	8.0	7.9	7.7	7.8	7.6	8.9	8.7	8.7
Nonfactor services (net)	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0
GDP	8.5	8.5	8.5	8.5	8.5	8.5	8.5	8.5	8.5
					(Ratios)				
Net official capital inflows plus official transfers/GDP	5.0	5.1	5.1	5.1	5.1	5.1	5.0	5.0	4.9
Debt service ratio 6/	20	18	18	18	17	18	17	16	15
Of which: IMF	(2.0)	(0.4)	(0.9)	(1.3)	(1.7)	(1.5)	(1.2)	(0.7)	(0.3)
Debt/GDP 7/	67	65	63	62	60	59	57	56	56

Source: Staff estimates.

1/ Excluding official transfers.
2/ Assumes zero purchases. Fund credit outstanding is zero by end-2001.
3/ Coffee, tea, and oil products.
4/ Private non-oil imports are classified as "other" imports in the balance of payments table.
5/ Derived as a residual in such a way that the financing gaps are zero and the reserve targets in months of imports are met.
6/ In terms of exports of goods, nonfactor services, and private transfers.
7/ Including IMF.

(excluding official grants) can fall from a projected 4.1 percent in 1993 to 3.7 percent by 2000. These projections assume that traditional exports and imports grow at 7 percent a year, with nontraditional exports, encouraged by government policies to reduce cost distortions and administrative obstacles to manufactured exports, growing somewhat faster at 8 percent. With strict limits on commercial borrowing and average maturities of about 14 years on concessional borrowing, the capital account is expected to remain strong. As a result, overall surpluses allow an accumulation of reserves that rise to over four months of nongovernment imports by 2000. In this way, the Government can achieve a steady decline in the debt service ratio by the end of the decade while maintaining a ratio of net capital inflows and official transfers to GDP at about 5.0 percent. This scenario depends critically on the Government's ability to control domestic demand and inflation while persisting with policies that allow export diversification by reducing the existing antiexport bias in the economy. Successful external performance in the long run also depends on controlling the amount of nonconcessional borrowing by the public sector in order to reduce the future burden of foreign exchange payments.

Debt service to the Fund in relation to exports of goods, nonfactor services, and private transfers is expected to be about 3 percent in 1992, and 16.8 percent of gross reserves (Table 10). In 1994-2001, ESAF repayments lead to debt service ratios of 1.6 percent at their peak in 1997, or 7 percent of reserves. During 1990-91 the cumulative ratio of gross financing from the Fund to Kenya's gross financing needs will be 0.22.

The Kenyan Government has had an excellent record in meeting its obligations to the Fund on time and is fully committed to continuing to do so. On the basis of the balance of payments performance expected under the long-term scenario discussed above, the staff expects that Kenya will be able to discharge these commitments.

7. Social and environmental impact of the program

Since the magnitude of Kenya's economic distortions and structural imbalances is less than in other adjusting developing countries, the structural reforms required and their potential social impact are correspondingly smaller. Nevertheless, the Government aims to minimize any adverse effects on disadvantaged groups. Specifically, steps have been taken to ensure that the recently introduced user charges in health and increased cost-sharing in education do not limit access by low-income groups to these services. In the health sector, the Government has exempt those who cannot afford to pay for the types of services that must be encouraged for social reasons. In the education sector, a bursary scheme has been introduced to assist poor and deserving students to meet the high costs of secondary education, while the present policies exempting low-income students from the new university tuition scheme will be maintained.

Table 10. Kenya: Indicators of Fund Credit, 1990-2002

(In percent)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
	Projections 1/												
Outstanding Fund credit/GDP	4.6	5.1	4.0	3.3	2.9	2.4	1.8	1.2	0.7	0.3	—	—	—
Outstanding Fund credit/quota	224.4	260.6	219.2	188.0	181.1	163.0	133.5	95.5	59.5	28.3	8.5	—	—
Debt service to the Fund/gross official international reserves	30.8	10.9	16.8	10.6	2.1	4.5	6.3	7.1	5.9	4.5	2.5	1.0	0.9
Debt service to the Fund/exports of goods, nonfactor services, and private transfers													
Baseline scenario 1/	5.2	2.1	3.0	2.0	0.4	0.9	1.4	1.6	1.4	1.1	0.7	0.3	0.2
Scenario 2/	5.3	2.1	3.1	2.0	0.5	0.9	1.4	1.7	1.5	1.1	0.7	0.3	0.3

Sources: IMF, Treasurer's Department; and staff projections.

1/ Baseline scenario as presented in Tables 7 and 9.
2/ Assumes 3 percentage point lower export growth in each year, 1990-2001.

Over the medium term, the Government's environmental priorities will focus on the forestry sector, wildlife resources, and arid and semiarid lands (ASALs). With the assistance of IDA and other donors, steps are being taken to strengthen forestry policies and institutional support for reforestation and ASALs programs. Recently the Government has also begun to address the critical situation in the wildlife sector. In addition to strengthening antipoaching measures and banning the export of ivory, the Wildlife Department has been reconstituted as a separate agency, headed by a renowned scientist, to increase its effectiveness in policy formulation and the management and protection of wildlife.

IV. The Program for 1990

In the context of the medium-term framework of the program, the basic macroeconomic objectives for 1990 are largely as outlined at the outset of the ESAF arrangement, and seek (a) to achieve a growth rate of real GDP of 5.2 percent; (b) to lower the rate of inflation on an end-of-period basis from 10.1 percent in 1989 to 7.5 percent in 1990; (c) to narrow the external current account deficit from 5.9 percent of GDP in 1989 (8.6 percent, excluding official transfers) to 5.4 percent of GDP in 1990 (7.3 percent, excluding official transfers); and (d) to build up gross reserves from the equivalent of 2.2 months of nongovernment imports in 1989 to 2.5 months of nongovernment imports in 1990.

In late 1989 and early 1990 a number of unfavorable economic developments occurred. Liquidity expansion was more rapid than anticipated in the second half of 1989. Inflationary pressures intensified after October 1989--the measured consumer price index rose to 10.8 percent in January (end-period) from 9.4 percent at end-October--and shortages of some price-controlled commodities suggest that the measured index may understate inflation in the economy. In the external sector, tourist receipts have been sluggish since November, and there was a sharp increase in import license applications during the second half of 1989, reflecting the impact of the import initiatives carried out earlier in the year. These latter factors, combined with the higher cost of imported petroleum, put some pressure on gross foreign exchange reserves in early 1990.

In view of these developments, the policy package for 1990 has been tightened in a number of respects. In addition to the already targeted reduction in the overall budget deficit, a substantial contraction in credit and monetary growth has been programmed, including sizable adjustments in interest rates. The exchange rate will continue to be managed flexibly with a view to maintaining competitiveness. To encourage a restructuring of the economy over the medium term and a broadened basis for growth, the program also aims to diversify export production and to reduce distortions in the external and industrial sectors.

1. Fiscal policy

The overall budget deficit for 1989/90 is programmed at 4.2 percent of GDP (6.4 percent, excluding grants). This represents a further tightening of the fiscal stance relative to the 1988/89 budget deficit on a commitment basis (4.6 percent of GDP), and reflects the decision of the authorities not to seek a higher budget deficit in the context of larger-than-anticipated external concessional development assistance. Revenue is projected to rise to 23.7 percent of GDP from 22.9 percent in 1988/89, just short of the earlier program target of 24.1 percent. This reflects some delays in the introduction of the presumptive tax on agricultural products together with sharply lower coffee prices, some transitional costs in the adoption of the new VAT, and the ambitious original program targets for collection of import duties under import liberalization. User charges will play a greater role in financing recurrent outlays, rising from about 0.6 percent of GDP in 1988/89 to 1.3 percent in 1989/90, with increased tariffs in agriculture, livestock, roads, health, and education.

The share of expenditure and net lending in GDP will increase slightly from 29.7 percent in 1988/89 to 30.1 percent in 1989/90, largely because of the small increase in the share of recurrent expenditure that was originally programmed. Major efforts were made to meet the structural benchmark of limiting the growth of the wage bill to 7.5 percent, including a freeze on vacancies exceeding six months and a decision not to grant a salary revision, despite a cumulative rate of inflation of almost 30 percent over the last three years. Nevertheless, the wage bill is expected to grow by just over 11 percent in 1989/90, primarily as a result of the implementation of the new 8-4-4 education system and the attendant demand for additional trained teachers. Interest outlays on domestic debt are likely to be higher than anticipated owing to higher interest rates, and this will largely offset the savings arising from interest remissions and debt forgiveness from a number of donors (Canada, France, the Federal Republic of Germany, the Netherlands, and the United States) (see Section II). Development expenditure will fall short of the program target by 0.5 percent of GDP, as the Government has postponed a number of lower priority projects and slowed the rate of project absorption consistent with the overall macroeconomic framework and the need to finance the future costs of operations and maintenance. To facilitate the analysis of expenditure, an economic classification of the budget has been prepared and a monthly monitoring system of wages and operating expenses is being developed.

Foreign financing of the deficit will be somewhat higher than originally projected, reflecting higher program loan assistance. To ensure continued mobilization of nonbank resources, the yields on treasury securities will be made more attractive and greater publicity will be given in the media to the effective yields offered in recent treasury auctions. Bank financing of the deficit will be held to 0.5 percent of GDP in 1989/90, less than originally anticipated. The Government recognizes that meeting quantitative fiscal targets by an

increased float is inconsistent with the objectives of the program. Therefore, the level of unpresented checks at the end of 1989/90 will not exceed K Sh 1.1 billion, the level at end-1987/88.

Consistent with the medium-term policy framework and the need to further tighten the stance of fiscal policy, the 1990/91 budget deficit will be reduced to 3.8 percent of GDP (5.6 percent of GDP, excluding grants). Revenue as a share of GDP is expected to rise to 24.1 percent, reflecting further steps to replace the sales tax with a uniform VAT, the broadening and extension of user fees to other services, and the effect of new revenue measures to be announced when the budget is presented. Total expenditure and net lending is budgeted to decline to about 29.7 percent of GDP, wholly reflecting slower growth in recurrent spending. To contain the growth of wages and salaries, a significant effort will be made to reduce further the rate of growth of government employment; civil service employment growth in the published 1990/91 estimates will be limited to 2 percent above the number of posts authorized in the 1989/90 budget (relative to about 4 percent in 1989/90), and the increase in the number of teachers employed by the TSC will not exceed 8 percent of the level outstanding on February 1, 1990 (compared with 11 percent in 1989/90). Together with the normal salary increments of 4 percent, the combined wage bill of the Central Government will rise by no more than 9 percent in 1990/91. By the end of 1990, the monthly monitoring and reporting system for the wage bill and operating expenses should be operational. Development outlays are targeted to rise slightly, to 7.2 percent of GDP. Considerable efforts are under way to strengthen the budgeting and implementation of development outlays and to prune the number of projects in order to ensure a high-productivity investment program. A detailed ministry-by-ministry project list has been included for the first time in the 1990/91 budget, with a forward budget for proposed outlays during the period 1991/92-1992/93, permitting more rational selection of development projects and a focus on more rapid implementation of ongoing projects.

The 1990/91 budget deficit will be financed largely from foreign concessional sources and domestic nonbank sources. Bank financing will be limited to K Sh 650 million or 0.3 percent of GDP. The nonbank sector is expected to finance about two thirds of the domestically financed deficit.

2. State corporations

In 1989/90, with technical assistance from the Fund, a major effort has been initiated to establish an information system and data base which would provide quarterly and annual indicators of economic and financial performance for a core group of enterprises. Monitoring of the budgetary impact of enterprises has already been undertaken for ten large enterprises, and such monitoring will be extended this year to another ten enterprises. In 1990, a PFP for state corporations will be

completed. A plan for restructuring the major development finance institutions in the industrial sector has been developed in consultation with IDA, for implementation beginning in 1990.

Kenya Airways has experienced financial and organizational difficulties in recent years, reflecting deficiencies in its management and maintenance capacity, and excess staffing. A major part of its fleet is in need of upgrading. It has recently undertaken to lease an Airbus and four new Boeing jets. Two aircraft were delivered in late 1989 and two more are due in late 1990. Technical assistance from the World Bank will be provided shortly in the formulation of a restructuring plan, which is to be completed by end-August 1990. Efforts are also under way to obtain management assistance from a major foreign airline. The Government is fully committed to implementing a restructuring plan by late 1990 as well as undertaking the steps required to rationalize staffing.

3. Monetary and financial sector policies

Monetary policy in 1990 will seek to maintain the growth of net domestic assets of the banking system and liquidity consistent with reducing inflationary pressures, and supporting external adjustment through a slowdown of the pace of import demand and a buildup of up reserves, as well as improving the efficiency in the allocation of resources. This requires a cautious credit policy that limits government recourse to the banking system, while providing adequate credit to the private sector. In view of the expected growth of real GDP, and the targets for inflation and net foreign assets, the growth of the money supply is programmed to decelerate, from 18 percent at end-December 1989 to below 11 percent by the second quarter of 1990. This implies an increase in velocity from the end of the previous year. In 1989, the growth of the money supply exceeded program targets, despite the fact that the benchmarks and performance criterion on total domestic credit were met, largely on account of significant fluctuations in "other items, net" at the end of each quarter. To facilitate the realization of monetary targets in 1990, the performance criterion on total domestic credit has been changed to a ceiling on net domestic assets. Accordingly, the growth of net domestic assets is programmed to decelerate from 14.1 percent at end-December 1989 to 11.2 percent at end-June 1990, and 9.2 percent at end-December 1990.

Interest rates will continue to be maintained positive in real terms. In addition to the sizable increase in interest rate ceilings on both deposits and loans called for under the program, greater flexibility in adjusting interest rates will arise from the removal of the legal requirement that the loan interest rates subject to ceilings be inclusive of all lending-related fees and charges. The removal of this requirement represents an important step in the liberalization of interest rates, for it will allow the effective interest rates to significantly exceed the formal ceilings on loan interest rates. The authorities remain committed to the removal of interest rate ceilings by June 1991.

In 1990, the program will seek to increase reliance on market mechanisms for allocating financial resources and implementing monetary policy. With technical assistance from the Fund, reserve money management will be introduced. Strong efforts will be made to publicize auctions of treasury instruments and at the same time, the Central Bank will gradually move away from quantitative credit ceilings toward open market operations as a more efficient means of controlling monetary aggregates.

4. External policies

An important part of the Government's strategy to create an environment conducive to a more diversified and sustainable basis for growth, particularly in the export sector, is the continuation of its exchange rate management. Since 1985, on a fourth-quarter basis, the real effective exchange rate of the Kenya shilling has depreciated by 29 percent. Over 7 percent of this occurred between December 1988 and December 1989. A number of factors suggest, however, that this depreciation has not been adequate. First, the overall balance of payments position was in deficit in three of the five years 1985-89 (Kenya also made purchases from the Fund in three of these years). Second, real export growth has been slow, rising by only little over half the rate of real GDP growth in trading partners. More important, given Kenya's need to diversify exports, growth in noncommodity exports has been disappointing. Third, while Kenya has begun to liberalize its highly restrictive import system, controls still exist on many final imports and average tariffs on the unrestricted categories are still at high levels. The persistence of these high tariffs suggests that at the current exchange rate, a reduction of tariffs would lead to unacceptable payments deficits. Finally, the parallel market rate for the U.S. dollar has been about 30 percent more depreciated than the official rate.

Indicators of relative price incentives for Kenyan producers in the tradable goods sector suggest that incentives may have deteriorated substantially since 1985. 1/ Indicators of export prices relative to various indices of home goods prices, labor costs, and input costs show a weakening of profitability and production incentives in the export sector. For various categories of import-competing home goods (such as food, oil, and fats, and miscellaneous manufacturing), there is evidence that domestic prices have risen more rapidly than imports, suggesting that Kenyan consumers have had price incentives to import. Finally, labor costs as well as imported input prices have risen relative to final domestic goods prices, indicating deteriorating incentives for production of import substitutes. If these indicators are correct, the relative price incentives needed to promote external adjustment have weakened since 1985. An estimate of the real effective exchange rate based on relative labor costs in manufacturing in Kenya and its trading partners also suggests that the Kenyan manufacturing sector has become

---

1/ See Appendix VI.

less competitive abroad, and that there has been some real appreciation of the rate since 1987 (see Chart 1 above). 1/

Taking account of the above factors in 1990, the authorities intend to continue to manage the exchange rate with a view to reaching a level that is consistent with external viability and that can be sustained by the fiscal and monetary policies controlling domestic demand pressures and inflation. The staff will discuss these issues further at the time of the midterm review.

Trade policies in 1990, as noted in Section III 4, include the implementation of the last phase of the import liberalization and the initiation of new policies to reduce constraints on nontraditional exports. Quantitative controls will be removed on more than half the eligible items in the last category of imports to be liberalized--Schedule IIIC, which comprises final consumer goods. Textiles are to be treated separately, and a timetable for removing controls on these goods will be drawn up once an IDA study on restructuring the sector is completed in July 1990. The controls will be replaced by equivalent tariffs. At the same time, price controls will continue to be lifted on goods in the remaining 18 general categories that are still controlled, as well as on several commodities controlled under the Specific Order.

The Government's strategy to reduce the antiexport bias in the economy is being developed in discussions with IDA. The intention is to improve access by exporters to imported inputs at international prices by establishing a duty exemption scheme that would be functional by early 1991. The legislation for establishing export processing zones will also be prepared during the year for submission in January 1991. The current export compensation scheme will, as a transitional measure, be extended to cover more goods in 1990 and will begin to be implemented by commercial banks to reduce delays in payments to exporters.

With the implementation of the policies under the second-year ESAF arrangement, an overall surplus in the balance of payments of SDR 46 million is projected for 1990. The targeted reserve accumulation of SDR 50 million should permit gross reserves to rise to 2 1/2 months of nongovernment imports. The current account deficit (with two more leases of airplanes by Kenya Airways) is expected to contract to 5.4 percent of GDP (including official transfers). (Without the leases, the ratio of 4.4 percent of GDP should be close to the original program level of 4.1 percent.) With continued declines anticipated in coffee prices, the main contribution to improved current account performance is

---

1/ The current measurement of the real effective exchange rate using the official consumer price index may not fully reflect Kenya's relative competitiveness in foreign markets because the CPI may understate actual inflation (see the introductory paragraph in Section IV). These issues were discussed with the authorities, who are committed to constructing a new price index during 1990.

expected to come from imports. In volume terms, real aggregate imports are projected to rise by about 3 percent in 1990. Within this total, nongovernment non-oil import volumes are forecast to rise by some 5 percent--in line with real GDP. Government imports are expected to decline by some 2 percent in real terms from the high level of 1989, partly as the Government further slows the rate of project absorption with improved budgetary supervision of development expenditures, and partly as government imports for the Turkwell power project fall by more than 50 percent as the project nears completion.

With continued import liberalization and sound macroeconomic policies, total export volumes are expected to grow by more than 9 percent in 1990, slightly faster than in 1989. Coffee earnings are anticipated to remain sluggish, given a further 13 percent decline in prices (in SDR terms), on the assumption that no new agreement on quotas will be reached during the year. Despite lower prices, coffee volumes are estimated to rise by about 13.5 percent, given the high level of stocks held by the Coffee Board and the historical demand for good quality Kenyan coffee in international markets. Tea earnings are likely to remain buoyant. Higher earnings in local currency terms are estimated to elicit some short-run supply response, while continued strong demand and lower supplies of tea to international markets by other producers are expected to maintain firm international prices. Nontraditional exports such as horticulture, manufactures, and pyrethrum are predicted to continue to grow strongly in real terms as competitiveness is improved and markets expand outside the region. Net service earnings are likely to grow steadily. During 1990, tourism earnings are expected to recover somewhat from the decline in receipts from the United States in the last quarter of 1989, offset partly by more tourist arrivals from Europe and partly by an easing of the impact of recent adverse media reports on tourist arrivals from the United States.

The capital account in 1990 is expected to remain strong. Official inflows are predicted to be only somewhat lower than in 1989, and to reflect some bilateral cofinancing of the Bank's Financial Sector Adjustment Credit, new World Bank credits for the agricultural sector and export development, and bilateral sources of balance of payments funds. These assumptions will be reassessed at the time of the midterm review of the second-year ESAF arrangement. In 1990, despite the contracting of aircraft leases, the debt service ratio should fall from 30.8 percent in 1989 to 27.5 percent. The cancellation of some debt by the Federal Republic of Germany in 1989 and some by the United States and France in 1990 more than offsets the payments due on the leases in 1990. To ensure a viable debt service ratio in the medium term, the authorities are committed to continuing strict limits on external nonconcessional borrowing by the public sector. Accordingly, the plans for the construction of a large media center announced by the press in December 1989 that was to call for large external loans have been significantly modified. Furthermore, a broader definition of public sector debt is now included within the external nonconcessional debt limits, together with a widening of the 1989 maturity range on longer-term debt

from 1-12 years to 1-15 years. The upper limit in 1989 of $100 million was accordingly raised to $155 million.

5. Benchmarks and performance criteria

For the second annual arrangement under the ESAF, the quantitative and structural benchmarks as set forth in the attached table (Appendix Table 1) are proposed. The table also gives the performance criteria for end-June 1990 under the second annual ESAF arrangement. The standard clause regarding the exchange and trade system shall also constitute a performance criterion under the second annual arrangement. The disbursement of the second loan under the second annual arrangement will also be subject to a midterm review with the Fund, to be completed by end-November 1990. The midterm review will assess the budget for 1990/91 and the implementation of the program, and will set targets for net domestic assets and net credit to the Government for the second half of fiscal year 1990/91.

V. Staff Appraisal

During 1988 and 1989 Kenya continued to demonstrate its commitment to economic adjustment and to structural reform. In 1988, Kenya successfully implemented all major elements of the program, met all performance criteria under the stand-by arrangement, and observed most of the benchmarks under the first annual arrangement under the SAF. the 1989 program, supported by the first annual arrangement under the ESAF, remains essentially on track--all end-September 1989 performance criteria were met, as were most of the benchmarks for the year. The exceptions were a small shortfall in the official reserve target at the end of the year and the 1989/90 wage bill, which is expected to exceed the growth limit of 7.5 percent. Fiscal policy on the whole was on target, as were interest rate and exchange rate policies. While all quarterly ceilings on domestic credit and subceilings on net credit to the Government under the 1989 program were observed, monetary expansion in the second half of 1989 was considerably higher than called for under the program, on account of the growth of net domestic assets of the banking system. This monetary expansion, together with a deterioration in the external terms of trade and the ongoing import liberalization, resulted in inflationary pressures and a weakened external reserve position.

The program objectives for the second year under the ESAF arrangement remain largely as originally targeted. Real growth is expected to edge up to 5.2 percent. The rate of inflation is slated to decline to 7.5 percent. The external current account deficit excluding official transfers is projected to narrow by 1.3 percentage points to 7.3 percent of GDP; and gross reserves are targeted to rise to the equivalent of 2.5 months of nongovernment imports. In order to achieve these objectives, which have become more ambitious in view of the incipient adverse developments in late 1989 and early 1990, the author-

ities have agreed to a considerable tightening of the stance of financial policies. Accordingly, the money supply growth is programmed to decelerate in 1990, implying a significant increase in velocity. In order to facilitate the realization of the monetary targets, the performance criterion on total domestic credit has been changed to a ceiling on net domestic assets; and the recourse of the Government to the banking system has been limited to a fraction of the money supply at end-1989. Furthermore, interest rates have been increased across the board and the removal of the cap on fees and charges will allow the effective interest rates to significantly exceed the formal ceilings. This represents an important step toward interest rate liberalization scheduled for June 1991. The Government will continue to implement the financial sector adjustment program, supported by IDA and technical assistance from the Fund, aimed at replacing credit controls with indirect monetary policy instruments.

Fiscal policy will contribute to the adjustment effort through consecutive reductions in the budget deficit in 1989/90-1991/92, totaling 1.2 percentage points. These deficit reductions should be viewed against the backdrop of the strong pressures on expenditure stemming from the rapid population growth in past years, which necessitates higher levels of government services. In 1989/90 the authorities have agreed to adhere to the original deficit target of 4.2 percent of GDP, notwithstanding higher-than-anticipated concessional development assistance. In 1990/91, a small increase in the revenue share of GDP and restraint in the recurrent budget should allow for the further reduction in the budgetary deficit. To ensure that the commitment deficit does not exceed the cash deficit, the authorities have also agreed to limit the level of unpresented checks to that prevailing at the end of the 1987/88 fiscal year. Realization of these fiscal targets is critical to the success of the adjustment effort, and the authorities should err on the conservative side in the implementation of the budget.

During 1989 and 1990 the authorities introduced a number of important reforms in the tax area, including the introduction of a value-added tax and cost-sharing in health and education. The staff welcomes the intention of the Government to extend the coverage of user charges so as to finance a rising share of recurrent expenditure and improve the quality of government services. While revenue in relation to GDP is broadly adequate, tax policy should focus on broadening the tax base and enhancing its efficiency and equity. In this regard, the continuation of the reform to replace the sales tax with a uniform value-added tax and to reduce reliance on international trade taxes for revenue represent positive steps that should be strengthened.

On the expenditure side, the authorities have taken steps to improve the quality of expenditures and strengthen the budgetary process, particularly as regards the development budget. However, the continuing high rate of growth in government employment in 1989/90 and the rate expected for 1990/91 are disappointing and will make the adequate correction of the prevailing imbalance between wage and nonwage

operating and maintenance expenditure over the medium term all the more difficult. The authorities share this concern, but have noted the problems posed by the growth in population and the high demand for education. In the event of further slippages in the wage bill, the authorities need to make comprehensive cutbacks in low-priority expenditures, rather than in nonwage operations and maintenance in the priority sectors. Regarding development outlays, the authorities should intensify their recent initiatives to scrutinize carefully locally funded development projects. The commitment to seek assistance from IDA in reviewing the 1991/92 public investment program is also an important step forward.

While some important progress has been made in restructuring several major state corporations, and in formulating a framework for the analysis and the monitoring of the economic and financial performance of state corporations, this sector remains a source of considerable inefficiency in the economy. Consequently, public enterprise reform initiatives must become more central to the structural adjustment effort over the medium term.

To provide a broader basis for economic growth that would accommodate the growing pressures of a rapidly expanding population, the program stresses the implementation of structural reforms in the trade and industrial sectors, particularly export promotion. Important steps in import liberalization and price decontrol have already been taken and further progress is expected during 1990-92. The promotion of nontraditional exports is key to sustained economic expansion. Kenya has a good potential for increasing its range of nontraditional exports, including horticulture and manufactured goods. Diversification, both in terms of products and markets, has become critical in light of the recent decline in coffee prices in international markets and Kenya's historical dependence on coffee. Both exchange rate management and specific export promotion initiatives should be used in a stable macroeconomic environment to improve the overall competitiveness of production, move toward more uniform rates of protection, and reduce administrative obstacles to efficient performance.

With the vigorous implementation of adjustment policies to reduce demand pressures and with the continued pursuit of structural reforms, Kenya has good prospects for strengthening its external position in the medium term. Although the country has benefited substantially from recent debt cancellation initiatives by Canada, France, the Federal Republic of Germany, the Netherlands, and the United States, Kenya will still need to rely on concessional assistance in the form of grants and loans. The authorities will have to adhere firmly to a prudent foreign borrowing policy, and in particular to limit nonconcessional loans, regardless of maturity, so that the projected decline in the debt service ratio is attained. In this regard, the authorities have agreed to a more comprehensive nonconcessional borrowing ceiling for the public sector, which covers loans and leases of maturities of 1-15 years. They have also indicated their decision to modify significantly their plans

for the construction of a media tower. The staff welcomes the commitment of the authorities to ensure that all nonconcessional borrowing for development projects meets rigorous tests of economic and financial viability. In these circumstances, and in view of Kenya's excellent record in meeting its external debt obligations on time, the staff believes that Kenya will continue to discharge its obligations to the Fund on schedule. The balance of payments, however, remains vulnerable to external shocks, and the authorities must stand ready to take additional corrective measures if the need arises.

The authorities intend to continue liberalizing the prices both of broad categories of goods under the General Order and commodities under the Specific Order. The staff believes this to be an important element of the ongoing structural reform that is consistent with the liberalization of imports, and urges the authorities to identify the specific items to be decontrolled in 1990, at the latest by the time of the midterm review.

Despite the progress being made in liberalizing the exchange and trade regime, Kenya still maintains restrictions on the making of payments and transfers for current international transactions subject to Fund approval under Article VIII, Section 2(a), in the form of limits for the remittances of rental income of nonresidents and of a foreign exchange budget on the basis of which import licenses for nonliberalized import items are issued. In light of the adjustment program being implemented and the authorities' intention to continue to liberalize the system, the staff recommends that the Executive Board grant temporary approval for the retention of these restrictions.

The staff believes that the actions already taken by the authorities, in combination with those planned for the remainder of the program period, are substantial and appropriate in the circumstances of Kenya and is therefore of the view that Kenya's program deserves Fund support under the ESAF. However, the staff would underline that the authorities' adjustment efforts during 1990-92 will need to be supported by adequate and timely inflows of external assistance.

It is recommended that the next Article IV consultation with Kenya be held on the standard 12-month cycle.

VI. Proposed Decisions

The following draft decisions are proposed for adoption by the Executive Board:

A. 1990 Consultation

1. The Fund takes this decision relating to Kenya's exchange measures subject to Article VIII, Section 2(a) and in concluding the 1990 Article IV consultation with Kenya, in the light of the 1990 Article XIV consultation with Kenya conducted under Decision No. 5392-(77/63) adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Kenya maintains the restrictions on payments and transfers for current international transactions as described in SM/90/ in accordance with Article XIV, Section 2, except that there are restrictions subject to Fund approval under Article VIII, Section 2(a), in the form of limits for the remittances of rental income of nonresidents and of a foreign exchange budget on the basis of which import licenses for nonliberalized import items are issued. In the circumstances of Kenya, the Fund grants approval for their retention until June 30, 1991, or the conclusion of the next Article IV consultation with Kenya, whichever is earlier.

B. ESAF Arrangement

1. The Government of Kenya has requested the second annual arrangement under the enhanced structural adjustment facility.

2. The Fund has appraised the progress of Kenya in implementing economic policies and achieving the objectives under the program

supported by the first annual arrangement, and notes the updated policy framework paper (EBD/90/).

3. The Fund approves the arrangement set forth in EBS/90/64.

Kenya--Second Annual Arrangement Under
the Enhanced Structural Adjustment Facility

Attached hereto is a letter dated March 2, 1990, with an attached memorandum on the economic and financial policies of the Government of Kenya from the Minister for Finance and the Governor of the Central Bank of Kenya, requesting from the International Monetary Fund the second annual arrangement under the three-year arrangement and setting forth the objectives and policies of the program to be supported by the second annual arrangement.

To support these objectives and policies, the Fund grants the requested arrangement in accordance with the following provisions, and subject to the Regulations for the Administration of the Structural Adjustment Facility and the Instrument to Establish the Enhanced Structural Adjustment Facility Trust:

1. Under the second annual arrangement:

(a) the first loan, in an amount equivalent to SDR 40,233,334, will be available on May 15, 1990 at the request of Kenya; and

(b) the second loan, in an amount equivalent to SDR 40,233,333, will be available on November 15, 1990 at the request of Kenya subject to paragraph 2 below.

2. Kenya will not request disbursement of the second loan specified in paragraph 1(b) above:

(a) if the Managing Director finds that at the end of June 1990

(i) the limit on net domestic assets of the banking system referred to in paragraph 31 of the memorandum and specified in Table 1 attached to it was not observed, or

(ii) the limit on net credit to the Central Government by the banking system referred to in paragraph 31 of the memorandum and specified in Table 1 attached to it was not observed, or

(iii) the limit on contracted or nonconcessional external loans guaranteed by the Government referred to in paragraph 31 of the memorandum and specified in Table 1 attached to it was not observed, or

(iv) the limit on short-term loans contracted or guaranteed by the Government referred to in paragraph 31 of the memorandum and specified in Table 1 attached to it is not observed

(v) the implementation of the import liberalization program described in paragraphs 27 and 32 of the memorandum was not carried out; or

(vi) the implementation of export measures described in paragraphs 27 and 28 of the memorandum was not carried out; or

(b) if Kenya

(i) imposes or intensifies restrictions on payments and transfers for current international transactions, or

(ii) introduces or modifies multiple currency practices, or

(iii) concludes bilateral payments agreements which are inconsistent with Article VIII, or

(iv) imposes or intensifies import restrictions for balance of payments reasons; or

(c) until the Fund has determined that the midterm review of Kenya's program referred to in paragraph 33 of the memorandum has been completed.

If the Managing Director finds that any of the performance clauses that have been established in or under this paragraph 2 have not been met, the second loan specified in paragraph 1 above may be made available only after consultation has taken place between the Fund and Kenya, and understandings have been reached regarding the circumstances in which Kenya may request that second loan.

3. Before approving the third annual arrangement, the Fund will appraise the progress of Kenya in implementing the policies and reaching the objectives of the program supported by the second annual arrangement, taking into account primarily:

(a) the indicators referred to in paragraphs 7 and 11 of the attached memorandum;

(b) imposition or intensification of restrictions on payments and transfers for current international transactions;

(c) introduction or modification of multiple currency practices;

(d) conclusion of bilateral payments agreements which are inconsistent with Article VIII; and

(e) imposition or intensification of import restrictions for balance of payments reasons.

4. In accordance with paragraph 3 of the attached letter, Kenya will provide the Fund with such information as the Fund requests in connection with the progress of Kenya in implementing the policies and reaching the objectives supported by these arrangements.

5. In accordance with paragraph 4 of the attached letter, during the period of the second annual arrangement, Kenya will consult with the Managing Director on the adoption of any measures that may be appropriate at the initiative of the Government of whenever the Managing Director requests such a consultation. Moreover, after the period of the second annual arrangement and while Kenya has outstanding financial obligations to the Fund arising from loans under that arrangement, Kenya will consult with the Fund from time to time, at the initiative of the Government or whenever the Managing Director requests consultation on Kenya's economic financial policies. These consultations may include correspondence and visits of officials of the Fund to Kenya or of representatives of Kenya to the Fund.

Nairobi, March 28, 1990

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. Camdessus,

1. The objectives of a three-year programme of economic and financial adjustment are set out in the policy framework paper (PFP) for the period January 1990-December 1992, which was prepared in collaboration with the staffs of the Fund and the World Bank and which is being transmitted to you herewith.

2. The attached Memorandum on Economic and Financial Policies of the Government of Kenya, based on the PFP referred to above, sets out the objectives and policies that the Government intends to pursue in the three-year period beginning January 1, 1990, and the objectives and policies for the second annual programme thereunder. In support of these objectives and policies, the Government of Kenya hereby requests, the second annual arrangement under the three-year arrangement under the enhanced structural adjustment facility (ESAF), in an amount equivalent to SDR 80.5 million (56.7 percent of quota).

3. Kenya will provide the Fund with such information as the Fund requests in connection with Kenya's progress in implementing the economic and financial policies and achieving the objectives of the programme.

4. The Government believes that the policies and measures set forth in the attached Memorandum on Economic and Financial Policies are adequate to achieve the objectives of its programme, but will take any further measures that may become appropriate for this purpose. During the period of the second annual arrangement, Kenya will consult with the Managing Director on the adoption of any measures that may be appropriate, at the initiative of Kenya or whenever the Managing Director requests such a consultation. Moreover, after the period of the second annual arrangement and while Kenya has outstanding financial obligations to the Fund arising from loans under that arrangement, Kenya will consult with the Fund from time to time, at the initiative of the Government or whenever the Managing Director requests consultation on Kenya's economic and financial policies.

5. In addition, Kenya will conduct with the Fund a midterm review of its second annual programme. The review, expected to be completed by the end of November 1990, will assess the budget for 1990/91 and the implementation of the program and agree on targets for net domestic assets and net credit to the Government for the second half of fiscal year 1990/91.

Sincerely yours,

Professor George Saitoti
Vice President and
Minister for Finance

Eric C. Kotut
Governor
Central Bank of Kenya

Attachment: Memorandum on Economic and Financial Policies

Memorandum on the Economic and Financial Policies of the Government of Kenya

1. In the face of deteriorating financial and economic conditions, in late 1987 Kenya adopted a major stabilization and structural adjustment programme supported by an 18-month stand-by arrangement and arrangements under the structural adjustment facility. The major elements of the adjustment programme were successfully implemented during 1988, and its objectives with respect to growth, financial stability, and the external sector were to a large extent achieved. Concurrently, the Government began introducing important structural reforms in agriculture, industry, and international trade, the financial sector, government expenditure, and public enterprises. In early 1989 the Government requested that the programme for 1989-91, which would broaden and reinforce the adjustment process, be supported by arrangements under the enhanced structural adjustment facility (ESAF). On May 15, 1989, arrangements under the ESAF were approved by the Fund, with a total access of SDR 241.4 million.

Programme implementation during 1989

2. During 1989, the first year of the Fund-supported programme under the ESAF, elements of the adjustment programme were implemented and all end-September 1989 performance criteria were met, as were most of the benchmarks for the year. Preliminary data for 1989 indicate that the real GDP growth rate was on target at about 5 percent--despite less favorable weather conditions at the beginning of 1989, and lower-than-anticipated coffee production. The end-period inflation rate of 10.1 percent, while representing a slight deceleration from 10.4 percent in 1988, was higher than the 8 percent programmed, largely because of greater-than-targeted growth in broad money. Gross domestic expenditure is estimated to have increased from 105.1 percent of GDP in 1988 to 105.9 percent of GDP in 1989, reflecting an increase of 1.7 percentage points in gross domestic investment, to 25.3 percent of GDP in 1989, largely on account of the leasing of aircraft by Kenya Airways, and higher private sector gross fixed capital formation. Consumption declined by 0.9 percentage point to 80.6 percent of GDP on account of lower private and public consumption. Accordingly, national saving is estimated to have risen from 15.4 percent of GDP in 1988 to about 16.5 percent in 1989.

3. The overall budget deficit on a commitment basis in 1988/89 (July-June), at 4.6 percent of GDP, was slightly above the programme target of 4.5 percent. Excluding grants, the deficit was 6.9 percent of GDP, equal to the programme target. In relation to GDP, both revenue and expenditure were lower than estimated in the revised programme. At 22.9 percent of GDP, revenue fell short of earlier estimates, reflecting lower-than-expected collection of import duties and sales tax, and to some extent user charges. Expenditure was lower than programmed in both the recurrent and capital categories. For recurrent expenditure, the larger-than-budgeted wage bill was more than offset by lower spending on operations and maintenance; and the lower-than-projected capital expen-

diture was associated with a somewhat lower rate of project implementation. The cash deficit, at 3.5 percent of GDP, was substantially below the commitment deficit, almost wholly reflecting a buildup in the stock of unpresented cheques by about K Sh 1.8 billion (about 1.1 percent of GDP) which was monetized in early July 1989. Adjusting for the liquidation of these cheques results in a cash deficit of 4.6 percent of GDP. External sources accounted for about half of the financing while recourse to the domestic banking system (inclusive of the liquidation of the K Sh 1.8 billion unpresented cheques) was about 1.3 percent of GDP; the nonbank sector financed the remainder of 0.9 percent of GDP).

4. Broad money grew by 17.8 percent in calendar year 1989 compared with the programme target of 11.6 percent. This rate of expansion of liquidity was largely a result of a 14.1 percent increase in net domestic assets, accounting for a 15.2 percent rise in relation to the stock of broad money at end-1988. Net credit to the Government declined by 5.6 percent (unadjusted for the sale of over K Sh 2.7 billion (net) of Treasury bills at end-December), far below the 17.4 percent growth expected in the programme. "Other items net" were considerably higher than in the programme. Credit to the nongovernment sector grew by 17.9 percent (6.4 percent in the programme) with private sector credit rising by 22.1 percent. In an attempt to tighten monetary policy, the minimum commercial banks' saving deposit rate and the maximum lending rate for loans of three years or less were raised in November 1989 by 0.5 percentage point to 12.5 percent and 15.5 percent, respectively, following substantial increases in lending and deposit rates in April. The maximum lending rate of 18 percent was applied to loans of more than three years.

5. Performance in the external sector was weaker than programmed during 1989, particularly during the final quarter of the year. The overall balance of payments surplus was some SDR 6 million below the target of SDR 58 million and as a consequence, the increase of SDR 33 million in gross reserves was short of the SDR 40 million target. This still represented a reversal of the overall deficits of the previous two years. The stronger-than-anticipated capital account included larger disbursements by multilateral organisations of balance of payments financing and the counterpart for leases by Kenya Airways for two aircraft in December 1989. These inflows virtually offset the weaker current account position and contributed the major share of budget financing in calendar year 1989. The current deficit, including official transfers and excluding the aircraft leases, was 4.5 percent of GDP--0.8 percentage point below the 1988 ratio, and 0.5 percentage points higher than originally anticipated. Including the leases, the deficit-to-GDP ratio was 5.9 percent. The larger current deficit in SDR terms reflected weaker trade performance. Lower export revenues were mainly due to the 30 percent fall in coffee prices and sluggish volumes of oil exports to neighbouring countries. The impact of these two effects was partially offset by tea exports, which grew by about 17 percent in volume terms, while other export volumes, notably horticulture, also continued to exhibit strong real growth. Import growth

rose by 3 percent in real terms, and an average price increase of over 18 percent in shilling terms led to both public and private import values that were above target levels. Public sector imports rose in volume terms by about 24 percent, partly reflecting the leases of the airplanes by Kenya Airways. Private non-oil imports remained unchanged in volume terms, despite the continued liberalization of import controls. Oil import values rose slightly as the lower prices of 1988 were reversed and volumes stagnated. Official transfers were some SDR 36 million lower than predicted, as disbursements under foreign financed projects were slower than had been anticipated. Kenya continued to pursue the flexible exchange rate policy agreed under the programme during 1989 to maintain external competitiveness while the second phase of the import liberalization programme was completed. Between December 1988 and December 1989, the Kenya shilling depreciated by 7.2 percent in real effective terms.

6. Progress continued to be made in 1989 in implementing the structural policy measures of the programme. In the agricultural sector, the annual review of producer prices was undertaken and producer prices for grain were raised; a cotton pricing system based on auctioning is being implemented; progress was made in developing a food security plan; and the financial restructuring of the National Cereals and Produce Board (NCPB) was virtually completed. Initial steps were also taken to restructure other public enterprises. A number of important measures were adopted in 1989/90 in the fiscal area. These included the elimination of the export tax on coffee and tea, the adoption of a presumptive tax on the value of gross sales of agricultural produce, the lowering of the effective corporate tax rate as well as the top rate of the personal income tax, the introduction of user charges in the health sector, adoption of a bank loan scheme for university students, and passage of legislation substituting a value-added tax (VAT) for the manufacturing sales tax at the beginning of 1990. Specific incentives to promote the efficiency of the industrial sector concentrated on consolidating the reform of the trade system by completing the second phase of the import liberalization programme. In mid-1989, quantitative restrictions were lifted on items in Schedule IIIB for imports, which consists of about 11 percent of all import items and about 5 percent of import values (in 1986/87 terms). Since Schedules I, II, and IIIA had been liberalized in 1988, almost 70 percent of all items and 93 percent of import values are now unrestricted and carry tariffs as the sole form of protection. The import licensing system was made more transparent in February 1989. As a result, the time between the application for a license and the approval of the foreign exchange allocation has been considerably shortened, from over six months to about three weeks. The combined import-weighted average tariff for goods in Schedules I and II has been reduced and the number of tariff categories cut from 17 to 12. Consequently, the structural performance criterion relating to the implementation of the import liberalization programme and the development of an effective system for monthly monitoring of its operations was met before end-September. In the area of price controls, with the decontrol of prices for fertilizer,

animal feed, and soft drinks, the number of categories under the Price Control (General) Order was reduced from 20 to 18. In the financial sector, an action plan has been prepared with IDA assistance and approved for restructuring development finance institutions; a revised Banking Act was passed by Parliament, and in late 1989 the Capital Markets Authority (CMA) was established.

II. Objectives and Policies for 1990-92

7. As indicated in the updated policy framework paper (PFP), the Government's overall objectives over the medium term are to achieve a sustained noninflationary real GDP growth rate that is higher than the population growth rate and to provide productive employment for the country's rapidly growing labor force. The Government's strategy stresses the important role of the private sector in revitalizing the economy and the need for the Government to establish market-based incentives to promote private sector activity. To achieve these objectives, the programme for 1990-92, supported by ESAF arrangements from the Fund, will emphasize increased productivity in agriculture, and the restructuring of industrial incentives to reduce the existing antiexport bias and to improve export competitiveness.

8. The key macroeconomic objectives for the 1990-92 programme are (a) to achieve an annual rate of growth of real GDP of over 5 percent; (b) to reduce the rate of inflation, on an end-period basis, from 10.1 percent in 1989 to about 5 percent by 1992, which would correspond to the level expected of Kenya's major trading partners in 1992; (c) in order to maintain a viable balance of payments, to reduce the external current account deficit from 5.9 percent of GDP in 1989 (4.5 percent of GDP excluding aircraft leases, and 8.6 percent of GDP excluding grants) to about 3.6 percent of GDP in 1992 (5.2 percent of GDP, excluding grants); (d) to lower debt service as a ratio of exports of goods, nonfactor services, and private transfers from 31 percent in 1989 to below 25 percent in 1992; and (e) to build up gross reserves from the equivalent of 2.2 months of nongovernment imports in 1989 to 3.0 months of nongovernment imports in 1992.

9. Accordingly, the investment-saving gap would be narrowed. During 1990-92 gross domestic investment would stabilize at about 25 percent of GDP but its composition would change, with an increasing share of private sector investment, and a higher efficiency of investment as distortions are removed. National saving would rise from about 16.5 percent of GDP in 1989 to about 19 percent of GDP in 1992 with about equal increases in both private sector saving and government saving. To achieve these objectives, the mix of financial policies will emphasize financial restraint and increasing productivity in the public sector, strengthen returns to domestic saving, ensure that the stance of monetary policy is consistent with the inflation and the external targets, and pursue an exchange rate policy that maintains competitiveness. In particular, the central government overall cash deficit will

be steadily reduced from 4.2 percent of GDP in 1989/90 (6.4 percent of GDP, excluding grants) to 3.8 percent of GDP in 1990/91 (5.6 percent of GDP, excluding grants) and to 3.4 percent of GDP by 1991/92 (4.9 percent, excluding grants).

10. Consistent with these financial policies, structural reforms will continue to be carried out in key areas. These reforms will emphasize new initiatives in the promotion of exports, and the reduction of anti-export bias in the continued liberalization of imports; the restructuring of government expenditure by restraining the rate of growth of overall personnel expenditure and, in the priority economic and social sectors, by increasing the share of outlays on nonwage operations and maintenance; the extension of the VAT to additional services and the strengthening of the tax administration system; the restructuring and revitalision of financial and nonfinancial public enterprises; continued financial sector reform; and price decontrol.

III. Programme for 1990

11. The Government's programme for 1990 seeks to achieve a real GDP growth rate of 5.2 percent, lower the rate of inflation to 7.5 percent in 1990, and narrow the external current account deficit (excluding the leases) to 4.4 percent of GDP. To achieve these objectives, the programme provides for a reduction in the overall budget deficit and a tightening of the monetary stance, supported by an appropriate exchange rate policy. To encourage a restructuring of the economy over the medium term and a broadened basis for growth, the programme aims to diversify export production and to reduce distortions in the external and industrial sectors.

a. Fiscal policy

12. The overall budget deficit for 1989/90 is programmed at 4.2 percent of GDP (6.4 percent, excluding grants), which represents a further tightening of the fiscal stance relative to the budget deficit on a commitment basis at the end of 1988/89 (4.6 percent of GDP). Revenues will rise as a share of GDP, from 22.9 percent in 1988/89 to 23.7 percent of revised GDP, just short of the initially-programmed target of 24.1 percent of GDP. This reflects some delays in the introduction of the presumptive tax on agricultural products, some transitional costs in moving from a sales tax to the VAT, and the ambitious original programme targets for collection of import duties under import liberalization. User charges play a greater role in financing recurrent outlays, rising from about 0.6 percent of GDP in 1988/89 to 1.3 percent, with increased tariffs in agriculture, livestock, roads, health, and education. The overall expenditure share in revised GDP is projected at 30.1 percent, compared with the original programme target of 30.9 percent of GDP, largely owing to a reduced pace of absorption of development expenditures. Foreign financing of the deficit will be higher than originally projected, reflecting higher programme loan assistance. A

strong effort will be made to mobilize nonbank resources through the sale of Treasury bonds and bills. In addition to increasing the attractiveness of the yields of these instruments, greater publicity will be given in the media to the effective yields offered in recent Treasury auctions. Bank financing of the deficit will be held to 0.5 percent of GDP in 1989/90, less than originally anticipated in the programme. The Government recognizes that meeting quantitative fiscal targets by an increased float or delays in the preparation of vouchers is inconsistent with the objectives of the programme. Therefore, the level of unpresented cheques at the end of 1989/90 will not exceed K Sh 1.1 billion, the level at end-1987/88.

13. Recurrent expenditures are likely to fall somewhat below the programme target of 23.1 percent of GDP. Difficult measures have been implemented relating to the structural benchmark calling for limiting wage and salary bill growth to 7.5 percent, including a freeze on vacancies exceeding six months as well as in the number of lower level posts, and a decision not to grant a salary revision, despite a cumulative inflation of almost 30 percent over the last three years and 67 percent since the last salary review in 1983. Nevertheless, the pressures for employment growth are strong, primarily as a result of the implementation of the new 8-4-4 education system, and the attendant demand for additional trained teachers. Regrettably, the overall wage and salary bill will grow by about 11 percent in 1989/90. In order to increase productivity in the priority economic and social sectors (livestock, agriculture, water supply, health, and roads), efforts were made to redress the imbalance between wages and nonwage operation and maintenance (O&M) expenditure in the budget. To facilitate analysis of expenditure, an economic classification of the budget has been prepared and a monthly system for the monitoring of wages and operating expenses is being developed. To control expenditure, a Parliamentary Committee is reviewing possible sanctions to apply in cases where ministerial outlays rise above authorized budget limits. With respect to development expenditure, the Government intends to take advantage of the availability of additional concessional external financing for meritorious projects, as long as such investments are compatible with the overall macroeconomic framework and the need to finance the future costs of O&M. In this context, the Government has postponed a number of lower priority projects and slowed the rate of project absorption so as to restrain development spending to well below the programme target of 7.6 percent of GDP.

14. Consistent with the medium-term policy framework and the need to tighten the stance of fiscal policy, the 1990/91 budget deficit will be reduced to 3.8 percent of GDP (5.6 percent of GDP, excluding grants). Revenue as a share of GDP is expected to rise to 24.1 percent. Total expenditure and net lending is budgeted to decline to about 29.7 percent of GDP, wholly reflecting slower growth in recurrent spending. Development outlays are targeted to rise to 7.2 percent of GDP. The deficit will be financed largely from domestic nonbank and foreign concessional sources. Bank financing of the deficit will be limited to about

K Sh 650 million, or 0.3 percent of GDP. The nonbank financial sector is expected to finance about two thirds of the domestically financed deficit.

15. Tax policy will focus on broadening the tax base and enhancing the elasticity, efficiency, and equity of the tax system. In particular, the Government will continue replacing the sales tax with a VAT. The institutional capacity for tax policy analysis will be strengthened, and computerization and other administrative improvements will be introduced in the Income Tax, Sales Tax, and Customs and Excise Departments, under the Tax Modernization Project supported by UNDP and other donors. Cost-sharing will be broadened and extended to other services.

16. In formulating the 1990/91 budget, the Government recognizes the need to decrease the overall share of recurrent expenditures in order to reduce the overall budget deficit, while maintaining the important role of the government development budget in promoting overall economic growth. To contain the growth of wages and salaries, a significant effort will be made to reduce further the rate of growth of government employment; civil service employment growth in the published 1990/91 estimates will be limited to 2 percent above the number of posts authorized in the 1989/90 budget, and the increase in the number of teachers employed by the Teachers Service Commission will not exceed 8 percent of the level outstanding on February 1, 1990. Together with the normal salary increments of 4 percent, the combined wage and salary bill of the Central Government will rise by no more than 9 percent in 1990/91. In the event of a salary revision award, the Government will undertake to begin the disbursement of such awards only in 1991/92. To ensure that the personnel expenditure targets are adhered to, cash limits on the wage bill will be set and enforced for each Ministry and the Teachers Service Commission. External assistance is increasingly being sought for the funding of operating expenses in the development budget (notably in the areas of agriculture, livestock, and water supply). Sectoral norms are being developed for defining appropriate staffing and nonwage inputs for different types of public services in key priority areas. By the end of 1990, the monthly monitoring and reporting system for the wage bill and operating expenses should be operational. Considerable efforts are also under way to strengthen the budgeting and implementation of development outlays. Progress in improving the project appraisal and investment budgeting process and in the preparation of a public sector project list will be key elements in ensuring a high productivity programme. A detailed ministry-by-ministry project list has been prepared for the first time for 1990/91, with a forward budget for proposed outlays for the period 1990/91-1992/93, permitting a more rational selection of development projects and a focus on more rapid implementation of ongoing projects. A comparable project list has begun to be prepared for the major nonfinancial parastatals in 1990/91. In preparing for the 1991/92 budget, the Government will seek external assistance in reviewing and assessing the relative economic merits of the major projects included in the public investment programme.

b. Public enterprises

17. In recent years, the Government has taken steps to clarify both the financial situation of parastatals and the Government's relationship with them. In 1989/90, with assistance from the Fund, a major effort has been initiated to establish an information system and database for an initial core group of enterprises, which will provide quarterly and annual indicators of economic and financial performance. Monitoring of the budgetary impact of enterprises has already been undertaken for ten large enterprises, and such monitoring will be extended in 1990 to another ten enterprises. The Government will also clarify its position as a creditor of state corporations by quantifying, on a quarterly basis, both their commitments and actual payments of debt service. In 1990, a policy framework paper for state corporations will be developed and the Government will formulate criteria on the basis of which some state corporations will be designated as strategic and others as potential candidates for restructuring. An active plan for restructuring the major development finance institutions in the industrial sector (the Industrial Development Bank (IDB) and the Industrial and Commercial Development Corporation (ICDC)) has been developed in consultation with IDA, for implementation beginning in 1990. Finally, the Government intends to undertake a reform of the present categorization of state corporations' salary scales in the commercially oriented enterprises with a view toward reducing rigidities and strengthening management.

18. Kenya Airways has experienced financial and organizational difficulties in recent years, reflecting deficiencies in its management, maintenance capacity, and excess staffing. A major part of its fleet is in need of upgrading. In 1989/90 the Government has taken several steps to strengthen its operations. It has recently purchased a Fokker jet, and has undertaken to lease an Airbus and four new Boeing jets. The Airbus and one Boeing were delivered in late 1989, and two more Boeings are due in late 1990. An initial assessment of the financial and management operations of the airline has been completed by an internationally reputable accounting firm, and the World Bank will shortly provide technical assistance in the formulation of a restructuring plan, which is to be completed by September 1990. Efforts are also under way to obtain management assistance from a major foreign airline. By late 1990, the Government is fully committed to implement a restructuring plan and to undertake the steps required to rationalize staffing.

c. Monetary and financial sector policies

19. Key objectives of monetary policy are to improve the efficiency of resource mobilization and allocation, reduce reliance of the Government on domestic bank financing, and broaden the range of financial instruments available to savers and investors. The Government adopted a major financial sector adjustment programme in 1989 supported by a financial sector operation from IDA, and technical assistance from the Fund. In 1990, the programme will seek increased reliance on market mechanisms for allocating financial resources and implementing monetary policy.

With technical assistance from the Fund, reserve money management will be introduced and active use of available monetary policy instruments through the Monetary Policy Committee initiated. Cash reserve ratios will continue to be an important instrument of monetary policy. Strong efforts will be made to publicize auctions of Treasury instruments in order to increase the volume of sales. At the same time, the Central Bank will gradually move away from quantitative credit ceilings toward open market operations as a more efficient means of controlling monetary aggregates.

20. Interest rates will be maintained positive in real terms. During 1990, the experience with a broader set of monetary policy instruments will be reviewed. Further progress will be made toward the establishment of a more market-determined rate structure through raising the ceilings on deposit and lending rates. Additional flexibility in adjusting interest rates will arise from the elimination of the legal requirement that the loan interest rates subject to ceilings must be inclusive of all lending-related fees and charges. This change in regulations will allow effective interest rates on loans (inclusive of such charges) to rise above the formal ceilings; developments in this regard will be monitored by the Central Bank. By June 1991, formal interest rate ceilings will be removed. To facilitate the development of short-term money markets, secondary trading in treasury securities will be encouraged. Nonbank financial institutions (NBFIs) will be required to shorten the current three-month lag in submitting their financial returns to the Central Bank of Kenya to one month. Commercial banks that meet prescribed criteria will be allowed to issue bearer-negotiable certificates of deposit. To strengthen the banking system, a revised Banking Act was passed by Parliament in 1989. By June 1990, regulations will be issued which link capital adequacy requirements to assets and require banks and NBFIs to maintain prescribed capital/assets ratios.

21. The financial sector programme also aims to promote capital market activity. To this end, in late 1989 the Capital Markets Authority (CMA) was established. The CMA will promote public issues and demand for securities as well as financial intermediation. Accordingly, by June 1990 the CMA and the Government will propose measures to reduce disincentives to holding and issuing securities, encourage greater participation of insurance companies and other institutional investors in private securities markets, and enhance investor protection. When the CMA becomes operational, the role of the Capital Issues Committee in setting share prices in respect of domestic companies will be discontinued.

22. Monetary policy in 1990-91 will seek to maintain the growth of domestic credit and liquidity consistent with reducing inflationary pressures, improving efficiency in the allocation of resources, supporting external adjustment through a slowing of the pace of import demand, and building up reserves. This requires a cautious credit policy that limits government recourse to the banking system, while

providing adequate credit to the private sector. In view of the observed wide swings of "other items net" in the monetary accounts, steps will be taken to minimize these swings so that "net domestic assets" move in tandem with domestic credit. The authorities are committed to observing benchmarks and performance criteria through end-December 1990 (Table 1 attached), which will be consistent with a projected expansion in broad money of 11 percent in 1990.

23. The current consumer price index is calculated utilizing a commodity basket and income groups based on 1975 weights. Recognizing that there may have been fundamental changes in the relative price and income structure in the Kenya economy, and given the importance of price-controlled items in the basket, the Government is preparing a new consumer price index, which will be chained back into the 1980s, and which is expected to be completed by the end of 1990.

d. External and industrial policies

24. With the implementation of the policies under the second-year ESAF arrangement, an overall surplus in the balance of payments of SDR 46 million is projected for 1990, with a targeted reserve accumulation of SDR 50 million. The current account deficit (with two more leases of airplanes by Kenya Airways) is expected to contract to 5.4 percent of GDP (including official transfers). Without the leases, the ratio of 4.4 percent of GDP should be close to the revised programme level of 4.1 percent. With continued declines expected in coffee prices, and the limited potential of the rest of the export sector to respond significantly to new price and other incentives in the short run, the main contribution to improved current account performance is expected to come from imports. In volume terms, real aggregate imports are expected to rise by about 3 percent in 1990. Within this total, nongovernment non-oil imports are forecast to rise by some 5 percent--a growth that allows for some adjustment by the private sector to the liberalized system for imports and less stockbuilding of foreign goods. Government imports are expected to decline by some 2 percent in real terms from the high level of 1989, partly as the Government further slows the rate of project absorption. With continued management of the exchange rate to achieve external balance, given the pressure on domestic resources and the need to improve competitiveness, total export volumes are expected to grow by about 10 percent in 1990. Coffee earnings are expected to remain sluggish, with a further 13 percent decline in prices (in SDR terms) projected on the assumption that the International Coffee Organization is not likely to establish a new agreement on quotas during the year. Despite lower prices, coffee volumes are estimated to rise by about 13.5 percent, in light of the high level of stocks held by the Coffee Board and the historical demand for good quality Kenyan coffee on international markets. Tea earnings are likely to remain buoyant. Higher earnings in local currency terms are expected to elicit some short-run supply response while continued strong demand and lower supplies of tea to international markets by producers such as Sri Lanka are expected to maintain firm international

prices. Nontraditional exports such as horticulture, manufactures, and pyrethrum are predicted to continue to grow strongly in real terms as competitiveness is improved and markets expand outside the region. Net service earnings are expected to grow steadily. During 1990, tourism earnings are expected to recover from the decline in receipts from the United States in the last quarter of 1989, partly from more tourist arrivals from Europe and partly as the impact of media reports on U.S. arrivals eases.

25. The capital account in 1990 is expected to weaken somewhat relative to 1989, but the lower current account deficit will be offset by net inflows of long-term capital, as it was in 1989. Official inflows from existing and new loan commitments are predicted to fall to about SDR 540 million and principal repayments are expected to be only somewhat less than half that level. Additional financing needs are expected to be met by cofinancing of the Financial Sector Adjustment Credit, new World Bank disbursements for the export development programme and the agricultural sector credit due in the last half of the year, and bilateral sources of balance of payments funds. Gross reserve accumulation would be SDR 50 million--bringing reserves to 2.5 months of nongovernment imports. In 1990 the debt service ratio should fall from 30.8 percent in 1989 to 27.5 percent. With respect to all external nonconcessional borrowing for development projects, the Government will ensure that such borrowing meets rigorous and acceptable tests of economic and financial viability.

26. During 1990 the authorities intend to maintain their policies aimed at broadening the growth base in the external sector. Diversification, in terms of both products and markets, has assumed critical importance in the light of the recent decline in coffee prices on international markets and Kenya's historical dependence on coffee for more than one fourth of its export earnings. Both exchange rate management and specific trade initiatives will be used to improve the overall competitiveness of production, move toward more uniform rates of protection, and reduce obstacles to efficient performance. To maintain the momentum of trade reform to a liberalized system, the Government intends to remove, over 1990 and 1991, quantitative restrictions on all nonexempt imports still subject to control (except textiles). These goods, currently in Schedule IIIC, will be shifted to the now unrestricted Schedule IIIB. The items to be shifted, which account for about 46 percent of import items in Schedule IIIC (on a SITC basis) and 5 percent of 1986/87 import values, will be liberalized in two installments in July 1990 and July 1991 and replaced by equivalent tariffs. Controls on at least 55 percent of the number of import items which are currently controlled and nonexempt in Schedule IIIc will be removed in July 1990. These represent a third of the 1986/87 import values of the goods to be liberalized. The remaining items, including five that account for 47 percent of the value of the goods to be liberalized, will be liberalized in 1991. A timetable for unrestricted licensing of textile imports in Schedule IIIC, which account for 51 percent of items in Schedule IIIC on a SITC basis, will be formulated when the IDA study of the sector is

completed in July 1990. With regard to price decontrol, a substantial number of the commodities in the 18 categories under the General Order will be removed in 1990 as well as several items from the Specific Order. In 1991, further significant reductions will be made in the number of commodities under both the General and Specific Orders.

27. The Government intends to act on a number of specific initiatives in 1990 to reduce Kenya's reliance on coffee and tea exports. Based on its discussions with IDA, the Government will decide before April 15 on measures to be implemented before July 1990 that would substantially improve access by exporters to raw materials and intermediate inputs at international prices. Such an initiative may include the formulation in 1990 of a duty drawback/exemption scheme for reimbursing exporters of manufactured goods for duties on imported inputs which would to be fully functioning in early 1991, as well as measures to facilitate exporters' access to credit. Meanwhile, current export incentive schemes will be made more effective. As an interim measure until an IDA-supported programme is in place, the Government will, before July 1990, broaden and publish the list of items eligible under the export compensation scheme and publish the criteria for eligibility for the scheme. The lags in disbursing payments by the Customs Office and Central Bank were considerably shortened from an average of 20 weeks in 1985/86 to 6 weeks in 1988/89. To reduce further the delays in the receipt of export compensation, by end-April 1990 the Government will begin to implement a system by which commercial banks pay compensation to exporters within 90 days, upon evidence of shipment of goods through customs. The Government will also formulate a programme for export processing zones; the requisite legislation will be prepared and submitted by January 1991.

28. During 1990, the Government is committed to adjusting the exchange rate to ensure external competitiveness and the achievement of a sustainable external position, and intends to support this level with appropriate monetary and fiscal policies. This rate would be consistent with other incentives being taken to diversify export production beyond coffee and tea as well as to support the import liberalization programme.

e. Impact of adjustment on poverty and the environment

29. Since the magnitude of Kenya's economic distortions and structural imbalances is less than in other adjusting countries, the structural reforms required and their potential social impact are correspondingly smaller. Nevertheless, the Government aims to minimize any adverse effects on disadvantaged groups. Specifically, there is a need to ensure that the recent introduction of user charges in health and increased cost-sharing in education does not limit access by low income groups to these services. In the health sector, the Government has exempted those who cannot afford to pay and the types of services that must be encouraged for social reasons. In the education sector, a bursary scheme has been introduced to assist poor and deserving students

to meet the high costs of secondary education. At the tertiary level, present policies exempting low-income students from the new university loan scheme will be maintained. A serious constraint on the Government's ability to design and implement targeted interventions to mitigate the social costs of adjustment has been the lack of an appropriate data base and welfare monitoring system. The Government has recently requested to join the Social Dimensions of Adjustment programme being implemented in sub-Saharan Africa with the assistance of IDA and other donors.

30. Kenya's environmental problems arise mainly from population pressures on limited land resources. These include: forest and woodland depletion, soil erosion and land degradation, and increasing conflicts with wildlife. Environmental problems are particularly severe in arid and semiarid lands (ASALs), which account for four fifths of Kenya's land area. Over the medium term, the Government's environmental priorities will focus on the forestry sector, wildlife resources, and ASAL areas. With the assistance of IDA and other donors, steps are being taken to strengthen forestry policies and institutional support for a reforestation programme. Recently, the Government has also begun to address the critical situation in the wildlife sector. In addition to strengthening antipoaching measures and banning the export of ivory, the Wildlife Department has been reconstituted as a separate agency to increase its effectiveness in policy formulation and the management and protection of wildlife. With the assistance of IDA, an ASAL Environmental Action Plan is being prepared, which will identify policies and investment priorities for the rehabilitation and environmentally sound development of these areas.

IV. Benchmarks and Performance Criteria

31. For the second annual arrangement under the ESAF, it is proposed that the quantitative benchmarks, as set forth in the attached Table 1, comprise quarterly limits on: (i) net domestic assets; (ii) net bank credit to the Central Government; (iii) new nonconcessional loans, leases or letters of awareness contracted or guaranteed by the public sector within the 1-to 15-year maturity range; (iv) short-term loans contracted or guaranteed by the Government (other than import-related credits); and (v) targeted minimum cumulative increases in net official international reserves.

32. The performance criteria and benchmarks for monitoring structural policy implementation under the second annual arrangement under the ESAF will relate to: (i) the implementation of the import liberalization programme; (ii) the streamlining of export promotion measures to reduce the cost to exporters of imported inputs; (iii) further reductions in the number of price controlled items; (iv) measures to contain the rise in personnel expenditures at 9.0 percent in 1990/91; and (v) increases in existing ceilings on commercial bank deposit and lending rates.

33. Under the second annual ESAF arrangement, the performance criteria for end-June 1990, as set forth in Table 1, will include the quantitative limits described in (i), (ii), (iii), and (iv) in paragraph 31 above, and the structural benchmarks (i) and (ii) included in paragraph 32 above. The standard clause regarding the exchange and payments system shall also constitute a performance criterion under the second annual arrangement. The disbursement of the second loan under the second annual arrangement will also be subject to a midterm review with the Fund, to be completed by end-November 1990. The midterm review will assess the budget for 1990/91 and implementation of the program and will set targets for net domestic assets and net credit to the Government for the second half of fiscal year 1990/91.

Table 1. Kenya: Performance Criteria and Benchmarks of the Second Annual Arrangement Under the Enhanced Structural Adjustment Facility

	1989	1990		
	December Actual	June 1/	September 2/	December 2/
Quantitative performance criteria/benchmark		(In millions of Kenya shillings)		
Net domestic assets 3/ 4/	54,428	56,513	58,610	59,450
Net bank credit to the Government 4/ 5/	12,671	16,370	17,110	17,313
Memorandum items:				
Net bank credit to the Government in monetary survey	17,481	21,180	21,320	22,123
Less: CSFC	4,040	4,040	4,040	4,040
Less: Debt assumed from parastatals	770	770	770	770
		(In millions of U.S. dollars)		
New nonconcessional external loans or leases contracted or guaranteed by the Government 6/ (cumulative per calendar year)				
a. 1-15 years' maturity	167	155	155	155
b. Short-term credits of less than one year's maturity 7/	— 8/	—	—	—
Quantitative benchmark		(In millions of SDRs)		
Minimum cumulative increase in net official international reserves from end-December 1988 9/	-60.3 8/	13.0	5.0	45.0

Nonquantitative performance criteria

Review: A midterm review will be completed by end-November 1990 to assess the 1990/91 budget, and the implementation of the program, and to set quantitative benchmarks and indicative targets for the second half of 1990/91.

Trade and payments restrictions: The Government of Kenya will continue to maintain a liberal exchange and trade system and will not introduce any new, or intensify existing, restrictions.

Structural performance criteria	Target Date
Implement the import liberalization program, by removing controls on at least 55 percent of the number of import items (excluding textiles) that are currently controlled and nonexempt (in Schedule IIIC).	July 1990.
To improve access by exporters to raw materials and intermediate inputs at international prices, and streamline and make more effective the export compensation scheme; the Government will begin to implement a system by which commercial banks pay compensation to exporters within 90 days upon submission of evidence of shipment of goods through customs.	May 1990.
Structural benchmarks	
Remove price controls on a substantial number of items under the General Order of price controls, as well as several items from the Specific Order.	September 1990.
Raise existing ceiling on commercial bank lending rates consistent with removing ceilings on interest rates by June 1991; maintain positive real interest rates.	Throughout 1990.
Confine the growth of the Government's personnel wage bill (including teachers employed by the Teachers' Service Commission) to 9.0 percent in fiscal year 1990/91, reflecting a limit of 2 percent in the growth of of civil service posts relative to the 1989/90 budget and 8 percent growth in the number of teachers relative to the number employed on February 1, 1990.	July 1990.

Source: Memorandum attached to the letter of request of Kenyan authorities of March 28, 1990.

1/ Performance criteria.
2/ Quantitative benchmarks.
3/ Net domestic assets of the banking system is broad money minus net foreign assets of the banking system. A one-time stock adjustment will be made when the new Consolidated Bank, which amalgamates nine failing nonbank financial institutions, with total assets tentatively estimated at K Sh 1 billion, commences operating as a commercial bank.
4/ This target will be adjusted downward to the extent that net external financing of the deficit during the July 1989-June 1990 period, excluding A-in-A financing, exceeds K Sh 816 million, or to the extent that domestic nonbank financing exceeds K Sh 600 million. Such net external financing is defined to include all cash loans received by the Paymaster General's Account during this period.
5/ Net credit to the Government is net credit to the Government from the banking sector. The ceiling excludes the operations of the Cereals and Sugar Finance Corporation (CSFC), and the amount of public enterprise debt (K Sh 770 million) assumed by the Government after June 1989 and reclassified from outstanding private sector credit.
6/ In addition to nonconcessional borrowing contracted or guaranteed by the Government, this ceiling also applies to the borrowing of all state corporations (including cases where their borrowing is associated with a "letter of awareness" from the Government), as well as leases. The ceiling excludes the lease of Kenya Airways aircraft expected in October 1990 that was signed in 1989, conditional on the formulation of a restructuring plan by August 30, 1990. For the purposes of this definition, a loan or lease is nonconcessional if it has a grant equivalent of less than 25 percent. Grant equivalence shall be determined by reference to published DAC tables and is a function of the interest rate, grace period, and maturity. "Maturity" is defined as the sum of the grace period and the term of payment. For purposes of converting new nonconcessional external loans into U.S. dollars, the U.S. dollar exchange rates cabled to the Central Bank of Kenya from the Federal Reserve Bank of New York for January 2, 1990, will be used.
7/ Other than normal import-related credits, this limit also excludes nonguaranteed borrowing by the Coffee Board of Kenya associated with short-term trade financing.
8/ Actual outstanding amount at end-December 1989.
9/ Net official international reserves are defined as the Central Bank of Kenya's net foreign reserve assets (SDRs, gold, and foreign exchange holdings) minus its short-term deposit liabilities to foreigners; plus the Central Government's net foreign reserve amounts (excluding those related to Fund transactions); plus Kenya's reserve position in the Fund; minus Kenya's net use of Fund credit.

KENYA - Relations with the Fund
(As of February 25, 1990)

I. Membership Status

(a)	Date of membership	February 3, 1964
(b)	Status	Article XIV

A. Financial Relations

II. General Department

(a) General Resources Account:

(i)	Quota	SDR 142.0 million
(ii)	Total Fund holdings of Kenya's currency	SDR 326.40 million (229.85 percent of quota)
(iii)	Fund holdings of Kenya's currency subject to repurchase	SDR 196.60 million (138.45 percent of quota)
	Of which: credit tranche	SDR 71.39 million (50.28 percent of quota)
	EAR	SDR 66.26 million (46.66 percent of quota)
	CFF - cereal	SDR 18.95 million (13.34 percent of quota)
	CFF - export	SDR 40.00 million (28.17 percent of quota)
(iv)	Reserve tranche	SDR 12.22 million (8.60 percent of quota)

Kenya - Relations with the Fund (continued)

(b) Special Disbursement Account:

(i) Structural adjustment loan	SDR 28.40 million (20 percent of quota)
(c) Enhanced structural adjustment loan 1/	SDR 42.60 million (30 percent of quota)

III. Current or Previous Stand-By Arrangements and Special Facilities

(a) Previous arrangements:

One extended arrangement approved in July 1975, and seven stand-by arrangements approved, respectively, in November 1978, August 1979, October 1980, January 1982, March 1983, February 1985, and February 1988. Amounts range from SDR 17.25 million to SDR 241.50 million. Cumulative purchases made under these arrangements amounted to SDR 521.0 million.

(b) Special facilities:

(i) Under the compensatory financing facility for export shortfalls and cereal imports, Kenya made purchases of SDR 60.4 million (58 percent of then quota) in June 1982, SDR 37.9 million (27 percent of quota) in December 1985, and SDR 40.0 million (28 percent of quota) in October 1988.

(ii) The first annual arrangement under the structural adjustment facility became effective on February 1, 1988. The first loan of SDR 28.4 million was disbursed on February 4, 1988. The arrangement was replaced by an ESAF on May 15, 1989.

(iii) A 36-month enhanced structural adjustment facility arrangement totaling SDR 241.4 million became effective on May 15, 1989. Under the first annual arrangement loans of SDR 40.23 million each were disbursed on May 31, 1989 and November 30, 1989, respectively.

1/ Utilization of outstanding ESAF arrangement loan comprises SDR 42.60 million from the Special Disbursement Account (SDA) and SDR 37.87 million from the ESAF Trust.

Kenya - Relations with the Fund (continued)

IV. SDR Department

(a) Net cumulative allocation - SDR 36.99 million
(b) Holdings: amount to SDR 2.30 million or
6.22 percent of net cumulative allocation

V. Administered Accounts

(a) Trust Fund Loans:

(i) Disbursed - SDR 46.91 million
(ii) Outstanding - SDR 1.00 million

(b) SFF Subsidy Account:

(i) Payments by Fund - SDR 13.84 million

(c) ESAF loans: Trust Account

(i) Disbursed - SDR 37.87 million
(ii) Outstanding - SDR 37.87 million

VI. Financial Obligations to the Fund

	Overdue Financial Obligations (2/28/90)	Principal and Interest Due				
		Mar.-Dec. 1990	1991	1992	1993	1994
Principal	--	68.0	29.3	58.8	44.4	9.7
Repurchases	--	67.2	29.1	58.8	41.5	--
Trust Fund Repayments	--	0.8	0.2	--	--	--
ESAF Trust repayments	--	--	--	--	--	1.9
SAF repayments	--	--	--	--	2.8	7.8
Charges and interest including SDR and TF (provisional)	--	14.3	16.3	11.8	6.2	3.7
Total	--	82.3	45.7	70.5	50.6	13.4

B. Nonfinancial Relations

VII. Exchange System

Pegged to composite. At end-February 1990 the exchange rate was K Sh 22.1280 = US$1

Kenya - Relations with the Fund (concluded)

VIII. Last Article IV Consultation

The 1989 Article IV consultation (EBS/89/84, 4/27/89, and SM/89/83, 5/9/89) was concluded by the Executive Board on May 15, 1989. The following decision was adopted:

1. The Fund takes this decision relating to Kenya's exchange measures subject to Article VIII, Section 2(a), in the light of the 1989 Article IV consultation with Kenya conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Kenya maintains restrictions on payments and transfers for current international transactions subject to Fund approval under Article VIII, Section 2(a), in the form of limits for remittances of rental income of nonresidents and of a foreign exchange budget on the basis of which licenses for nonliberalized import items are issued. In the circumstances of Kenya, the Fund grants approval for their retention until June 30, 1990, or the conclusion of the next Article IV consultation with Kenya, whichever is earlier.

Kenya is on the standard 12-month cycle for Article IV consultations.

IX. Technical Assistance

CBD: Technical assistance missions on Kenya's financial system (March and May-June 1984), on bank supervision procedures (June 1988), and on the operational aspects of monetary policy implementation (November 1988). Advisor on Open Market Operations, from CBD panel of experts, began assisting the Central Bank of Kenya in November 1989. Technical assistance mission on reserve money management (March 1990).

FAD: Technical assistance in fiscal field (1981). Technical assistance mission on public enterprises (January-February 1990).

BUR: Technical assistance mission on money and banking statistics (November 1987).

Relations with the World Bank Group

The World Bank has a large ongoing program in Kenya. As of September 30, 1989, it had committed US$2.2 billion, of which US$1.7 billion had been fully disbursed (Table 1). Investments by IFC totaled US$146 million, of which US$128 million had been fully disbursed.

1. Agriculture

The Bank's assistance to agriculture is centered around a policy reform program supported by a quick-disbursing sector adjustment credit which was approved in June 1986. Among the components of this program are (i) measures to increase the availability and distribution of agricultural inputs (especially fertilizer); (ii) movement toward price flexibility and deregulation; (iii) rationalization of government expenditure in the sector; (iv) the divesting of some agricultural parastatals and the restructuring of others in the context of better defined policies on parastatals; and (v) improvements in agriculture credit programs.

These policy measures are complemented by ongoing investment projects in coffee rehabilitation, forestry, agriculture research, rehabilitation of animal health services and the provision of countrywide extension services.

For the future, Bank assistance to the sector will continue to emphasize adjustment lending with a view to broadening and consolidating a policy framework that is conducive to a more vigorous contribution to growth by agriculture. Investment lending will continue to complement the policy reforms with greater attention being given to implementing the results from pilot projects in the areas of agriculture credit, livestock development, land and environmental management and arid and semiarid agricultural techniques. The Bank is currently developing and testing new methodologies or approaches in these areas in order to ensure replicability before embarking on large-scale national investments.

2. Energy

The Bank's efforts in this sector are concentrating on lessening Kenya's dependence on imported oil through hydroelectric development, geothermal development, and petroleum exploration promotion. While future lending will be consistent with the least cost recommendations of the recently completed power study, greater attention will be focused on alleviating policy constraints (e.g., pricing and distribution) to attain a more efficient and integrated energy sector.

Kenya - Relations with the World Bank Group (continued)

Table 1. The Status of Bank Group Operations in Kenya

A. Statement of Bank Loans and IDA Credits as of September 30, 1989

Amount (less cancellations)

(In millions of U.S. dollars)

Loan or Credit No.	Year	Borrower	Purpose	Bank	IDA	Undis-bursed
Forty one (41) loans and thirty-eight (38) credits fully disbursed				826.82	467.95	--
1107	1981	Kenya	Fifth Education	--	40.00	15.61
2098	1982	Kenya	Forestry III	11.50	--	4.79
1237	1982	Kenya	Cotton Processing and Marketing	--	22.00	3.19
1238	1982	Kenya	Integrated Rural Health and Family Planning	--	23.00	8.16
1387	1983	Kenya	National Extension	--	15.00	6.91
2319	1983	Kenya	Secondary Towns	0.02	--	--
1390	1983	Kenya	Secondary Towns	--	22.00	13.21
2359	1984	Kenya	Kiambere Hydroelectric	80.00	--	3.38
2409	1984	Kenya	Second Highway Sector	5.00	--	3.57
F017	1984	Kenya	Second Highway Sector	--	40.00	38.88
1486	1984	Kenya	Geothermal Exploration	--	24.50	0.72
1566	1985	Kenya	Water Engineering	--	6.00	1.98
2574	1985	Kenya	Third Telecommunications	17.60	--	4.28
1673	1986	Kenya	Sixth Education	--	37.50	40.20
1675	1986	Kenya	Petroleum Exploration Technical Assistance	--	6.00	4.53
1718	1986	Kenya	Agricultural Sector Management	--	11.50	7.19
1738	1987	Kenya	KIE 2nd Small Scale Industry	--	6.00	6.35
1758	1987	Kenya	Animal Health Services	--	15.00	13.48
1820	1987	Kenya	Second Railway	--	28.00	19.61
1849	1988	Kenya	Agriculture Research	--	19.60	19.66
A0360	1988	Kenya	Industrial Sector Operation	--	10.00	--
1904	1988	Kenya	Population III	--	12.20	11.48
1927-0	1988	Kenya	Industrial Sector Operation	--	102.00	46.06
1927-1	1989	Kenya	Industrial Sctor Operation	--	53.70	--
1973	1989	Kenya	Geothermal Development	--	40.70	40.31
1974	1989	Kenya	Rural Services	--	20.80	19.71
2049	1989	Kenya	Financial Sector Operation	--	120.00	84.63
2058	1989	Kenya	TA	--	5.00	4.68
2060	1989	Kenya	Third Nairobi Water Supply Project	--	64.80	62.64
2062	1989	Kenya	Coffee II	--	46.80	46.56
			Total	940.94	1260.05	531.77
			Of which: repaid	310.49	15.95	--
			Total held by Bank and IDA	630.45	1244.10	--
			Amount sold	11.74	--	--
			Of which: repaid	11.74	--	--
Total undisbursed						531.77

Kenya - Relations with the World Bank (continued)

Table 1. The Status of Bank Group Operations in Kenya (concluded)

B. Statement of IFC Investments in Kenya as of September 30, 1989

Fiscal Year	Obligor	Type of Business	Amount in Millions of U.S. Dollars Loan	Equity	Total
1967) 1968) 1973)	Kenya Hotel Properties	Hotels	5.2	0.7	5.9
1970) 1974) 1977) 1979) 1981) 1988) 1989)	Pan African Paper Mills	Pulp and Paper	40.7	6.3	47.0
1972	Tourism Promotion Services	Hotels	2.4	-- 1/	2.4
1976	Rift Valley Textiles Limited	Textiles	6.3	2.8	9.1
1977	Kenya Commercial Bank Limited	Capital Market	2.0	--	2.0
1980)) 1984)	Development Finance Company of Kenya Limited	Development Finance	5.1	1.3	6.4
1981	Kenya Commercial Finance	Money and Capital Market	5.0	--	5.0
1982	Bamburi Portland Cement Company Limited	Cement and Construction Material	4.4	--	4.4
1982	Diamond Trust of Kenya Limited	Money and Capital Market	--	0.8	0.8
1982)) 1987)	Industrial Promotion Services (Kenya) Limited	Money and Capital Market	--	2.0	2.0
1983	Tetra Pak Converters Limited	Pulp and Paper Products	2.2	0.4	2.6
1984	Leather Industries of Kenya Limited	Tanning	2.1	0.6	2.7
1985	Madhu Paper International Limited	Pulp and Paper Products	37.1	2.0	39.1
1986	Equatorial Beach Properties	Tourism	5.6	--	5.6
1986	Oil Crop Development Limited		9.7	1.4	11.1
	Total Gross Commitments		127.8	18.3	146.1
	Less cancellations, terminations, repayments and sales		90.7	9.0	99.7
	Total Commitments now held by IFC		37.1	9.3	46.4
	Total Undisbursed		16.5	1.2	17.7

1/ US$44,937.

Kenya - Relations with the World Bank Group (continued)

3. Industry/finance

Until recently, Kenya's industry has obtained World Bank lending through development finance intermediaries. In support of an industrial reform program in June 1988 an industrial sector adjustment credit for US$112 million was approved. In order to stimulate investment, promote export production, and make industries more efficient, the reform program covers areas such as trade liberalization, tariffs, price controls, export promotion, corporate taxation, financial sector policies, and industrial public enterprises. A complementary financial sector adjustment operation is currently being implemented. It addresses inter alia interest rate reforms, rationalization of the banking regulatory framework, restructuring of depository institutions, and the development of capital and money markets.

4. Infrastructure

Highway projects and the promotion of railways have accounted for most of the lending to date. A major water supply project for Nairobi was approved by the Board in 1989. In addition, the Bank is preparing an urban development project whose main feature will be to enhance the financing and management capacity of municipal authorities.

5. Population

The third IDA-financed project to help the Government promote fertility control was approved in 1988 and is now being implemented. To help meet the growing demand for contraceptives and maintain the momentum of recent progress, IDA is preparing a fourth Population Project.

6. Education and health

The Bank's attention is currently directed at developing viable financing and management capacity in both sectors. Lending operations designed to promote more efficient utilization of resources and to implement appropriate mechanisms to increase cost sharing are being prepared.

7. Adjustment lending

The World Bank negotiated and fully disbursed two structural adjustment loans (SAL) to Kenya. The first, negotiated in March 1980, was for US$70 million and was fully disbursed by September 1980. The second, negotiated in July 1982 for SDR 130 million, was disbursed in two tranches: in September 1982 and January 1984. The SAL programs were implemented under adverse external circumstances which negatively affected Kenya's performance. The protracted balance of payments crises of 1981 and 1982, as well as the coup attempt in August 1982, forced

Kenya - Relations with the World Bank Group (concluded)

adjustments in the Government's policies and led to delays and reversals in policy initiatives included in the SAL programs. The speed of implementation was also affected by a shortage of technical personnel and the preoccupation of the authorities with short-term stabilization efforts.

It has been agreed between the Bank and the Government that, for the near future, Bank financial support for the Government's structural adjustment efforts will take the form of sector adjustment credits rather than the comprehensive SAL. Sector adjustment credits in agriculture and industry have been completed and fully disbursed. Further sector adjustment operations are planned in agriculture, export development, education, and health.

Kenya--Statistical Issues

1. Outstanding Issues

None.

2. Coverage, Currentness, and Reporting of Data in IFS

The table below shows the currentness and coverage of data published in the country page for Kenya in the March 1990 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Central Bureau of Statistics, which during the past year have been provided on a timely basis.

Status of IFS Data

		Latest Data in March 1990 IFS
Real Sector	- National Accounts	1988
	- Prices	October 1989
	- Production	1988
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	October 1989
	- Financing	October 1989
	- Debt	n.a.
Monetary Accounts	- Monetary Authorities	October 1989
	- Deposit Money Banks	October 1989
	- Other Financial Institutions	August 1989
Interest Rates	- Discount Rate	September 1989
	- Bank Lending/ Deposit Rate	September 1989
	- Bond Yield	n.a.
External Sector	- Merchandise Trade:	
	Values	1988
	Prices	1988
	- Balance of Payments	1988
	- International Reserves	January 1990
	- Exchange Rates	December 1989

KENYA - Basic Data

Area, population, and GDP per capita

Area	582,600 square kilometers
Population: Total (1989)	23.6 million (est.)
Growth rate	3.8 percent (est.)
GDP per capita (1989)	SDR 280 (est.)

GDP (at 1982 market prices)	1984	1985	1986	1987	1988	1989 Est.
Total (in billions of Kenya shillings)	72.5	75.5	80.8	85.5	90.6	95.1
Agriculture (percent of total)	26	26	26	26	26	26
Manufacturing (percent of total)	11	11	11	11	11	11
Government (percent of total)	13	13	13	13	13	13
Annual real rate of growth (percent)	2.1	4.1	7.0	5.8	6.1	5.0
Investment as percent of GDP (at current market prices)	20	25	19	20	19	18
Prices (percent change)						
GDP deflator	9	8	12	8	8	9
Cost of living index (annual average)	10	13	5	6	9	10
Cost of living index (end of period)	11	11	4	7	10	10

	1984/85	1985/86	1986/87	1987/88	1988/89 Prel. actuals	1989/90 Prel. est.
Central government finance 1/	(In billions of Kenya shillings)					
Total revenue	20.5	24.3	28.0	32.7	37.4	42.9
Foreign grants	1.5	1.1	1.6	3.2	3.7	4.2
Total expenditure and net lending	27.6	31.9	39.8	39.8	48.6	56.1
Recurrent	20.8	24.4	29.5	30.6	37.1	42.9
Development and net lending	6.8	7.5	10.2	9.2	11.5	13.2
Adjustment to cash basis	0.8	0.7	0.7	0.5	1.7	—
Overall cash deficit (-)	-4.7	-5.8	-8.2	-5.9	-7.6	-7.8

1/ Fiscal year, July 1-June 30.

KENYA - Basic Data (continued)

Central government finance (continued)	1984/85	1985/86	1986/87	1987/88	1988/89 Prel. actuals	1089/90 Prel. est.
	(In billions of Kenya shillings)					
Foreign financing (net)	1.1	-1.0	0.5	1.4	4.0	6.3
Domestic financing (net)	3.6	6.8	8.9	4.5	3.6	1.5
Of which: from banking system and CSFC	(0.8)	(1.9)	(5.9)	(-0.1)	(2.0)	(0.9)

	1984	1985	1986	1987	1988	1989
Money and credit	(Percent change)					
Domestic credit	11	13	29	21	7	10
Government	11	10	54	30	-7	-6
Other	11	14	18	15	17	18
Money and quasi-money	13	10	28	12	8	18

	1984	1985	1986	1987	1988	1989 Est.
Balance of payments	(In millions of SDRs)					
Exports, f.o.b.	1,009	928	998	702	757	800
Imports, c.i.f.	-1,514	-1,447	-1,435	-1,457	-1,559	1,703
Trade balance	-505	-520	-438	-755	-802	-903
Services and private transfers (net)	283	322	282	258	269	336
Official transfers (net)	114	108	127	110	191	178
Current account balance	-108	-89	-29	-387	-342	-389
Capital account (net)	152	-2	106	311	297	442
Official	104	-55	73	192	249	429
Private	48	54	32	118	47	12
Of which: long-term	(9)	(22)	(36)	(-8)	(-15)	(5)
Overall surplus or deficit (-)	44	-91	76	-76	-45	52
Current account deficit as percent of GDP						
Including grants	1.8	1.5	0.5	6.3	5.3	5.9
Excluding grants	3.7	3.3	2.5	8.1	8.3	8.6
Gross official foreign reserves (end of period)	416	381	362	202	222	255
In weeks of imports	14	14	13	8	8	9

KENYA - Basic Data (concluded)

	1984	1985	1986	1987	1988	1989 Est.
External public debt	(In millions of SDRs)					
Disbursed and outstanding (end of period)	2,963	3,070	3,331	3,439	3,753	3,870
Debt service as percent of exports of goods and nonfactor services						
Excluding the Fund	21	22	22	26	24	23
Including the Fund	27	29	29	34	29	31
Social and demographic indicators						
Population density per square kilometer	37.5					
Life expectancy at birth (years)	53.7					
Crude birth rate (per thousand)	52.0					
Crude death rate (per thousand)	12.0					
Infant mortality rate (per thousand)	74.0					
Population per physician (thousand)	10.1					
Population per hospital bed	654.0					
Adult literacy rate (percent)	45.0					
Primary school enrollment rate (percent)	94.0					

Kenya--Indicators of Competitiveness

In this note an attempt is made to develop some indicators that address the issue of whether, with the changes in the exchange rate since 1985, the relative price incentives for export production, the consumption of home goods, and import substitution have been strengthened. While the underlying data have deficiencies, the results indicate that this may not have been the case, particularly recently. Export prices have deteriorated relative to various indices of domestic and imported input costs since 1985. The detailed indicators show that the profitability of agricultural exports has declined significantly, and that real incomes of agricultural exporters have fallen. On the consumption side, the detailed indicators show that domestic prices have risen faster than import prices for most categories of import-competing final goods, suggesting that incentives have developed for consumers to turn to cheaper foreign goods. Incentives for import substitution have also worsened, particularly where labor is an important input into production. All three effects--lower profitability in export production, higher prices of import-competing home goods relative to comparable import prices, and lower prices of domestic finished goods relative to imported input and domestic labor costs--will have worsened the trade account and may indicate a lack of competitiveness of Kenyan goods at the current exchange rate.

Several broad measures were calculated of performance since 1985 of traded goods prices relative to domestic costs, or alternatively, to home goods prices. The aim was to establish whether price incentives have existed for production of exports and import substitutes, and to identify the changes in the incentives for consumption of home goods relative to traded goods. To examine the direction in which the relative price incentives for export production have moved, calculations were made for the ratios of various export price indices to four alternative indices of home goods prices and production costs. In particular, two indices of home or local goods prices were derived from the available data on the GDP deflator and the consumer price index (low-income) and two indicators of production costs were based on data on hourly earnings in manufacturing and on a weighted index of imported input prices. The estimates of home goods price indices were derived from the GDP deflator and the CPI on the basis of the following two equations:

(1) $$P_y = xP_x + (1-x)\,P_h$$

$$P_h = \frac{P_y + xP_x}{1-x}$$

Where P_y = an index of the GDP deflator

x = share of exports in constant price GDP

P_x = a local currency price index for exports

P_h = a price index for home goods

(2) $P_c = mP_m + (1-m) P_l$

$$P_l = \frac{P_c - mP_m}{1-m}$$

where P_c = an index for low-income consumer prices

m = share of imports in constant price GDP

P_m = a local currency price index for imports (total and non-oil were estimated separately)

P_l = a price index for local goods

All indices were based on 1985 = 100 and local currency values.

Kenya's terms of trade have deteriorated by some 27 percent since 1985, and this effect has strongly affected the aggregate measures of relative export price indices developed in this note. An assessment was also made of other factors that have affected the relative profitability of the traded goods sector, and related production and consumption incentive. These included (1) indices of producer prices of export commodities relative to the CPI, as a gauge of the real incentives for export production relative to production for domestic markets and of real incomes in the agricultural export sector; (2) an index of finished goods prices in the CPI relative to the costs of imported inputs, to obtain a rough measure of the effects of rising prices of imported inputs on the profitability of the production of final goods (this is the sector the authorities have targeted for expansion); (3) an index of finished goods prices in the CPI relative to the cost of labor, to measure the possible effects of rising labor costs on the profitability of final goods production; and (4) indices of the prices of imports, by category, relative to the matching import competing category in the CPI, to obtain a rough measure of the relative price incentives for the consumption of imported rather than domestic goods. Ideally, indices (2) and (3) should have been combined in an index measuring domestic final goods prices relative to input costs, but detailed input shares by sector were not available. It should also be noted that the index of hourly earnings in manufacturing was used as an indicator of domestic labor costs, and may not have accurately reflected labor costs in all sectors.

All indicators of price incentives in the export sector relative to different measures of domestic costs show a steady deterioration since

1985 (Table 1). The ratios of export prices to hourly earnings in manufacturing or imported input costs show a worsening of 14-34 percent. The disaggregated data on producer prices relative to the CPI show that the real incomes of farmers producing tea has worsened the most, reflecting both the increase in the CPI as well as a 33 percent decline in international tea prices over 1985-88 translated into a similar fall in prices paid to producers. The profitability of coffee, sisal and rice has deteriorated by 12-18 percent. Real incomes in the agricultural export sector have fallen. Even before the sharp price decline of 1989, since 1985 the ratio of coffee producer prices to the CPI had still deteriorated by 7 percent. The aggregate ratios of export prices to prices of nontraded goods show that returns to exports have also fallen relative to returns in the nontraded sector.

As regards the incentives for consumption of imported goods, home prices have risen relative to import prices in several branches of activity (Table 2). The ratios of import prices to the CPI show that for all but three categories--beverages and tobacco, manufactured goods and machinery and transport--domestic prices have risen relative to import prices. Even food is cheaper to import. These results suggest that in the product categories where domestic and foreign goods are close substitutes (food, crude materials, oils and fats, chemicals, miscellaneous manufactures), at the current exchange rate consumers have an incentive to import rather than buy home goods.

The profitability of import substitution has also worsened (Table 3). Looking at the ratios of finished goods prices (in the CPI) to imported input costs and labor costs, both have deteriorated sharply since 1987, after an initial improvement. The deterioration in profitability is greatest in the case of labor costs. Disaggregated data on prices of food and finished goods in the CPI relative to labor costs show that returns on the production of food, beverages and tobacco, and clothing and furniture have all worsened. If the finished goods categories are largely domestically produced, then a deterioration in the ratio is indeed an indication of declining profitability. If the finished goods are largely imported items, then the deteriorating ratios indicate that rising costs are making it more difficult to produce at world prices.

Table 1. Kenya: Competitiveness Indicators--Export Production

(Indices, 1985 = 100)

	1985	1986	1987	1988	1989
Export production					
$Px/_{L}$	1.00	1.03	0.77	0.7	0.66
Px/P_{mr}	1.00	1.12	0.93	0.92	0.86
$Px/_{Ph}$	1.00	0.97	0.74	0.79	0.78
$Px/_{Pl}$	1.00	1.02	0.79	0.84	0.82
Producer prices/CPI					
Coffee	100.00	121.51	83.93	93.04	82.90
Tea	100.00	96.61	67.61	50.09	57.05
Sisal	100.00	101.05	90.77	87.23	88.32
Pyrethrum	100.00	101.16	95.78	89.94	101.81
Seed cotton	100.00	94.15	91.40	101.05	93.19
Maize	100.00	101.84	101.77	99.16	90.28
Sugarcane	100.00	105.75	101.15	109.72	102.44
Rice	100.00	97.85	99.04	93.47	85.23
Wheat	100.00	103.94	99.11	97.43	95.79

Note: See text for definitions of Px, Ph, Pl. L is an index of hourly earnings in manufacturing. Pmr is a weighted average index of prices of imported inputs (oil, crude materials, chemicals and machinery and transport).

Table 2. Kenya: Competitiveness Indicators--Consumption

(Indices, 1985 = 100)

	1985	1986	1987	1988	1989
Import prices/CPI 1/					
Food and animals	100.00	113.20	84.25	90.32	98.22
Beverages and tobacco	100.00	106.01	115.63	108.45	113.55
Inedible crude materials	100.00	69.49	66.15	73.79	68.79
Non-mineral oils and fats	100.00	60.93	49.10	69.00	64.33
Chemicals	100.00	71.78	63.80	74.87	69.80
Manufactured goods	100.00	91.02	93.97	103.98	111.71
Machinery and transport	100.00	126.52	118.69	134.63	125.72
Miscellaneous manufactures	100.00	79.28	82.94	103.88	96.85

1/ Index of individual import prices relative to index of individual CPI category.

Table 3. Kenya: Competitiveness Indicators--Import Substitution

(Indices, 1985 = 100)

	1985	1986	1987	1988	1989
Finished goods prices/ Pmr 1/	1.00	1.12	1.23	1.10	1.06
Finished goods prices/L 1/	1.00	1.03	1.02	0.84	0.82
CPI food/L	1.00	0.99	0.96	0.83	0.78
CPI beverages and tobacco/L	1.00	1.05	1.06	0.91	0.89
CPI clothing and furniture/L	1.00	1.00	1.00	0.82	0.78
CPI miscellaneous/L 2/	1.00	1.19	1.16	0.91	1.00

Note: Pmr is a weighted average index of prices of imported inputs (oil, crude materials, chemicals and machinery and transport); L is an index of hourly earnings in manufacturing.

1/ The numerator is a weighted average index of finished goods prices in the CPI.
2/ Miscellaneous goods exclude rent, fuel, health, transport, and recreation and education, as well as the items listed above.

Kenya, 1794

IMF OFFICIAL MESSAGE

WASHINGTON, D. C. 20431

DO NOT SOFT ROLL EXCEPT WHEN ALIGNING INTO LINE 23

MARK XX FOR CODE

( ) CODE

LIST OF TWO

KENYA

DISPATCHED IMF

1989 DEC 20 A 10: 29

DISTRIBUTION

CC:

MR. EL KOGALI

MR. BASU, ETR

AS WE ARE ABOUT TO ENTER THE SECOND ANNUAL ARRANGEMENT UNDER THE ESAF WITH THE OBJECTIVE OF ACHIEVING ECONOMIC GROWTH WITH LOW INFLATION AND A VIABLE EXTERNAL POSITION WE ARE ENCOURAGED BY THE STRUCTURAL REFORMS WHICH ARE ONGOING IN AGRICULTURE AND THE FINANCIAL AND INDUSTRIAL SECTORS. DURING THE EXECUTIVE BOARD MEETING ON NOVEMBER 10, 1989 ON THE MID-TERM REVIEW UNDER THE FIRST ANNUAL ARRANGEMENT FOR KENYA UNDER THE ESAF, EXECUTIVE DIRECTORS NOTED THAT KENYA HAD DISPLAYED A STRONG COMMITMENT TO THE ADJUSTMENT PROGRAM. HOWEVER, THEY URGED THE GOVERNMENT TO MAINTAIN ITS FIRM EFFORTS TO AVOID NONCONCESSIONAL EXTERNAL BORROWING. WITH REGARD TO THE LATTER, WE ARE CONCERNED ABOUT RECENT INFORMATION ON THE POSSIBLE CONTRACTING OF SIZABLE NEW FOREIGN COMMERCIAL LOANS WHICH THE GOVERNMENT OF KENYA WOULD GUARANTEE. WE HAVE THREE MAJOR CONCERNS ABOUT THESE FOREIGN COMMERCIAL LOANS. FIRST, SUCH LOANS WOULD INCREASE THE STOCK OF CONTRACTED OUTSTANDING EXTERNAL DEBT TO COMMERCIAL CREDITORS

SPECIAL INSTRUCTIONS — TEXT MUST END HERE

TELEX NO.: 22324/22721 NAIROBI KENYA

DRAFTED BY NAME (TYPE): MKatz:djh EXT.: 7465 DEPT/DIV: AFR DATE: 12.19.89

AUTHORIZED BY NAME (TYPE): MAMOUDOU TOURE AUTHORIZED BY NAME (TYPE):

TYPE ** ON LAST OR ONLY PAGE OF MESSAGE

Log

SEC. 48 REV. 2 8-14-87

SIGNATURE (PLEASE KEEP SIGNATURE IN SPACE ALLOWED) SIGNATURE

IMF OFFICIAL MESSAGE
WASHINGTON, D. C. 20431

DO NOT SOFT ROLL EXCEPT WHEN ALIGNING INTO LINE 23

MARK XX FOR CODE
(______) CODE

START ADDRESS IN THE BOX

KENYA

DISTRIBUTION

START TEXT HERE

DO NOT TYPE HERE

(INCLUDING SUPPLIERS' CREDIT) BY SOME 50 PERCENT, AND WOULD REPRESENT A DEPARTURE FROM THE PAST POLICY OF RELYING ON FOREIGN CONCESSIONAL LOANS. THIS POLICY DEPARTURE RUNS COUNTER TO OUR UNDERSTANDING OF KENYA'S POLICY COMMITMENTS REGARDING THE CONTRACTING OF EXTERNAL DEBT UNDER THE CURRENT ESAF PROGRAM. SECOND, SUCH LOANS WOULD RESULT IN A DEBT SERVICE RATIO THAT IS CONSIDERABLY HIGHER THAN THE ONE TARGETED UNDER THE PROGRAM. THE PROJECTS THAT THESE FOREIGN COMMERCIAL LOANS WOULD FINANCE ARE NOT LIKELY TO GENERATE THE FOREIGN EXCHANGE REQUIRED TO SERVICE THEIR DEBT AND COULD THUS MAKE KENYA'S EXTERNAL FINANCIAL POSITION MORE VULNERABLE. THIRD, WHILE THE MATURITIES OF SOME OF THESE LOANS MAY BE OUTSIDE THE FORMAL DEBT LIMITS OF THE IMF SUPPORTED PROGRAM, THEY WOULD NONETHELESS BE INCOMPATIBLE WITH THE MEDIUM TERM FRAMEWORK WHICH WAS APPROVED BY OUR EXECUTIVE BOARD. SUCH LOANS TOGETHER WITH COUNTERPART DOMESTIC FUNDS WOULD PUT PRESSURE ON DOMESTIC DEMAND, MAKE IT MORE DIFFICULT TO

IF REQUIRED INITIAL BELOW

SPECIAL INSTRUCTIONS — TEXT MUST END HERE

TELEX NO.:

DRAFTED BY NAME (TYPE): EXT.: DEPT./DIV.: DATE:

AUTHORIZED BY NAME (TYPE): AUTHORIZED BY NAME (TYPE):

TYPE ** ON LAST OR ONLY PAGE OF MESSAGE

Log

SEC. 48 REV. 2 8-14-87

SIGNATURE (PLEASE KEEP SIGNATURE IN SPACE ALLOWED) SIGNATURE

IMF OFFICIAL MESSAGE
WASHINGTON, D. C. 20431

DO NOT SOFT ROLL EXCEPT WHEN ALIGNING INTO LINE 23

REDUCE INFLATION AND WOULD UNDERMINE THE DEVELOPMENT OF NONTRADITIONAL EXPORTS BY COMPETING FOR SCARCE RESOURCES. WE REGARD THESE PROSPECTIVE LOANS AS AN IMPEDIMENT WHICH COULD HAMPER THE NEGOTIATIONS FOR THE SECOND YEAR PROGRAM. THEREFORE, WE WOULD STRONGLY RECOMMEND THE AVOIDANCE OF SUCH FOREIGN BORROWING. WE REMAIN CONFIDENT THAT KENYA WILL CONTINUE TO PURSUE PRUDENT POLICIES AND THAT THE PROGRAM FOR THE REMAINING TWO YEARS UNDER THE ESAF WILL BE CARRIED OUT SUCCESSFULLY.

HIGHEST REGARDS

TOURE

COUNSELLOR AND DIRECTOR

AFRICAN DEPARTMENT

INTERFUND

SPECIAL INSTRUCTIONS — TEXT MUST END HERE

TELEX NO.:

DRAFTED BY NAME (TYPE): EXT.: DEPT/DIV: DATE:

AUTHORIZED BY NAME (TYPE): AUTHORIZED BY NAME (TYPE): (**)

TYPE ** ON LAST OR ONLY PAGE OF MESSAGE

Log

SEC. 48 REV. 2 8-14-87

SIGNATURE (PLEASE KEEP SIGNATURE IN SPACE ALLOWED) SIGNATURE

LIST OF TWO
NAIROBI

DISPATCHED IMF
1989 DEC 20 A 10: 29

THE HONORABLE GEORGE SAITOTI
VICE-PRESIDENT AND MINISTER OF FINANCE
MINISTRY OF FINANCE
NAIROBI, KENYA

MR. ERIC KOTUT
GOVERNOR
CENTRAL BANK OF KENYA
NAIROBI, KENYA

Kenya. 1794

IMF OFFICIAL MESSAGE

WASHINGTON, D. C. 20431

DO NOT SOFT ROLL EXCEPT WHEN ALIGNING INTO LINE 23

THE TREASURY
MINISTRY OF FINANCE
P.O. BOX 30007
TREASURY BUILDING, HARAMBEE AVENUE
NAIROBI, KENYA

DISPATCHED IMF
1989 NOV 11 P 9 54

MARK XX FOR CODE
(______) CODE

DISTRIBUTION

EXECUTIVE BOARD TOOK FOLLOWING DECISION NOVEMBER 10, 1989:

QUOTE

THE FUND DETERMINES THAT THE MIDTERM REVIEW SPECIFIED IN PARAGRAPH 2(c) OF THE FIRST ANNUAL ARRANGEMENT UNDER THE ENHANCED STRUCTURAL ADJUSTMENT FACILITY (EBS/89/84, SUP. 1, 5/26/89) HAS BEEN COMPLETED. UNQUOTE

VAN HOUTVEN, SECRETARY, INTERFUND

CC: SEC
MD
DMD
MR. EL KOGALI
AFR
ETR
FAD
LEG
RES
TRE
MR. H. SIMPSON

SPECIAL INSTRUCTIONS — TEXT MUST END HERE

TELEX NO.:

DRAFTED BY NAME (TYPE): KFriedman:BJOwen:jrw EXT.: 6712 DEPT/DIV: SEC DATE: 11/10/89

AUTHORIZED BY NAME (TYPE): Leo Van Houtven AUTHORIZED BY NAME (TYPE): (**)

TYPE ** ON LAST OR ONLY PAGE OF MESSAGE

Log A5151

SEC. 48 REV. 2 8-14-87

SIGNATURE (PLEASE KEEP SIGNATURE IN SPACE ALLOWED) SIGNATURE

Kenya, 1794

1. KENYA - ENHANCED STRUCTURAL ADJUSTMENT FACILITY - REVIEW UNDER FIRST ANNUAL ARRANGEMENT

The Executive Directors considered a staff paper on the midterm review under the enhanced structural adjustment arrangement for Kenya approved on May 15, 1989 (EBS/89/196, 10/16/89).

The staff representative from the African Department said that he wished to note several developments since the circulation of the staff paper. First, according to data that had been received recently, the authorities had met the September 1989 performance criteria relating to total domestic credit, net bank credit to the Government, and external borrowing with comfortable margins. Second, in the middle of October, the authorities had implemented, as agreed and on schedule, the interest rate adjustments mentioned in the paper. Also, in view of the weakening of the external position, the authorities had allowed the real effective exchange rate to depreciate further in September by just over 2 percent according to preliminary data, making the real effective depreciation between the end of December 1988 and the end of September 1989 about 6.8 percent.

Third, the inflation rate at the end of September had remained at the 8.9 percent level--on a month-on-month basis--recorded at the end of August, down from 10.4 percent at the end of July, the staff representative from the African Department noted. Fourth, in recent months the Government had undertaken some of the structural measures that had been mentioned on previous occasions, particularly the introduction of user charges in the medical sector and the introduction of legislation in the Parliament for the establishment of a Capital Markets Authority.

Mr. El Kogali made the following statement:

On behalf of the Kenyan authorities I wish to express their gratitude to management and staff for the balanced assessment and appraisal of the recent performance of the Kenyan economy. As Directors will have noted from the staff paper, the authorities have met all the quantitative and structural benchmarks under the 1989 enhanced structural adjustment program, reaffirming once again Kenya's strong commitment to pursue its adjustment program and its outstanding performance as one of the success stories in the region.

The GDP growth rate is estimated at 4.9 percent, while the expected rate of inflation of 9 percent represents good progress compared with the 10.4 percent rate of the previous year. In the balance of payments, the collapse of the International Coffee Agreement led to a 24 percent decline in the export price of coffee, causing a shortfall of SDR 30 million. For the rest of fiscal year 1989/90, the authorities believe that, a tighter fiscal and monetary policy, and some recovery in coffee prices, should facilitate the attainment of the original program objectives for 1990.

The vulnerability of the medium-term balance of payments position remains a major challenge to Kenya's structural adjustment effort. The overall strategy of strengthening the balance of payments has given considerable weight to exchange rate policy. Under the 1989 program, the authorities have fully complied with the recommended flexible exchange rate policy and, indeed, as illustrated in the chart on page 10 of the staff report, considerable real effective depreciation has taken place. Yet very little has been achieved in export diversification. The programmed improvement in the current account deficit from 5.5 percent of GDP in 1989 to 4.1 percent in 1990 is due largely to the projected 20 percent coffee price recovery from the third quarter of 1989 to the end of 1990. Indeed, Executive Directors will recall that the exchange rate policy took center stage in the Board's review of Kenya's stand-by arrangement in October last year. It was acknowledged then that the limited effect of prolonged exchange rate adjustment in bringing about a diversification of exports called for a better understanding of the appropriate sequencing of policy instruments and exchange rate and structural reforms. It is in light of this background that the staff recommendation to accelerate the pace of depreciation should be carefully considered.

Against a backdrop of such little progress in export diversification, the structural program provides for maximum promotion of nontraditional exports from the supply side. As is confirmed in the staff paper, all structural performance criteria in this sector were met ahead of schedule. The authorities, with the assistance of the World Bank, are according higher priority to restructuring industries in order to enhance nontraditional export competitiveness and promote more investment in that sector. In this connection, a high-level Cabinet Committee on Investment, headed by the Vice President, has been established to expedite investment promotion and approval. The authorities are also working on a comprehensive medium-term export promotion program.

Fiscal policy has been implemented as envisaged in the 1989/90 budget, under which the cash deficit, including grants, was programmed to rise moderately, from 3.9 percent in 1988 to 4.2 percent in order to permit utilization of available concessional external financing while maintaining domestic financing. It is important to note in this connection that Kenya's budget deficit is well below the developing countries' average of 4.5 percent of GDP in 1989. The program entails tight control on expenditure levels and a substantial increase in government revenue. In fact, the authorities face increasing pressure to maintain expenditures within these limits. In the 1989/90 budget, for example, capital expenditures have been limited to a very small number of projects and real increases were allowed only in recurrent expenditure for operations and maintenance.

These expenditures are geared to redressing the imbalance between nonwage expenditure and the wage bill. As is explained in the staff paper, effective guidelines have been put in place to restrain the growth in the wage bill in 1989/90 to 7.5 percent, compared with 16 percent in the previous year. The 1989/90 budget includes a number of far-reaching and broad-based measures to increase revenues by 0.9 percent of GDP compared with the previous year. The burden of these measures will affect practically the entire population, as they take the form of indirect taxation. They include mainly sales taxes and the value-added tax to be introduced at the beginning of 1990, import taxes, and user charges on such essential services as education, health, and other public services.

In the field of public enterprise reform, the authorities have completed the financial restructuring of the National Cereals and Produce Board, and the reorganization of other large enterprises is under way and is to be completed soon. At the same time, an action plan has been prepared for the rehabilitation of the portfolio of enterprises under the Industrial Development Bank and the Industrial and Commercial Development Corporation. Regarding the overall public enterprise sector, the Government is formulating a comprehensive policy, with technical assistance from the UNDP.

For the rest of the year, the Government has tightened monetary policy more than envisaged under the program in order to curb inflation more effectively, and, in the meantime, interest rate policy is being assigned a greater role in financial intermediation. Under the program, interest rate policy has been increasingly applied to mobilize financial savings and channel investment to priority activities. To this end, the authorities have ensured that minimum savings deposit rates have remained well above the rate of inflation. At the same time, the term structure of lending rates has been designed to encourage longer-term production-related loans rather than short-term loans. Accordingly, on October 16, 1989, minimum savings deposit rates were raised from 12.0 percent to 12.5 percent, and the maximum lending rates on short-term loans of maturities up to three years were raised from 15 percent to 15.5 percent, while rates on longer-term loans were raised to 18 percent. In the meantime, structural measures have been implemented as scheduled to strengthen the financial institutions and the supervisory capacity of the Central Bank. The authorities will review the adequacy of interest rate policy and structural measures early in 1990 when formulating the second annual program under the enhanced structural adjustment facility.

The social impact of the adjustment program on the population is becoming increasingly felt. The introduction of user

fees on essential services has a significant impact on the low-income groups and on those with irregular earnings in the rural areas. The authorities are therefore proceeding with considerable caution to avoid social and political resistance. Since independence, in 1963, the Government has provided increasingly subsidized or free social services, such as education and medical facilities. The tight fiscal stance, along the lines of the medium-term path of fiscal deficit reduction of 3.7 percent of GDP in 1990/91 and 3.2 percent in 1991/92, allows little room for projects intended to mitigate the program's hardships on the poor. It is feared that this could further intensify the burden of adjustment, with the potential of ushering in adjustment fatigue. While the authorities consider it necessary to sustain the adjustment effort in order to attain the program objectives, increased external grants and concessional assistance will therefore play a critical role in safeguarding the program and maintaining the moderate rate of growth under stable conditions.

The authorities have little room for external borrowing, except on very concessional terms, due to, inter alia, the need to keep the debt service burden below 30 percent. They have remained current on all their external obligations, but clearly at a high cost, as indicated by the high debt service ratio. The authorities believe that countries that discharge their financial obligations in a timely fashion should not be made to face undue difficulties. Therefore, they look forward to favorable treatment by all their creditors.

In conclusion, while transmitting the appreciation of the Kenyan authorities to the international financial community for its support, I must reiterate the continued need for further assistance. To widen the scope for financing social programs, it will be necessary in the medium term to increase external financing on several fronts, including debt write-offs, highly concessional financing, and substantial increases in grants.

Mr. J. E. Ismael said that he was pleased to note the good performance of Kenya under the enhanced structural adjustment arrangement, and the observance of all the performance criteria as well as the implementation of the quantitative and structural benchmarks for the period under review. Most of the program targets were expected to be realized in 1989. Inflation, however, did not seem to have been fully contained, and tighter demand-management policies might be needed.

On the whole, he broadly agreed with the staff appraisal, including the positive assessment of the Kenyan authorities' adjustment efforts and the policy recommendations contained in the staff paper, Mr. Ismael continued. He endorsed the measures envisaged for the remainder of the year, as they seemed adequate to ensure the realization of the objectives of the program.

Consistent with his chair's position during previous Board discussions of reviews under enhanced structural adjustment arrangements, he wished to note that, in the present case, in which the program was on track and no major difficulties were foreseen for the remainder of the year, the paper could have been submitted for approval on a lapse of time basis. That procedure would have contributed to a lessening of the Board's crowded agenda, especially for the current month. He supported the proposed decision.

Mr. Enoch made the following statement:

I very much welcome the staff's report that the Kenyan authorities have met all the quantitative and structural benchmarks for this midterm review, and that the program as a whole remains essentially on track.

On the domestic side, the overall control of the fiscal deficit has been successful, but I was disappointed to hear of lower than expected revenues. More serious, however, is the pattern of adjustment in expenditures, as the burden fell in large measure on development outlays because of the increased wage bill. It is essential that the authorities apply with vigor their proposed measures to restrain the growth of wage expenditure in the future.

On the financing side, I was disturbed to learn of the degree to which credit from the banking system to the Government was kept under control by maintaining a high level of unpresented checks outstanding over the fiscal year-end, and I welcome the intention not to allow any increase from this level at the end of the next fiscal year. Indeed, there would have seemed to be a good case for seeking some reduction.

The persistence of double-digit inflation is blamed in part on the greater than expected growth in broad money. A contributing factor to this growth was the sharp rise in foreign assets resulting from the borrowing of the Coffee Board. The footnote on page 12 of the staff paper explains the confusion between the authorities and the staff over the constraints on such public enterprise borrowing. It is essential that this issue be resolved in the next round of negotiations, not only because of the monetary implications, but also because of the potential impact of such borrowing on the debt ratio.

On monetary policy in more general terms, I welcome the authorities' prompt action in raising interest rates in April, and again in October, with the intention to take further action as necessary. Recent legislative measures to strengthen the financial system are also very welcome. Other structural reforms, including trade liberalization, seem to be progressing

well, but more urgency might be introduced into reforming the parastatals and adopting measures to facilitate increased investment flows.

Encouraging inward investment is particularly important in view of the vulnerability of the current account and the upward revision of the estimated financing gap for 1990. More rapid growth in private flows than that projected in Table 6 would be welcome, particularly in the context of export diversification. The expected reversal in 1990 of this year's current account deterioration is uncomfortably dependent on projections for both higher price for and volume of coffee exports. I would be interested in staff comments on the risks associated with these projections.

I note that the authorities' response to the external deterioration will incorporate a more restrictive monetary stance, while rightly maintaining their flexible exchange rate policy. But given the persistence of inflation, it would seem appropriate also to look closely at further measures to reduce the fiscal deficit, particularly through parastatal reform. This area clearly should be central in the formulation of the second-year enhanced structural adjustment arrangement.

Kenya's enhanced structural adjustment program is on track, and the authorities should be commended for this. Therefore, like Mr. Ismael, I am a little surprised that this review was not handled on a lapse of time basis. Most reviews of enhanced structural adjustment arrangements could be so handled unless some benchmarks were missed, or the staff considers something is seriously adrift in the economy. The information given the Board by the staff at the start of the meeting that Kenya's end-September performance criteria were met and that the Kenyan authorities have taken additional adjustment and structural measures reinforces the argument that lapse of time treatment would have been appropriate on this occasion.

Mr. Iqbal made the following statement:

The midterm review reflects some important gains, the most significant of which is the acceptance and resolute implementation of a number of difficult structural reforms in the first half of 1989. The determination to go ahead with major structural measures during the 1989/90 budget period to rationalize expenditures and increase revenues augurs well for the future.

However, the prospects for the year are less promising than was expected in May 1989. Inflation has started to reaccelerate, and the external current account is likely to be worse than initially projected. Economic growth is also lagging. This

outcome is due partly to exogenous factors, but there may also have been a desire to achieve too many ambitious targets simultaneously. The program called for potentially contradictory objectives, such as an increase in the growth rate, a reduction in inflation, an improvement in the current account deficit, and an accumulation of net official foreign assets. Also, perhaps the instruments available to the authorities to achieve the objectives were limited.

I consider the strengthening of credit policy, the restraint underlying the 1989/90 budget, and the recent real effective depreciation of the Kenyan shilling to be steps in the direction of addressing the weakening of the external balance and the domestic inflationary pressures. Perhaps more needs to be done if all the planned targets are to be addressed adequately. However, in the absence of a clearer picture of the medium-term outlook, it is difficult to gauge the appropriateness of the magnitude of additional steps. In this respect, I am not fully persuaded by the staff's cautious optimism regarding a turnaround in the current account in 1990. It is therefore gratifying to note that the authorities are determined to strengthen their policies if the external accounts fail to recover.

Since I concur with the broad recommendations of the staff appraisal, I will emphasize issues that I consider should have been accorded greater recognition. At the heart of the structural adjustment in Kenya is the desire to create an environment in which the domestic resource constraint, that is to say, the savings-investment gap, is reduced, thus strengthening the economy's ability to respond to exogenously generated disruptions. Despite an improvement in government savings, overall savings are expected to decline, rather than increase, in 1989. Surely this phenomenon cannot be explained solely in terms of lower real interest rates. Does the staff consider this a temporary pause in the process of adjustment? If not, how will the widening domestic resource gap be addressed? Clearly, a continued large and growing dependence on foreign financing, irrespective of its concessionality, will have implications for macroeconomic adjustment in the years to come. The authorities and the staff will need to look at these matters carefully.

Kenya has traditionally been an attractive venue for foreign direct investment. However, in recent years such investment has played a less important role. In view of the special characteristics of direct investment--it fills the resource gap without creating excessive burdens on the balance of payments--it is high time that specific policies were considered to promote such flows within the context of the enhanced structural adjustment arrangement. As the macroeconomic policy framework is being corrected, there may be a need for another

look at the mix of incentives and regulations in the area of foreign direct investment in Kenya. Can the staff throw some light on this issue?

I would have liked a more comprehensive assessment of the social implications of the program. As was indicated at the May 1989 discussion on Kenya, there is a need to carefully monitor the social impact of, for example, interest rate policies and indirect taxes. Similarly, a more detailed appraisal of policies to protect the most vulnerable groups would have been helpful, and I hope that the staff will be able to do so in the context of the program for the second year of the arrangement. Finally, I support the proposed decision.

Mr. Warner made the following statement:

The staff paper on Kenya's economic performance this year conveys the impression of a country that is adjusting, growing, and in a comfortable balance of payments position. We agree with other Directors that the track record of the Kenyan authorities in the initial phase of their enhanced structural adjustment arrangement is satisfactory. In particular, we welcome the measures taken in the middle of the year to ensure that the program remained on track. We are also heartened by the progress described in implementing important structural reforms, and we hope that this is more a harbinger of things to come than a happy coincidence.

Despite the progress, the staff has focused attention on a few developments that are a cause for concern. In particular, we share the staff's concerns about the size of the latest civil service wage increase, the postponement of cash payments at the end of the fiscal year in order to meet program targets, and the borrowing by the Coffee Board, which permitted Kenya to meet the June 30 performance criterion for net international reserves. In contrast, we are encouraged by the 1989/90 budget, which suggests that some of the problems encountered earlier this year will not be repeated. The introduction of user fees in the health and education sectors is especially noteworthy.

As to the coming period, Kenya appears to have settled into a rhythm of steady, but slow, adjustment. We believe, however, that Kenya is capable of much more, and we would like to see Kenya adopt more ambitious targets for its second annual enhanced structural adjustment arrangement.

Except for its rapid population growth, Kenya seems to be well positioned to set a faster pace for growth. To succeed, we suspect that Kenya will have to move aggressively to eliminate administrative and legal barriers to investment--especially

foreign investment. In addition, it will have to reduce the size of the civil service, complete the reform of its public enterprise sector in a relatively short period, and modernize its financial sector. In short, to unleash the forces of economic growth as successfully as the dynamic economies of Asia, Kenya will have to provide more scope for the private sector.

In response to Mr. El Kogali's opening statement, we take a measurably different view of the role of foreign assistance and debt relief in Kenya's future economic development. We believe that if Kenya succeeds in its structural reform efforts and in maintaining appropriate macroeconomic policies, it will become less dependent on foreign aid and more capable of borrowing on nonconcessional terms. This view is aligned with our earlier observation that Kenya should strive for higher performance goals and achieve a stronger financial base.

In closing, I will comment briefly on the position of Mr. Enoch and several other speakers who supported the lapse of time approach to midterm reviews of programs supported by enhanced structural adjustment arrangements. This chair continues to believe that short Board discussions are a better approach. This approach offers Directors an opportunity to evaluate and comment on the program for the coming year, which is a key element of our oversight function. We do, however, recognize that certain cases may lend themselves to the lapse of time procedure.

Mr. Cirelli made the following statement:

Like other speakers, we are pleased to commend the Kenyan authorities for having met the quantitative and structural benchmarks of the program as well as the structural performance criteria on import liberalization. These satisfactory results stem from the authorities' strong commitment to firm economic and fiscal reforms and to wide-ranging adjustments in the agricultural, industrial, and financial sectors. It is also worth noting that such progress has been made despite the collapse of international coffee prices. However, the deterioration of the external situation, the persistence of inflationary pressures, as well as the steadily accelerating population growth clearly demonstrate that further efforts are needed to maintain this enviable track record.

We broadly agree with the conclusions provided by the staff paper, and I will focus my comments on two specific issues. First, in light of recent developments in the overall economic situation, the authorities must continue to pay close attention to areas of weakness in macroeconomic policies. In

the budget area, the decisive set of measures adopted for 1989-90 has to be implemented without delay in order to contain the deficit at a level consistent with available external and noninflationary domestic financing. Among these measures, the replacement of a manufacturing sales tax by a value-added tax is welcome. We also appreciate the emphasis placed on a better allocation of recurrent expenditures among consumers in public services and in the health and education sectors, coupled with the ceiling placed on the growth of the wage bill. Nevertheless, like Mr. Enoch, we wish to stress the importance that the authorities should give to improving the situation of postponed checks during this phase of the program.

As regards monetary and credit policies, we agree with the staff that a tighter stance is crucial to reduce inflationary pressures. We urge the authorities to implement the reserve money management reform with technical assistance from the Fund. Also, they should be ready to adopt additional interest rate measures in line with inflationary developments.

Second, the projected overall balance of payments position indicates an improvement over the 1988 deficit. However, this has to be seen in the context of the deterioration of the current account deficit due to a great extent to the successful far-reaching import liberalization policy and the less favorable terms of trade. Against this background, the authorities should make a concerted effort to maintain the present pace of structural reforms backed by the World Bank in order to broaden the productive base and increase external competitiveness. Maintaining a flexible exchange rate policy consistent with the objectives of the program, while taking corrective measures when needed, remains of the utmost importance. However, at this stage, even if national savings have to be improved, additional external financing seems to be crucial, according to the staff projections, to maintain the momentum of adjustment. Some comments from the staff on this matter would be welcome, particularly in view of the latest donors' meeting, which was held in Nairobi in October 1989.

In conclusion, in demonstrating their willingness to move ahead and to take corrective measures in a timely manner, the authorities deserve the support of the international financial community. At this stage of the program, we can establish that macroeconomic policies and structural reforms remain consistent with the program's broad objectives. We support the proposed decision.

Mr. Goos made the following statement:

I agree with the thrust of the staff appraisal and in particular with the view that the weakening of the external current account position and the increased inflationary pressure call for immediate corrective action. It is certainly also reasonable to advise the authorities to be prepared to strengthen their stabilization effort in a flexible and timely manner if the need arises further down the road.

Against this background, I also welcome the recent tightening of monetary policy and the upward adjustment of interest rates; these measures are quite encouraging. However, I am less convinced about the appropriateness of the fiscal policy stance and I am even less confident in the exchange rate policy. While I commend the authorities on the substantial expenditure cuts implemented in 1988/89 to compensate for the revenue shortfall of that year and meet the budget deficit target, it is quite unfortunate that in both 1988/89 and 1989/90 fiscal policy did not and will not make any contribution to the necessary additional adjustment. A more balanced policy mix would be preferable, not least because it would help ease the pressure on domestic interest rates and the corresponding burden on private sector activity. Further cuts in current expenditures also appear advisable, since increases in public sector savings offer the greatest potential for rapid improvement in the external current account. In that connection, I, like previous speakers, noted that the program projections for next year are based largely on the assumption that there will be a substantial recovery of coffee prices that could help reverse the current deterioration. But obviously, since the realism of this assumption remains to be seen, there is a clear need for caution. There is certainly room for exercising such caution in the government wage bill--where recent developments and projections show worrisome slippages--and in the check float and public sector enterprise reform.

In this context, I noted with considerable concern the additional authorization under the proposed 1989/90 budget for a substantial increase in project outlays and the plan for major investment expenditures for the national airline. I am, of course, not in a position to judge the merits of these projects and investments, but the reservation mentioned in the paper--that the stability of the macroeconomic framework must not be compromised--can hardly be overemphasized. Therefore, I welcome the authorities' intention to seek the Fund and the Bank's advice on the investment program for Kenya Airways and I hope that they will also seek advice on the supplementary budget authorizations for 1989/90.

With respect to exchange rate policy, I have great difficulty in endorsing the recommendations that the authorities should continue pursuing a flexible policy and stand ready to accelerate the pace of depreciation if the need arises. I have consistently expressed my reservations about this kind of policy advice of gradual devaluation, mainly because of its adverse effects on inflationary expectations and, hence, macroeconomic stability. These concerns are particularly warranted in the case of Kenya, given its history of continuous substantial depreciations of the exchange rate since 1985. Incidentally, according to Table 2, these depreciations--which since 1985 have amounted to a cumulative total of some 36 percent in real effective terms--were accompanied by a substantial decline in domestic savings and, according to Table 6, by erratic external private capital flows around a clearly declining trend. In addition, the ineffectiveness of exchange rate policy in promoting export diversification, observed by Mr. El Kogali in his opening statement, is of course cause for concern. Moreover, the remarkable 7 1/2 line discussion of exchange rate policy in the paper seems to offer little justification for the recommendation to further depreciate the exchange rate, particularly since it does not contain any reference to the competitiveness of the rate at the time of the discussions with the authorities.

I continue to feel that external competitiveness should be the main guidepost to exchange rate policy. Once such competitiveness is secured, all the other policy objectives, such as trade reform and expanding and diversifying the export base, should be pursued in the first instance through domestic financial and structural policies. Anything else would amount to competitive devaluation and policy prescriptions that would be bound to complicate the task of domestic stabilization. I continue to feel that exchange rate policy is so crucial for domestic and external stabilization that it certainly deserves to be given as much attention in our policy analysis as structural reform. I would like to repeat my request that exchange rate policy should in general be analyzed in an integrated fashion together with financial policies, and particularly interest rate policy.

I welcome the continued good record of policy implementation under the current arrangement, as reflected in the close adherence to the quantitative and structural benchmarks. This performance is no doubt a reflection of the authorities' commitment to adjustment, and I am therefore confident that they will take the necessary steps to realize the goals of their commendable program.

As to the lapse of time issue, I welcome the decision to bring this paper to the Board for discussion. Admittedly, there is no threat of an immediate derailment of the program, but the

exchange rate point I have raised suggests that there are substantial concerns on the horizon that warrant some reconsideration of the present policy stance. In general, I go along with the views expressed by Mr. Warner on this issue. Finally, I support the proposed decision.

Mr. Evans stated that he was very satisfied with the progress that Kenya had made. However, he wished to support Mr. Goos's comments on exchange rate policy. Mr. El Kogali had raised the exchange rate issue in his opening comments on the contribution that the policy might or might not have been making to export diversification. The staff should look more carefully at the issue and provide the Board with some material on it.

The Acting Chairman remarked that the staff would look at the exchange rate issue in Kenya more closely in the coming period. It was interesting to note that the large real effective depreciation since 1985 was partly a reflection of the thrust of the discussions in the Fund and subsequently the World Bank, which had noted the need for a significant real effective depreciation in order to improve Kenya's competitive position. Indeed, at one point in the past, concern was expressed in the Fund Board that the World Bank was not willing to move ahead in assisting Kenya because the Bank felt that the exchange rate at that time was not at a level that would support the kind of industrial diversification and opening up of the economy that the Bank was pressing for; there had been some discussion at the time of how the two institutions were working together.

Mr. Noonan made the following statement:

We too are encouraged to learn that the Kenyan program is essentially on track, and that significant progress has been made in implementing a wide range of structural reforms. The authorities' decision to adopt a more restrictive monetary and credit stance than originally programmed is an appropriate response to the increase in inflationary pressures experienced this year.

We would like to associate ourselves with other chairs in commending the Kenyan authorities on their success to date and in urging them to persist in their efforts. Where necessary, policies should be strengthened to ensure achievement of the overall objectives of the program. In that context, I would wish to mention a few areas that are a cause for concern.

Interest rate policy is one of them. We were therefore pleased to note that the authorities have recently taken action in this area and, in their letter of September 26, have indicated their intention to take further action if it is required.

On the expenditure side of the government accounts, we share the reservations expressed about the continuing practice of postponing cash payments and the buildup of unpresented checks at the end of the year. This practice, if persisted in, will undermine expenditure budgeting and expenditure control. In addition, the increase in the pay bill in 1988/89 of 16 percent does not carry conviction for the successful adherence to the 7 1/2 percent ceiling in 1989/90. On the revenue side, there could be implementation advantages in a more simplified structure for the proposed multiple rate value-added tax.

As to the external accounts, we agree with those chairs that have urged caution in formulating policies on the basis of a rebound in coffee prices next year. In our view, the possibility of a less favorable outcome than projected needs to be anticipated, and corrective measures should be taken as required. We agree with the staff that one part of such contingency action may have to be a more rapid depreciation of the real effective exchange rate, but we feel that the authorities should also have other measures ready to put in place if necessary.

In mentioning specific areas of concern, our intention is to help alert the authorities to some of the hazards that might beset their program. We do so without diminishing in any way our view that the authorities are to be commended on the progress they have made to date.

Mr. Hogeweg made the following statement:

The present paper, like previous ones on Kenya, shows the important and highly commendable progress Kenya has been making, both in structural issues and in its endeavors to follow prudent macroeconomic policies. At present, Kenya's terms of trade--although this concept does not seem to be used in the paper--are being adversely affected by the large fall in world market prices for coffee. Perhaps it was this development that led this midterm review to be brought to our agenda. This discussion gives me an opportunity to make a couple of points, one of which provides strong support for the positions just taken by Mr. Goos and Mr. Evans on exchange rate policy.

Earlier this week, in the discussion on Ghana, I tried to distinguish analytically between, on the one hand, adjustment in the sense of removing impediments to the functioning of the economy, such as allocative inefficiencies and macroeconomic imbalances, and, on the other hand, adjustment to terms of trade developments. A strict distinction is not possible, however, if only because adjustment to terms of trade changes is inescapable, and because such changes themselves give rise

to macroeconomic disequilibria. At the same time, adjustment to external shocks may be facilitated by earlier success in structural reform. It would be very useful to state clearly in our presentations that our programs address much more than adjustment to the terms of trade, and that actual terms of trade developments obscure the benefits of adjustment. In the recent case of Ghana, the staff did not respond to these observations. Perhaps it could do so on the present occasion.

On a different issue, the word "flexible," which seems to be used as a regrettable euphemism for downward movement, appears many times in this paper--too often for my taste. The staff commends the authorities on their flexible exchange rate policy, which is considered important in the light of Kenya's continued vulnerable balance of payments. The staff encourages the authorities to stand ready to accelerate the pace of depreciation of the real effective exchange rate if the need arises. Chart 1 shows that Kenya has depreciated its nominal, and in parallel, its real, effective exchange rate since 1985. I conclude that Kenya has used its nominal exchange rate to improve its competitiveness, which is important for diversification of its export base and growth in general, and certainly in the face of terms of trade losses. However, Mr. El Kogali stated that little has been achieved with respect to diversification. At the same time, Kenya has pursued financial policies that have been sufficiently tight to prevent the effects of nominal exchange rate depreciation from eroding, but not tight enough to make real depreciation exceed nominal depreciation.

Improving competitiveness, necessary as it may be in response to a terms of trade loss, is of course a relative concept: as your competitiveness improves, someone else's deteriorates. It is only natural that countries compete with each other for market shares. The emphasis in that struggle can be on domestic cost developments and productivity; it can also be on the exchange rate, or both. In stressing exchange rate policy in this respect as much as the staff does, the staff operates on the borderline of advocating competitive devaluations, which of course run counter to the spirit of this institution. Like Mr. Evans, I noted Mr. El Kogali's carefully worded expression of hesitation on the staff's recommendations. I am not implying that the exchange rate should not be used at all. Of course, exchange rates should be realistic. The issue in this case is one of emphasis and philosophy. There may well be a link with Kenya's disappointing inflation record. The contrast between this staff advice and that given in the context of programs for countries in the CFA franc zone--the other extreme--is striking.

Finally, I was struck by the remark that adverse social implications of some policy measures are minimized by their

gradual application. The other side of that coin is that the positive effects of these measures on Kenya's economy, with the accompanying positive social implications, are thus postponed as well.

Mr. Yoshikuni made the following statement:

I welcome today's discussion on the midterm review of Kenya's first-year enhanced structural adjustment arrangement. When the Board approved Kenya's request for this arrangement in May of this year, this chair supported the program but cautioned against the downside risk in its implementation, particularly in view of Kenya's precarious balance of payments situation, and called for the full implementation of the program. We are therefore encouraged by the fact that the program has been on track, with the quantitative and structural benchmarks having been observed. Particularly reassuring is the considerable progress made in the structural areas, including, inter alia, the import liberalization program. Also, the authorities are to be commended for their flexible exchange rate policy aimed at improving the resiliency of the external sector. Nonetheless, we have a number of caveats concerning the future implementation of the program. As most of our concerns are already addressed in the staff paper and Mr. El Kogali's opening statement, I will limit myself to a few specific points.

First and foremost, despite the progress just mentioned, Kenya's balance of payments position continues to be vulnerable to external developments, as evidenced by the deterioration in the current account, owing mainly to the unexpected fall in world coffee prices. As we pointed out in previous discussions on Kenya, as long as the heavy dependence of exports on small products--namely, coffee and tea--continues, there is always a risk that the program will fail to fully restore Kenya's external viability. Looking ahead, the staff expects coffee exports to rebound in 1990. However, while the export shortfall this year could be attributed largely to temporary factors, it is not clear why exports in 1990 will exceed the original projection. The staff could usefully elaborate on this point.

On the other hand, the deterioration in the current balance was offset by the capital inflow. It is regrettable, however, that part of the increased capital flow was the borrowing by the Coffee Board with no government guarantee, which was not envisaged under the program. Although the borrowing was short term and does not have a serious impact on the external debt management, it might be interpreted as representing a weakness in the authorities' monitoring ability.

On the fiscal front, the continued dependence on the postponement of cash payments is a cause for concern. Not only does this practice make the budget process less transparent, but it would also have an adverse effect on the monetary aggregates in the event the large unpresented checks are cashed in a short period.

In addition to the weak external balance, growing inflationary pressure, if left unchecked, would cast doubt on the sustainability of the program. The unexpectedly rapid growth in broad money should be addressed vigorously through a tight monetary policy. Although domestic credit growth as of the end of June was well below the program ceiling, this could be attributed to the postponement of payment by the public sector and does not necessarily imply strong monetary restraint.

In sum, the developments in the first half of the year under the enhanced structural adjustment arrangement clearly show the importance of a macroeconomic policy framework in implementing successful adjustment policies. Therefore, I encourage the authorities to continue the adjustment efforts in order to fully implement the program. Also, I hope that, in formulating the second annual program, points made in today's discussion will be taken into account by the staff and the authorities.

On the issue of the lapse of time procedure, I associate myself with Mr. Warner and Mr. Goos. In fact, my authorities attach importance to the midterm review process for enhanced structural adjustment arrangements, particularly since this facility is in its initial stage. In this particular case, while I recognize the authorities' achievement in fulfilling all the performance criteria, the deterioration in the external balance and persistent inflationary pressure deserve at least a short Board discussion, like this one.

I support the proposed decision.

Mr. Fogelholm made the following statement:

I welcome Kenya's economic performance to date under the enhanced structural adjustment arrangement, and endorse the staff's assessment of the present economic situation and of the need for further structural reforms. I am pleased to note that all the benchmarks for mid-1989 and the performance criterion related to import liberalization have been met. I am also encouraged by the expected realization of the growth and reserve targets in 1989.

Nevertheless, the external position in Kenya remains weak, as is manifested by the projected widening--instead of the previously forecast narrowing--of the current account deficit, as well as by the increasing balance of payments deficit over the medium term. The external sector's vulnerability to price fluctuations of coffee on world markets demonstrates the importance of expanding and diversifying the export base. The usual prescription in such a situation is a depreciation of the currency--and that is precisely what the staff proposes in this case. I note, however, from Mr. El Kogali's opening statement that the experience to date with this policy has not been particularly encouraging. In the light of the substantial foreign exchange rate adjustment that has already taken place and the inflationary pressures that still exist in the country, I tend to agree with Mr. El Kogali that the wisdom of a further depreciation could indeed be questioned. I also agree with Mr. Hogeweg that in this case we might have reached a situation in which further adjustment of the exchange rate can be regarded as competitive devaluations.

It is encouraging to learn from the staff's paper that progress has been made in import liberalization, which will undoubtedly facilitate domestic production. However, because of the less favorable external outlook, more energetic efforts seem to be warranted to improve the export promotion program, including the export compensation scheme and the export processing zones.

During the previous discussion of this program, several Directors voiced concern about the fiscal situation in Kenya. Similar concerns could be raised today, particularly with regard to the level of ambition of expenditure restraint. Although the fiscal deficit in 1989/90 is projected to be close to the original target, more ambitious cuts might have been appropriate given the medium-term objective of reducing the deficit to a level compatible with available external resources and noninflationary domestic financing. A more restrictive fiscal stance would also be helpful in accelerating development toward the necessary price stability.

Important aspects of the curtailment of the budget deficit are the introduction of a ceiling of 7.5 percent on the growth of the wage bill and measures introduced to restrict growth in civil service employment. I wonder, however, whether the measures proposed will be adequate to meet the program's target in this regard.

I agree with those Directors who noted that this medium-term review of Kenya's enhanced structural adjustment arrangement could have been handled on a lapse of time basis. I support the proposed decision.

Mr. Enoch said that during the present discussion there had been interesting comments on the exchange rate and exchange rate policy recommendations. He wondered whether it was fully correct to conclude that the flexible exchange rate policy of the past few years had had only a limited impact in promoting nontraditional exports. Its major impact might well have been on services. Table 6 showed that travel exports had risen by more than SDR 100 million over the past three or four years and was at present the largest export sector in the Kenyan economy.

Mr. Zhang considered that the Kenyan authorities were to be commended for the satisfactory results achieved under the first annual arrangement under the enhanced structural adjustment facility. Both the quantitative and structural benchmarks for mid-1989 had been observed, and in some cases by a wide margin. He agreed with the staff's analysis and appraisal and with the views held by previous speakers.

It was very encouraging to note that the authorities had expressed their strong commitment to continuing their adjustment efforts, Mr. Zhang said. A flexible approach to exchange rate policy was indeed crucial for further implementation of trade reform, export diversification and expansion, and hence the external sector's outlook for 1989-90, which appeared less favorable than initially projected. However, only when an appropriate magnitude of exchange rate adjustment was observed could the effectiveness of such adjustment be assessed. As was stated in the staff appraisal, the authorities' efforts to take corrective action and strengthen the external position needed to be supported by adequate and timely external concessional assistance. The authorities deserved such assistance from the international financial institutions. He supported the proposed decision.

Mr. Fogelholm commented that it was true that travel revenue had increased substantially during the past five years, although, as Mr. Hogeweg had suggested, there seemed to have been a continued competitive devaluation. It might be useful to consider how the improvement in Kenya's services account had affected other countries in the region.

Mr. Hammoudi made the following statement:

> We support the authorities' request for the second semi-annual disbursement under the enhanced structural adjustment arrangement. The Kenyan authorities are to be commended for the successful implementation of the program for 1989. Indeed, all the benchmarks and performance criteria were observed. Since we agree with the thrust of the staff's appraisal and the recommended measures, as well as the conclusion contained in Mr. El Kogali's opening statement, we will limit our comments to certain aspects of the program.
>
> In the area of public finance, the reduction in total expenditures, in response to the shortfalls in revenue, which resulted in narrowing the overall budget deficit from the

program target of 4.5 percent of GDP to 3.9 percent in fiscal year 1988/89, has been very encouraging. However, the substantial increase in wages could threaten the slight progress in the budget area. We urge the authorities to rationalize expenditures and broaden the tax base to limit the budget deficit.

The larger than projected increase in broad money has accelerated the rate of inflation to over 10 percent, in terms of the consumer price index, during the first half of 1989. We believe that, through the implementation of appropriate fiscal and monetary measures during the remainder of the year, the rate of inflation should decline.

As to structural reforms, the authorities' intensified efforts in various sectors were most encouraging. In this regard, the increase in agricultural producer prices, as well as the steps taken to improve the administrative and financial system of the National Cereals and Produce Board, are steps in the right direction. Furthermore, we welcome the reforms in public enterprises. Accordingly, it is important for the authorities to prepare a policy framework, with the support of the UNDP, for restructuring the public enterprise sector and the financial development institutions so as to introduce efficient management and responsible accountability in these enterprises. However, the adverse effects of the structural reforms on the poor segment of the population in the short term are a cause for concern. We recommend that these measures be taken gradually, and we urge the authorities to design an appropriate program containing social benefits for the needy segments of the population.

With respect to the external position, an expected slump in coffee export prices, owing to the collapse in the export quota mechanism under the International Coffee Agreement, is penalizing the authorities' efforts to overcome the economic difficulties. This unfavorable situation will most probably hurt the country's trade and current accounts in 1989. While continuation of a flexible exchange rate policy would be an effective step in coping with this problem, much attention should also be given to diversification of the country's exports structure. Similarly, improvement in the competitiveness of the country's external sector is of paramount importance. To this end, we encourage the authorities to persevere in implementing the measures already adopted to boost productive investments.

We welcome the authorities' intention to remove delays in payments under the export compensation scheme and to proceed further with the formulation of a fundamental program for export promotion in the medium term.

In the light of all these circumstances, we support the proposed decision.

Mr. Morshed made the following statement:

The praiseworthy continuing commitment of the Kenyan authorities to structural reform is demonstrated by the substantial structural content of the policies pursued during the past fiscal year. At this stage of the discussion, and as I am in general agreement with the broad thrust of the staff paper, I wish to emphasize a few points.

On export diversification, Mr. El Kogali's opening statement draws attention to the need for a better understanding of appropriate sequencing of policy instruments involving exchange rate policy and structural reforms. In this connection, in addition to exchange rate policy--on which I associate myself with the remarks of Mr. Goos and other speakers--it may be appropriate to simultaneously focus attention on the stronger than anticipated impact of import liberalization measures on the balance of payments. A recent Fund working paper on the impact of trade liberalization measures on external imbalances and growth also points to the uncertain and weak statistical link between these variables. While the principle of import liberalization and its welfare enhancing impact cannot be questioned, more effort needs to be directed at the appropriate timing and sequencing of import liberalization measures, and to the question whether it is appropriate to focus on such measures at a stage in a program when both current account and fiscal deficits are large relative to GDP.

I endorse the staff's recommendation that the authorities should maintain not only a tighter monetary and credit stance than originally envisaged, but also the pace of structural reforms in the fiscal area. Control of personnel-related budgetary expenditure, and relocation of budgetary expenditure toward operations and maintenance are also necessary. In this connection, the measures introduced to curtail growth in civil service employment are welcome and need to be implemented without any slippage. Finally, while I note the achievements with regard to public enterprises, progress in this area could proceed at a faster pace, and I encourage the authorities to do so.

While supporting the proposed decision, I agree with some other Directors that such cases preferably should be dealt with under the lapse of time procedure.

Mr. Garcia made the following statement:

We commend the Kenyan authorities for the quality of the program that has been implemented under the enhanced structural adjustment facility. The program remains on track, and some of the targets have been achieved with significant margins. The fact that some of the targets have not been met is attributed to unpredictable adverse external events, like the drop in coffee prices. However, the authorities have been ready to take the necessary steps to counteract those events, like the recent increase in real interest rates to avoid inflationary pressure, as the exchange rate has had to adjust.

Even though the program remains on track, there are some circumstances that should be called to the attention of the Kenyan authorities. There seems to be persistent inflationary pressure, as the fiscal deficit is still somewhat large. An appropriate economic policy mix is needed to avoid both further inflation and deterioration of the rate of growth of the economy. Kenya is one of the few countries that has achieved adjustment with growth, and that positive development should be preserved.

Excessive reliance on monetary policy to counteract inflation might endanger growth and be ineffective, as the fiscal deficit remains large. We agree that the relationship between the exchange rate, interest rates, and inflation mentioned by some Directors has to be examined in the context of the saving/investment imbalance in Kenya. Whether or not the exchange rate will remain at an appropriate level will depend very much on the fundamentals and on how market forces are permitted to work. In principle, in a context of fiscal balance and flexible interest rates, a floating exchange rate will adjust to bring about external equilibrium. In Kenya, according to the staff papers, the main disequilibrium seems to be the fiscal deficit, as interest rates are more or less market determined. We encourage the Kenyan authorities to take the necessary measures to reduce the fiscal deficit to restore basic macroeconomic balance in the economy, particularly in the public enterprises and parastatal institutions.

Structural reforms have a key role to play, and the Kenyan authorities have an excellent record in this regard, as they have implemented a strong program of trade liberalization. However, more work also needs to be done in the public sector, which could help to reduce the pressure on the fiscal side of the program.

Kenya's program is one of the most interesting cases in which adjustment has been undertaken in a context of real GDP

per capita growth, and it deserves the full support of the international community. We support the proposed decision.

The staff representative from the African Department commented that if in 1990 coffee prices did not rise above the 1989 average level, the current account deficit--including transfers--as a ratio of GDP would increase by about 0.2 percentage points to 4.3 percent. The staff had tried to be fairly conservative in making assumptions on the likely rebound in coffee prices in 1990, but certainly there was some risk associated with the projections, and the staff would monitor that important situation closely.

The authorities had taken a number of steps to promote direct foreign investment, the staff representative remarked. That the newly formed Cabinet Subcommittee on Investment Promotion was being chaired by the Vice President sent a signal of the importance that the authorities attached to that effort. The Vice President had taken an active role in the subcommittee, and the authorities were clearly very serious about trying to remove bureaucratic obstacles to direct foreign investment. There was obviously more work to be done, particularly with respect to the repatriation of profits.

The issue of the social impact of the adjustment program on the poorest groups had been addressed by the staff and the authorities in a serious manner, the staff representative said. The staff had held a lengthy discussion with the UNICEF representatives in Nairobi. They had exchanged views on a number of measures that were being taken, and not surprisingly, the views of the UNICEF representatives in that area were somewhat complex. The UNICEF representatives were not opposed to the introduction of user charges; indeed, they felt that such charges were probably warranted in the circumstances of Kenya, and especially given the extremely poor quality of the services being provided in the health and education sectors. They had noted that the poor were not intensively using health and education services because the quality of those services was very low, and they considered that the resources accumulated from user charges should be used to improve the quality. The staff had encouraged the UNICEF representatives to make suggestions for the contents of a possible policy framework paper for 1990, and the staff had recently received a long letter from them giving their ideas.

The donors' meeting in October 1989 had been relatively successful, the staff representative commented. Most of the donors had been favorably impressed by the quality of the program and had focused most of their remarks on small-scale enterprise strategies, the role of the informal sector in providing employment opportunities, and privatization.

In general, the staff agreed with speakers who had stressed the importance of increasing public savings, the staff representative said. Cutting the rate of growth of public sector employment would be helpful, but increasing public sector savings by squeezing nonwage operations and

maintenance certainly would not. Similarly, the increase in public savings should not be achieved by significantly cutting real wages in the public sector; an increase in those wages might well lead to some improvement in efficiency and quality. Simply squeezing current consumption to mobilize more money for investment that would in any event be insufficiently maintained would not contribute to economic growth; instead, it could result in further depreciation of the public sector's capital stock.

The adjustment program was not designed merely to address adverse terms of trade developments, the staff representative continued. The program included a range of measures in the areas of liberalization, fiscal reform, and public enterprise reform.

The exchange rate issue was important, and the staff would have to give it considerably more attention in the context of the coming year's program, the staff representative commented. The staff agreed that the authorities should aim for a competitive exchange rate and then minimize the extent to which the rate was continuously devalued. The difficulty in that connection was that the authorities were undertaking a fairly fundamental set of adjustments to replace the system of import licensing and quantitative restrictions with tariffs. When making that kind of structural change a government typically had great difficulty in knowing a priori exactly what the right exchange rate was. Of course, in moving along the process of reform one must be sensitive about the exchange rate. The level of non-oil imports in 1989 had been much higher than anticipated, and while the World Bank and the Fund had been very pleased with that outcome, it had meant that the external position was less favorable than expected, which suggested to the staff that there might be a need for some exchange rate action. Moreover, the deterioration in the terms of trade was also unanticipated and might further warrant possible movement on the exchange rate. The staff shared Mr. Goos's concern that one should not rely excessively on exchange rate policy vis-à-vis domestic policy instruments.

Mr. El Kogali considered that, in the context of the situation in Kenya, the Executive Directors had had a useful exchange of views on the role of exchange rate policy in developing countries. Exchange rate and interest rate policies generally worked very well in the developed economies, but it was always useful to review their roles in developing countries. Exchange rate policy was becoming the equivalent of aspirin in developing countries, in the sense that it was routinely prescribed for virtually any kind of illness facing an economy. In some African countries, the authorities were encouraged to devalue the rate in the official market even as the rate in the parallel market continued to rise.

The role to be played by tourism and a supportive exchange rate policy depended in part on the kind of tourists that a country was trying to attract, Mr. El Kogali noted. For example, tourists from Northern Europe interested in beach spots had observed that the level of the exchange rate made Tunisia and The Gambia less expensive than Greece. The demand for tourism was very inelastic in countries that, like Egypt,

were attractive to tourists because of particular and unique attractions. In those cases, the rate of exchange was not a dominant factor in tourists' decisions. Kenya might be competing with other countries in the region for tourists who were particularly interested in viewing wildlife. Such tourists tended to be in upper-income groups and paid less attention to the exchange rate than to hotel standards. For those countries, investment in hotels was therefore essential.

The Acting Chairman commented that the staff would wish to examine the exchange rate issue in the context of not only Kenya's next program, but also the situation in Uganda and Tanzania, as a part of the Board's general look at exchange rate issues. When conducting a midterm review of a program that was basically on track, as in the present case of Kenya, the staff typically did not undertake a detailed examination of exchange rate policy and the social effects of adjustment, as those issues would have been examined when the program was initially discussed by the Board. The summing up at the conclusion of the 1989 Article IV consultation with Kenya (EBM/89/55, 5/15/89) had noted, inter alia, that Directors had welcomed the pursuit of market-oriented interest and exchange rate policies and had stressed the importance of such policies in the context of the structural adjustment strategy; thus, the basic direction and strategy for the program had been set out at the beginning of the program period, and changing them during the midterm review would not be the best practice. During the next discussions with the authorities, the staff would certainly consider whether further real effective adjustment was called for, and, in that connection, whether the level of competitiveness was sufficient to support the authorities' structural adjustment efforts.

The Executive Board then took the following decision:

The Fund determines that the midterm review specified in paragraph 2(c) of the first annual arrangement under the enhanced structural adjustment facility (EBS/89/84, Sup. 1, 5/26/89) has been completed.

Decision No. 9282-(89/144), adopted
November 10, 1989

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/89/143 (11/8/89) and EBM/89/144 (11/10/89).

2. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/89/259 (11/7/89) is approved.

APPROVED: July 2, 1990

JOSEPH W. LANG, JR.
Acting Secretary

Kenya, 1794

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

EBS/90/194

CONFIDENTIAL

November 15, 1990

To: Members of the Executive Board

From: The Secretary

Subject: Kenya - Midterm Review of the Second Annual Arrangement Under the Enhanced Structural Adjustment Facility

Attached for consideration by the Executive Directors is the staff report for the midterm review of the second annual arrangement under the enhanced structural adjustment facility for Kenya, which has been tentatively scheduled for discussion on Friday, December 14, 1990. A draft decision appears on page 32.

Mr. Heller (ext. 8353) or Mr. Katz (ext. 7465) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

KENYA

Staff Report for the Midterm Review of the Second Annual Arrangement Under the Enhanced Structural Adjustment Facility

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 E.L. Bornemann and A. Basu

November 14, 1990

Contents | Page

I. Introduction 1

II. Recent Developments and Performance Under the Program 3

III. Policies for the Remainder of 1990 and 1990/91 12

1. Fiscal policy and structural reform in the budget 14
2. State corporations 16
3. Monetary policy and financial sector reform 17
4. Balance of payments outlook and external policies 17
5. Capacity to repay the Fund 24

IV. Social and Environmental Impact of the Program 27

V. Staff Appraisal 28

VI. Proposed Decision 32

Text Tables

1. Use of Fund Credit, June 1990-December 1991 2
2. Selected Economic and Financial Indicators, 1986-92 4
3. Performance During the Second Annual Arrangement Under the Enhanced Structural Adjustment Facility 5
4. Government Finances, 1987/88-1991/92 7
5. Monetary Survey, June 1988-June 1991 10
6. Medium-Term Balance of Payments, 1989-95 11

7. Impact of Oil Price Increases, 1989-91 20
8. Long-Term Balance of Payments Scenarios, 1991-2001 23
9. Indicators of Fund Credit, 1991-2001 25
10. Projected Payments to the Fund, 1990-99 26

Appendix I. Letter of Intent 33

Appendix II. Relations with the Fund 48

Appendix III. Relations with the World Bank Group 52

Appendix IV. Selected Social and Demographic Indicators 57

Chart

Central Government Operations, 1984/85-1991/92 14a

I. Introduction

On April 30, 1990, the second annual arrangement under the enhanced structural adjustment facility (ESAF) was approved by the Executive Board (EBS/90/64) and the first disbursement for SDR 40.2 million (28.3 percent of quota) was made on May 15, 1990. The discussions on the midterm review of this arrangement took place in Nairobi during September 3-15, 1990 and October 9-18, 1990. 1/

In the attached letter to the Managing Director from the Vice President and Minister for Finance and the Governor of the Central Bank of Kenya, dated November 12, 1990 (Appendix I), the authorities review progress made under the program for 1990, as well as the objectives and policies to be pursued for the remainder of the period. As the performance criterion on net domestic assets for end-June 1990 was not met, the authorities have requested that a waiver be granted. The authorities note that in view of the worsening external environment and the sharp deterioration in Kenya's external position, important policy actions have been taken to bring the program back on track.

As of October 31, 1990, total Fund credit outstanding to Kenya was equivalent to SDR 294.2 million, or 207.1 percent of quota (Table 1). In view of higher than originally programmed oil imports and the policies being implemented to minimize the impact of the oil price increase, the authorities have requested that the amount of the second disbursement under the current arrangement be augmented by SDR 20 million to SDR 60.2 million. After taking account of the recent strengthening of adjustment measures, the estimated increases in net oil imports in 1990 (SDR 40.7 million) and in 1991 (SDR 62.1 million) have led to a sharp weakening in the external reserve position in 1990 and to substantial deterioration in the overall balance of payments outlook for 1991. The augmented amount is the equivalent of somewhat less than one third of the estimated additional cost of net oil imports in 1990/91 (July-June) over the baseline program projections (see Section III.4).

Taking account of scheduled repurchases and the rephased prospective disbursements under the ESAF, total outstanding Fund credit at end-December 1990 would amount to SDR 338.7 million, or 238.5 percent of quota. By end-December 1991, when all the disbursements under the three-year ESAF arrangement would have taken place, total outstanding Fund credit would amount to SDR 370.1 million, or 260.6 percent of Kenya's present quota.

1/ The staff team consisted of Mr. P.S. Heller (AFR-Head), Mr. M. Katz (AFR), Mrs. J. Landell-Mills (ETR), and Mr. S. Gupta (FAD); Mr. J. Nnanna (AFR) and Mrs. V. Harvey (Assistant--ETR) participated in the September mission, and Ms. C. McAuliffe (AFR-EP) participated in the October mission.

Table 1. Kenya: Use of Fund Credit, October 1990-December 1991

	Outstanding Oct. 31, 1990	1990 Nov.-Dec.	1991 Jan.-March	April-June	July-Sept.	Oct.-Dec.
	(In millions of SDRs)					
Total transactions (net)		44.56	-4.76	21.94	-8.67	22.85
Transactions under tranche policies (net)		-10.93	-4.76	-8.29	-8.67	-7.38
Repurchases		10.93	4.76	8.29	8.67	7.38
Ordinary resources		(1.07)	(--)	(1.96)	(3.91)	(3.91)
Borrowed resources		(9.86)	(4.76)	(6.34)	(4.76)	(3.46)
Transactions under special facilities (net)		-4.74	--	--	--	--
CFF (net)		(-4.74)	(--)	(--)	(--)	(--)
ESAF loans		60.23	--	30.23	--	30.23
Total Fund credit outstanding 1/	294.15	338.70	333.93	355.87	347.20	370.07
Under tranche policies	(100.30)	(89.36)	(84.60)	(76.31)	(67.64)	(60.27)
Under special facilities	(44.74)	(40.00)	(40.00)	(40.00)	(40.00)	(40.00)
Under SAF	(28.40)	(28.40)	(28.40)	(28.40)	(28.40)	(28.40)
Under ESAF 1/	(120.70)	(180.93)	(180.93)	(211.16)	(211.16)	(241.40)
	(As percent of quota)					
Total Fund credit outstanding 1/	207.13	238.52	235.17	250.61	244.50	260.62
Under tranche policies	(70.62)	(62.93)	(59.58)	(53.74)	(47.63)	(42.44)
Under special facilities	(31.51)	(28.17)	(28.17)	(28.17)	(28.17)	(28.17)
Under SAF	(20.00)	(20.00)	(20.00)	(20.00)	(20.00)	(20.00)
Under ESAF 1/	(85.00)	(127.42)	(127.42)	(148.70)	(148.70)	(170.00)

Sources: IMF, Treasurer's Department; and staff estimates.

1/ Includes use of ESAF Trust resources.

Summaries of Kenya's relations with the Fund and the World Bank Group are presented in Appendices II and III, respectively; and a summary of social indicators for Kenya appears in Appendix IV.

II. Recent Developments and Performance Under the Program

With a deterioration in the external terms of trade, the basic macroeconomic objectives of the 1989 program--the first year under the ESAF--were not fully realized, although all end-September 1989 performance criteria, as well as most of the benchmarks for the year were met. The exceptions were a small shortfall in the net official reserves target and the increase in the Central Government's wage bill, which exceeded the targeted ceiling of 7.5 percent growth. Real GDP growth met the 5 percent target (Table 2). The end-year inflation rate of 10.1 percent, while representing a marginal deceleration from 10.4 percent in 1988, was higher than the 8 percent programmed, largely because of greater than targeted growth in the stock of broad money. The external current account deficit including official transfers was 7.4 percent of GDP, significantly worse than the deficit of 5.5 percent of GDP in 1988 and the 4.0 percent program target. However, as a result of stronger than anticipated official capital inflows, the external sectorrecorded an overall surplus of SDR 52 million--close to the programmed level--following overall deficits in the previous two years.

Overall performance under the program in the first half of 1990 was mixed. Credit expansion proved excessive, and there was a failure to realize targets for external reserve accumulation. The June 1990 performance criterion on net domestic assets was not observed (Table 3). The benchmarks on net official international reserves for June and September 1990 were missed by a wide margin, with shortfalls in net official reserves of SDR 99 million in June and SDR 127 million in September. The performance criteria on net bank credit to the Government and on nonconcessional borrowing were observed, as were the two structural performance criteria--progress in the development of an export promotion program and continued import liberalization. The structural benchmarks on price decontrol and on interest rates were also met; the benchmark limiting the wage bill in 1990/91 to 9 percent was exceeded in the budget but could still be met following a decision to reduce the number of civil servants relative to the original increase allowed for in the budget (see Section III.1).

For 1990 as a whole, the balance of payments is expected to be significantly worse than programmed as a result of a continued deterioration in Kenya's terms of trade, weak horticultural exports in 1989 and early 1990 (reflecting excessive rainfall, insufficient availability of transport, and costly packaging materials), the effects of the trade liberalization effort, the impact of recent oil price increases, strong domestic demand fueled principally by the public sector, and lower-than-expected inflows of cash program assistance. While the external current account deficit (including official transfers) is anticipated to narrow

Table 2. Kenya: Selected Economic and Financial Indicators, 1986-92

	1986	1987	1988	1989		1990		1991		1992
				Prog. 1/	Est.	Prog. 1/	Rev. prog.	Prog. 1/	Rev. prog.	Proj.
	(Annual percent changes, unless otherwise specified)									
National income and prices										
GDP at constant prices (factor cost)	5.6	4.8	5.2	5.1	5.0	5.2	4.9	5.4	4.5	5.5
GDP deflator	9.3	6.1	9.7	7.2	8.9	6.5	9.6	5.0	10.6	5.6
Consumer prices	4.3	6.6	10.4	8.0	10.1	7.5	12.0	5.5	8.0	5.0
External sector (on the basis of SDRs)										
Exports, f.o.b.	7.5	-29.7	7.8	8.8	-5.2	5.5	8.5	9.7	6.0	13.9
Imports, c.i.f.	-0.8	1.5	7.0	4.1	13.6	4.7	-0.8	5.9	-0.2	10.9
Non-oil imports, c.i.f.	18.7	0.7	13.1	2.8	11.9	4.4	-4.5	5.8	-2.6	15.2
Export volume	7.5	-29.6	3.3	5.7	1.0	4.5	10.8	5.6	2.5	11.6
Import volume	-0.8	1.5	5.9	—	10.4	1.8	-6.9	2.9	-4.8	10.5
Terms of trade (deterioration -)	12.0	-15.0	3.2	-1.1	-8.6	-1.9	-8.3	0.9	-1.3	1.7
Nominal effective exchange rate (depreciation -) 2/	-6.7	-15.8	-7.3	...	-11.1	...	-14.2	...	...	...
Real effective exchange rate (depreciation -) 2/	-4.4	-13.0	-2.2	...	-7.2	...	-11.8	...	...	...
Government budget 3/										
Revenue and grants	15.1	22.9	14.4	13.8	18.2	12.5	11.4	11.2	17.4	...
Total expenditure	17.2	6.3	22.1	12.6	15.3	10.5	7.0	9.4	11.7	...
Money and credit										
Net domestic assets 4/	36.9	18.1	10.7	8.7	14.1	9.0	14.5	9.1	6.4	2.9
Government	53.7	29.7	-6.7	13.3	-5.6	-6.6	54.5 5/	0.7	-14.1	2.6
Other sectors	17.7	14.9	16.7	8.7	17.9	12.4	7.1	11.3	10.8	14.3
Money and quasi-money (M2)	27.6	12.4	8.3	11.6	17.8	8.4	2.6	10.7	10.7	10.6
Velocity (GDP relative to M2) 6/	3.2	3.2	3.5	3.4	3.4	3.6	3.7	3.6	3.8	3.8
Interest rate (annual rate) 6/										
Savings deposit (minimum)	11.0	11.0	10.0	...	12.5	...	...	...	...	...
Average time deposit	11.5	9.8	12.4	...	...	...	...	...	...	...
Maximum lending rate	14.0	14.0	15.0	...	18.0	...	19.0	...	...	...
	(In percent of GDP)									
Government budget 3/										
Revenue and grants	23.6	25.3	25.7	26.6	26.7	26.9	26.0	27.0	26.0	...
Total expenditure	30.2	28.0	30.4	30.8	30.6	30.6	28.4	30.2	28.0	...
Overall cash deficit 7/										
Including grants	6.6	4.2	4.7	4.2	4.0	3.7	2.5	3.2	2.0	...
Excluding grants	7.8	6.4	7.1	6.7	6.5	6.3	5.1	5.7	3.8	...
Domestic bank financing	4.1	-0.1	0.1	0.6	-0.2	0.4	-1.2	—	-1.0	...
Nonbank financing	2.5	3.3	2.1	0.5	0.9	0.6	0.6	1.0	0.6	...
Foreign financing	—	1.0	2.5	3.1	3.3	2.0	3.1	2.2	2.4	...
Gross domestic investment	18.8	24.8	25.3	24.3	25.7	25.7	25.6	24.7	25.0	25.0
Gross domestic savings	18.9	19.7	20.1	20.1	18.1	21.4	19.6	22.8	20.8	21.1
External current account deficit										
Including grants	0.5	6.3	5.5	4.0	7.4	4.1	5.8	2.7	4.3	4.5
Excluding grants	2.5	8.1	8.5	7.0	10.5	7.4	8.4	5.7	6.3	6.3
External debt										
External debt inclusive of Fund credit	54	56	60	58	60	62	55	63	56	56
Debt service ratio 8/	29	34	29	30	32	28	31	24	29	28
Interest payments 8/	11	12	12	11	11	10	11	10	11	10
	(In millions of SDRs, unless otherwise specified)									
Overall balance of payments	76	-76	-45	8	51	-38	-215	-34	-57	-9
Gross official reserves (months of nongovernment imports)	3.7	2.1	2.1	2.3	2.1	2.6	0.5	3.0	2.0	2.2
External payments arrears	—	—	—	—	—	—	—	—	—	—

Sources: Data provided by the Kenyan authorities; and staff estimates.

1/ As shown in EBS/89/84.
2/ December-to-December variations. For 1990, September 1990 vis-à-vis December 1989.
3/ Fiscal year beginning July 1.
4/ Net domestic assets were not explicitly used before 1990.
5/ Not adjusted for the K Sh 2.7 billion of treasury securities sold at end-December 1989 and redeemed in early January 1990, and the K Sh 1.8 billion monetization of unpresented checks at end-June 1989.
6/ Level in percent.
7/ Figures do not add up from above totals because of adjustment to cash basis. The cash deficit in 1988/89 reflects the adjustment cited in footnote 4 of Table 4.
8/ In percent of exports of goods, nonfactor services, and private transfers.

Table 3. Kenya: Performance During the Second Annual Arrangement Under the Enhanced Structural Adjustment Facility

	1989 December Actual	1990 June 1/ Program	1990 June 1/ Actual
Quantitative performance criteria/benchmarks	(In millions of Kenya shillings)		
Net domestic assets 2/ 3/	54,428	56,513	58,150
Net bank credit to the Government 3/ 4/	12,671	16,370	15,143
Memorandum items:			
Net bank credit to the Government in monetary survey	17,481	21,180	20,414
Less: Cereals and Sugar Finance Corporation	4,040	4,040	3,847
Less: Debt assumed from parastatals	770	770	1,424
	(In millions of U.S. dollars)		
New nonconcessional external loans or leases contracted or guaranteed by the Government 5/ (cumulative per calendar year)			
a. 1-15 years' maturity	167	155	71
b. Short-term credits of less than one year's maturity 6/	—	—	--
Quantitative benchmark	(In millions of SDRs)		
Minimum cumulative increase in net official international reserves from end-December 1988 7/	-60.3 8/	13.0	-86.3

Nonquantitative performance criteria		Status
Review: A midterm review will be completed by end-November 1990 to assess the 1990/91 budget, and the implementation of the program, and to set quantitative benchmarks and indicative targets for the second half of 1990/91.		On target
Trade and payments restrictions: The Government of Kenya will continue to maintain a liberal exchange and trade system and will not introduce any new, or intensify existing, restrictions.		Met
Structural performance criteria	**Target Date**	
Implement the import liberalization program, by removing controls on at least 55 percent of the number of import items (excluding textiles) that are currently controlled and nonexempt (in Schedule IIIC).	July 1990	Implemented
To improve access by exporters to raw materials and intermediate inputs at international prices, and streamline and make more effective the export compensation scheme; the Government will begin to implement a system by which commercial banks pay compensation to exporters within 90 days upon submission of evidence of shipment of goods through customs.	May 1990	Implemented
Structural benchmarks		
Remove price controls on a substantial number of items under the General Order of price controls, as well as several items from the Specific Order.	Sept. 1990	Implemented
Raise existing ceiling on commercial bank lending rates consistent with removing ceilings on interest rates by June 1991; maintain positive real interest rates.	Throughout 1990	On target
Confine the growth of the Government's personnel wage bill (including teachers employed by the Teachers' Service Commission) to 9.0 percent in 1990/91, reflecting a limit of 2 percent in the growth of civil service posts relative to the 1989/90 budget and 8 percent growth in the number of teachers relative to the number employed on February 1, 1990.	July 1990	Exceeded in 1990/91 budget but could still be met

Source: Memorandum attached to the letter of request of Kenyan authorities of March 28, 1990.

1/ Performance criteria.

2/ Net domestic assets of the banking system is broad money minus net foreign assets of the banking system. A one-time stock adjustment will be made when the new Consolidated Bank, which amalgamates nine failing nonbank financial institutions, with total assets tentatively estimated at K Sh 1 billion, commences operating as a commercial bank.

3/ This target will be adjusted downward to the extent that net external financing of the deficit during the July 1989-June 1990 period, excluding A-in-A financing, exceeds K Sh 816 million, or to the extent that domestic nonbank financing exceeds K Sh 600 million. Such net external financing is defined to include all cash loans received by the Paymaster General's Account during this period.

4/ Net credit to the Government is net credit to the Government from the banking sector. The ceiling excludes the operations of the Cereals and Sugar Finance Corporation (CSFC), and the amount of public enterprise debt (K Sh 770 million) assumed by the Government after June 1989 and reclassified from outstanding private sector credit.

5/ In addition to nonconcessional borrowing contracted or guaranteed by the Government, this ceiling also applies to the borrowing of all state corporations (including cases where their borrowing is associated with a "letter of awareness" from the Government), as well as leases. The ceiling excludes the lease of Kenya Airways aircraft expected in October 1990 that was signed in 1989, conditional on the formulation of a restructuring plan by August 30, 1990. For the purposes of this definition, a loan or lease is nonconcessional if it has a grant equivalent of less than 25 percent. Grant equivalence shall be determined by reference to published DAC tables and is a function of the interest rate, grace period, and maturity. "Maturity" is defined as the sum of the grace period and the term of payment. For purposes of converting new nonconcessional external loans into U.S. dollars, the U.S. dollar exchange rates cabled to the Central Bank of Kenya from the Federal Reserve Bank of New York for January 2, 1990, will be used.

6/ Other than normal import-related credits, this limit also excludes nonguaranteed borrowing by the Coffee Board of Kenya associated with short-term trade financing.

7/ Net official international reserves are defined as the Central Bank of Kenya's net foreign reserve assets (SDRs, gold, and foreign exchange holdings) minus its short-term deposit liabilities to foreigners; plus the Central Government's net foreign reserve amounts (excluding those related to Fund transactions); plus Kenya's reserve position in the Fund; minus Kenya's net use of Fund credit.

8/ Actual outstanding amount at end-December 1989.

from 7.4 percent of GDP in 1989 to 5.8 percent in 1990, this exceeds the program target of 4.4 percent for 1990. Gross international reserves were, at end-October 1990, less than one month of nongovernment imports, and are not expected to improve by end-year.

Real growth in 1990, which was targeted at 5.2 percent, is now estimated at 5 percent. Favorable weather for the major crops and an enhancement of production incentives in the early part of the year combined to play an important role in mitigating the impact on output of the recent increase in oil prices. The inflation rate of 10.6 percent at end-September 1990 was higher than the end-1989 level mainly as a result of rapid monetary expansion in the second half of 1989 and early 1990 and the initial impact of the 31-49 percent increase in domestic oil prices that took place in early September. The forecast for the inflation rate at year-end has been revised upward to 12 percent, relative to the original target of 7.5 percent, following these oil price increases and a number of recently enacted tax measures.

Gross domestic expenditure is expected to decline from 107.7 percent of GDP in 1989 to 106 percent, reflecting relative contractions in both consumption and fixed capital formation. In particular, measures taken by the Government to reduce expenditure are expected to lead to a fall in public consumption to 18.6 percent of GDP, from 20 percent in 1989, while the combined investment by the General Government and state corporations is expected to fall by 0.3 percentage points to 7.1 percent of GDP. Private sector consumption is also expected to decline slightly to 61.8 percent of GDP, from 62 percent in 1989. Correspondingly, national saving is expected to rise to 16.6 percent of GDP, from 15.3 percent in 1989.

In 1989/90, the preliminary estimates of the authorities indicate that fiscal performance was broadly on target. The overall budget deficit (including grants) of 4 percent of GDP was somewhat lower than the 4.2 percent envisaged in the program, because foreign grants were higher than foreseen (Table 4). However, the overall deficit excluding grants was marginally higher at 6.5 percent of GDP. Expenditure and net lending exceeded the program level by 0.5 percent of GDP, but this was largely offset by additional revenue. Taking account of the Government's increased reliance on nonbank sources at the end of the fiscal year, there was a modest net repayment by the Government to the banking system of 0.2 percent of GDP, compared with programmed net borrowing of 0.5 percent. However, staff estimates of the budget deficit derived from data on the sources of budget financing during the period April to August suggest that the cash budget deficit including grants may in fact have been in the range of 4.5-5 percent of GDP.

Both recurrent and development expenditures overshot the targets, the former on account of higher-than-programmed outlays on wages and salaries, interest charges, and nonwage outlays (the last stemming from a very sharp increase in university enrollments). The structural benchmark (in the first annual arrangement under the ESAF) limiting wage and

Table 4. Kenya: Government Finances, 1987/88-1991/92

	1987/88	1988/89	1989/90		1990/91			1991/92
		Prelim. actuals	Revised prog. 1/	Prelim. actuals	Original program 1/	Budget	Revised program	Revised program
	(In millions of Kenya shillings)							
Revenue and grants	35,926	41,114	48,263	48,799	54,008	54,346	54,739	62,177
Revenue	32,738	37,381	44,076	44,187 2/	50,293	49 566	49,248	57,829
Grants	3,188	3,733	4,187	4,612	3,715	4,780	5,491	4,348
Expenditure and net lending	39,815	48,595	56,095	56,038	62,024	62,255	59,967	66,960
Recurrent expenditure	30,646	37,110	42,891	42,678 3/	46,912	46,285	45,133	50,220
Development expenditure and net lending	9,169	11,485	13,204	13,360	15,112	15,970	14,834	16,740
Overall deficit (treasury accounts), commitment basis	-3,889	-7,481	-7,832	-7,239	-8,016	-7,909	-5,228	-4,783
Adjustment to cash basis 4/	-2,057	-104	—	-100	—	1	—	--
Overall cash deficit 5/	-5,946	-7,585	-7,824	-7,339	-8,016	-7,908	-5,228	-4,783
(Excluding grants)	-9,134	-11,318	-12,011	-11,951	-11,731	-12,688	-10,719	-9,131
Financing	5,946	7,585	7,824	7,339	8,041	7,908	5,228	4,783
Foreign financing	1,429	4,000	6,322	6,024	6,120	6,148	6,503	5,787
Domestic financing	4,517	3,585	1,502	1,315	1,921	1,760	-1,275	-1,004
Nonbank financing	(4,637)	(3,359)	(602)	(1,644)	(1,271)	(1,264)	(1,264)	(1,400)
Banking system	(-120)	(226)	(900)	(-329)	(650)	(496)	(-2,539)	(-2,404)
Of which: adjustment for increase in unpresented checks 5/	(—)	(1,825)	(—)	(—)	(—)	(—)	(--)	(--)
	(In percent of GDP)							
Memorandum items:								
Revenue and grants	25.3	25.7	25.9	26.7	25.9	25.8	26.0	26.0
Revenue	23.1	23.4	23.7	24.1	24.1	23.5	23.3	24.2
Grants	2.2	2.3	2.2	2.5	1.8	2.3	2.6	1.8
Expenditure and net lending	28.0	30.4	30.1	30.6	29.7	29.5	28.4	28.0
Recurrent expenditure	21.6	23.2	23.0	23.3	22.5	22.0	21.4	21.0
Development expenditure and net lending	6.5	7.2	7.1	7.3	7.2	7.6	7.0	7.0
Overall deficit (commitment basis)	-2.7	-4.7	-4.2	-4.0	-3.8	-3.8	-2.5	-2.0
Overall cash deficit	-4.2	-4.7	-4.2	-4.0	-3.8	-3.8	-2.5	-2.0
(Excluding grants)	-6.4	-7.1	-6.4	-6.5	-5.6	-6.0	-5.1	-3.8
Foreign financing	1.0	2.5	3.4	3.3	2.9	2.9	3.1	2.4
Domestic financing	3.2	2.2	0.8	0.7	0.9	0.8	-0.6	-0.4
Of which: banking system and adjustment for increase in unpresented checks	(-0.1)	(0.1)	(0.5)	(-0.2)	(0.3)	(0.2)	(-1.2)	(-1.0)

Sources: Data provided by the Kenyan authorities; and staff estimates.

1/ As presented in EBS/90/64 (3/30/90).

2/ The revenue estimate includes K Sh 1,300 million of the 1990-91 central bank profits prepaid in 1989-90.

3/ Recurrent expenditures include K Sh 895.9 million interest obligations actually paid in 1989/90 but shown in the 1990/91 exchequer issues.

4/ The adjustment factor arises partly because financing data are derived from sources other than revenue and expenditure data. It also includes a float element resulting from differences between checks issued and checks cashed, statistical discrepancies, and, in 1987/88, and 1988/89, differences between payment orders issued and checks issued.

5/ The cash deficit for 1988/89 has been adjusted upward by K Sh 1.8 billion to reflect the increase in the stock of unpresented checks on June 30, 1989, which was largely liquidated by bank financing in early July 1989. This corresponds to the higher bank financing shown in the monetary survey for June 1989 (adjusted). Bank financing in 1989/90 is thus shown net of this liquidation, which is attributed to 1988/89. Bank financing for 1989/90 does not reflect the classification of K Sh 770 million of parastatal debt from the private to the government sector (as shown in the Monetary Survey).

salary bill growth in 1989/90 to 7.5 percent was exceeded by an estimated 3.5 percentage points, arising from a 7 percent increase in employment and a 4 percent increase in wages. Higher development outlays reflected the impact of unexpectedly large external grants. Preliminary estimates suggest that unpresented checks at end-June 1990 exceeded the program target of K Sh 1.1 billion by a margin of K Sh 0.2 billion.

In line with earlier commitments, the authorities replaced the sales tax with a value-added tax (VAT) and introduced a presumptive tax on agricultural produce in the course of 1989/90. However, owing to an overestimation of expected revenue from the presumptive tax and weak administration of the newly introduced VAT, there was a revenue shortfall from these taxes of K Sh 1.7 billion (0.9 percent of GDP). This was offset by increased nontax receipts, stemming in particular from an unanticipated extra K Sh 1.3 billion in profit remittances from the Central Bank of Kenya.

An important objective of the ESAF has been to strengthen the role of user charges in financing recurrent outlays; their share was programmed to rise from about 0.9 percent of GDP in 1988/89 to 1.3 percent in 1989/90. The authorities began to levy user charges for medical services in December 1989, but the new fees for certain services were rescinded in the course of 1990 in response to considerable public criticism. The authorities have indicated that these fees will be reintroduced once the public is convinced that the quality of the services provided by the government-run hospitals and health centers has improved. Delays have also arisen in the imposition of fees on university students. Reliance continues to be placed on a student loan scheme as a means of recovering some of the costs of education and to finance the cost of rising enrollments in the university system; loan recovery rates have nevertheless been quite low. As a consequence, recurrent user charges are estimated to have amounted to about 1 percent of GDP in 1989/90.

Monetary policy during the first half of 1990 was more expansionary than programmed despite efforts by the authorities to limit the extension of credit to the private sector. Effective April 1, 1990, the ceilings on interest rates on deposits and on short- and long-term loans were raised by 1 percentage point to 13.5 percent, 16.5 percent, and 19.0 percent, respectively. The ceiling on short-term loans was raised by a further 0.5 percentage point at end-August 1990, to 17.0 percent. More important, the authorities removed the legal requirement stipulating that lending-related fees and charges be inclusive of the loan interest rates subject to ceilings. This means that effective interest rates can significantly exceed the formal ceilings and that they are market determined. As a result, interest rates continue to be positive in real terms. In an effort to achieve better control over credit aggregates, in May 1990 the Central Bank of Kenya introduced a penalty deposit scheme for commercial banks that exceed their credit targets (based on the recommendations of a recent CBD technical mission).

Notwithstanding these measures, the recent change in the focus of the performance criterion from total domestic bank credit to net domestic assets of the banking system created monitoring difficulties for a number of large commercial banks. As a result, the ceiling on net domestic assets for end-June 1990 was exceeded by K Sh 1.6 billion, equivalent to 3.3 percent of the stock of broad money at end-June 1989. Thus, net domestic assets grew by 14.4 percent in 1989/90 compared with 11.2 percent in the program (Table 5). However, as net foreign assets were substantially lower than projected, broad money grew by only 8.7 percent, less than the 10 percent growth originally programmed. Preliminary monetary estimates for end-September indicate that the quantitative benchmarks on net domestic assets and bank credit to the Government were also not observed. The latter appears to have exceeded significantly the programmed level, largely as a result of much-lower-than-expected foreign financing of the budget in the first quarter of the fiscal year. Credit to the private sector at end-September 1990 is estimated to have been well below the indicative benchmark, reflecting the impact of the penalty deposit scheme on the lending of commercial banks.

The external current account worsened in 1989, with the deficit increasing by almost 2 percentage points to 7.4 percent of GDP (Table 6). With service receipts growing strongly, the deterioration came from both elements of the trade account, as a 9 percent terms of trade deterioration (in SDR terms) was associated with a decline in major export receipts, sharply higher oil import costs, and strong domestic demand for imports, particularly by the public sector. Merchandise imports rose sharply to 27.4 percent of GDP from less than 25 percent in the previous year, because of both higher oil costs and the leasing of two planes by Kenya Airways. Export values declined by 5 percent. While sharply lower international prices reduced coffee exports by 25 percent, the decline was offset by higher tea earnings. Other exports fared badly, with horticultural export volume down by 29 percent from its 1988 level as a result of transport bottlenecks, adverse weather conditions, and a loss in orders. However, with an unprecedentedly large inflow of official capital, much of it program assistance with no import content, the overall balance was in surplus for the first time since 1986, and gross foreign exchange reserves stood at more than two months of nongovernment imports at the end of 1989.

Partial trade data for the first six months of 1990 show no rebound from the low base of 1989. The merchandise trade deficit was some 9 percent higher than that for the same period in 1989, with both exports and imports growing at about the same rate. Tea receipts were well above 1989 levels, more than offsetting a continued decline in coffee and petroleum exports. However, payments were higher on several large import items, notably petroleum, machinery, and chemicals. Only fertilizer imports were significantly lower, reflecting the decline in coffee earnings and the reportedly lower usage of inputs by coffee farmers. Although tourism earnings were buoyant--24 percent above January-June

Table 5. Kenya: Monetary Survey, June 1988-June 1991 1/

	1988		1989					1990					1991	
	June	Dec.	March	June		Sept.	Dec.	March	June		Sept.	Dec.		
	Actual		Actual	Actual	Adj. 2/	Actual	Actual	Actual	Prog. 3/	Actual	Prog. 3/	Rev. Prog.	March 4/	June 4/
	(In millions of Kenya shillings)													
Net foreign assets	-3,143	-3,627	-2,517	-2,162	-2,162	-3,346	-2,499	-3,257	-2,761	-5,220	-3,099	-9,043	-8,036	-7,978
Net domestic assets 5/	42,932	47,722	48,295	49,037	50,837	52,202	54,428	54,775	56,513	58,150	58,610	62,300	60,700	61,300
Total domestic credit	48,401	52,666	51,636	52,422	54,223	55,631	57,750	59,858	63,588	60,005	65,600	70,110	67,416	64,514
Government (net)	17,121	18,512	17,775	17,510	19,310	20,019	17,481	22,199	21,180	20,414	21,920	27,000	23,000	18,354
Other	31,280	34,154	33,861	34,912	34,913	35,612	40,269	37,659	42,408	39,591	43,680	43,110	44,416	46,160
Other items (net) 6/	-5,469	-4,944	-3,341	-3,386	-3,386	-3,429	-3,322	-5,083	-7,075	-1,855	-6,990	-7,810	-6,716	-3,214
Money and quasi-money	39,788	44,095	45,778	46,875	48,675	48,856	51,929	51,518	53,752	52,930	55,511	53,258	52,664	53,322
	(Annual change in percent) 7/													
Net domestic assets	10.1	10.7	11.7	14.2	18.4	19.1	14.1	13.4	11.2	14.4	12.3	14.5	10.8	5.4
Total domestic credit	10.2	7.2	7.4	8.3	12.0	12.8	9.7	15.9	17.3	10.7	17.9	21.4	12.6	7.5
Government (net)	0.1	-6.7	0.3	2.3	12.8	18.5	-5.6	24.9	9.7	5.7	9.5	54.5 8/	3.6	-10.1
Other	16.7	16.7	11.6	11.6	11.6	9.8	17.9	11.2	21.5	13.4	22.7	7.1	17.9	16.6
Money and quasi-money	4.0	8.3	12.7	17.8	22.3	20.7	17.8	12.5	10.4	8.7	13.6	2.6	2.2	0.7
Velocity	3.57	3.46	3.45	3.48	3.36	3.46	3.36	3.50	3.46	3.52	3.46	3.68	3.86	3.95

Sources: Central Bank of Kenya; and staff estimates.

1/ The claims of the National Bank of Kenya on the public entities and credit to the private sector guaranteed by the Government are shown beginning in June 1988 as part of credit to the nongovernment sector. Before that date they were shown as part of credit to the Government. Beginning September 1989, net credit to Government includes K Sh 770 million debt of public enterprises that was assumed by the Government; previously this debt was classified under outstanding credi[illegible] the nongovernment sector.

2/ Adjusted for the monetization of unpresented checks of K Sh 1,800 million.

3/ As presented in EBS/90/64 (3/30/90).

4/ For March and June 1991, indicative targets.

5/ Prior to 1990 program ceilings were set on total domestic credit.

6/ The levels of other items net in 1990 are consistent with the level prevailing during the second half of 1989, except for June, September, and December.

7/ The annual change in percent for end-June 1990 is in relation to the adjusted end-June 1989 column.

8/ Not adjusted for the K Sh 2.7 billion of treasury securities sold at end-December 1989 and redeemed in early January 1990 and the K Sh 1.8 billion monetization of unpresented checks in early July.

Table 6. Kenya: Medium-Term Balance of Payments, 1989-95

	1989	1990		1991	1992	1993	1994	1995
		Prog. 1/	Rev. Est.	Projections				
	(In millions of SDRs)							
Current account	-481	-376	-395	-302	-339	-348	-276	-302
Exports, f.o.b.	718	890	779	826	941	1,074	1,166	1,254
Coffee	154	167	169	146	159	172	184	197
Tea	205	239	224	234	260	298	319	341
Oil products	43	59	38	38	36	37	40	43
Other	317	425	348	408	486	566	622	672
Imports, c.i.f.	-1,771	-1,825	-1,757	-1,753	-1,944	-2,143	-2,276	-2,466
Government 2/	-339	-344	-197	-170	-268	-314	-333	-356
Oil	-269	-276	-322	-356	-335	-352	-377	-403
Other	-1,164	-1,205	-1,238	-1,228	-1,342	-1,477	-1,566	-1,707
Trade balance	-1,052	-935	-978	-927	-1,003	-1,069	-1,110	-1,212
Services (net)	297	341	324	385	429	483	579	638
Private transfers (net)	79	82	86	93	100	108	116	124
Official transfers	195	136	173	148	135	130	139	149
Capital account	532	422	180	244	330	359	342	373
Long-term (net)	475	397	146	255	320	369	312	343
Official	421	390	84	169	225	264	212	243
Inflows 3/	(652)	(639)	(349)	(480)	(547)	(589)	(550)	(594)
Outflows	(-231)	(-248)	(-265)	(-311)	(-322)	(-325)	(-338)	-(352)
Private	53	6	62	86	95	105	100	100
Short-term (net) 4/	57	25	34	-11	10	-10	30	30
Overall balance	51	46	-215	-57	-9	11	66	70
Financing	-51	-46	215	57	9	-11	-66	-70
Gross reserves	-33	-50	191	-200	-45	-67	-142	-45
IMF credit (net)	-18	4	24	31	-59	-44	-10	-26
Other assets (net)	-1	--	--	--	--		--	--
Additional financing 5/	--	--	--	226	113	100	86	--
Memorandum items:								
Gross reserves (end of period)	255	305	64	264	309	376	518	563
Gross reserves								
In months of non-government imports	2.1	2.5	0.5	2.0	2.2	2.5	3.2	3.2
In months of total imports	1.8	2.0	0.4	1.8	1.9	2.1	2.7	2.7
	(In percent of GDP)							
Current account deficit								
Including official transfers	7.4	5.4	5.8	4.2	4.5	4.4	3.2	3.2
Excluding official transfers	10.5	7.3	8.4	6.3	6.3	6.1	4.9	4.8
Net official capital inflows plus official transfers 6/	9.5	7.6	3.8	7.7	6.3	6.3	5.1	4.2

Sources: Data provided by the Kenyan authorities; and staff estimates.

1/ EBS/90/64 (3/30/90).

2/ Beginning in 1986, data include special imports of defense-related equipment and civilian aircraft. They amounted to SDR 73 million in 1988, an estimated SDR 156 million in 1989, and are projected to amount to SDR 180 million in 1990, SDR 88 million in 1991, and SDR 76 million in 1992. These imports include Kenya Airways leases and purchase of Fokker 50 aircraft in 1991 (SDR 91 million in 1989 and SDR 11.0 milion in 1991).

3/ Includes loans financing imports of defense-related equipment and the KA leases described in footnote 2.

4/ Includes errors and omissions and valuation adjustments.

5/ Comprises, for 1991, commitments by donors for disbursements in 1991 in advance of the Consultative Group meeting in November 1990, plus quick-disbursing financing mainly related to IDA credits in other years.

6/ Including additional financing.

1989 levels in shilling terms--capital inflows (particularly program assistance) were substantially lower, leading to the decline in official reserves noted above.

As of October 1990, the public sector had contracted US$150 million in nonconcessional borrowing with 1 to 15 year maturities (as defined in the table of Appendix I), and such borrowing is expected to be below the limit set under the program for the year as a whole.

The structural measures of the program for the first half of the year were implemented as anticipated. In view of the continuing decline in terms of trade and the need to support the import liberalization process, the exchange rate was depreciated in nominal effective terms by 14.2 percent between end-December 1989 and end-September 1990, yielding 11.8 percent in real effective terms. The 1990/91 budget, which was presented to Parliament in June, reflects a strong commitment to trade liberalization and in particular, to reducing existing biases against the production of exportable goods, mainly of nontraditional industrial goods. In line with the ongoing strategy to promote a competitive environment by opening domestic markets to foreign imports, quantitative restrictions on a significant proportion (35 percent) of the few eligible imports still subject to controls were shifted to the liberalized category, and are now protected only by tariffs. 1/ Several specific initiatives were taken to promote exports. Nine new items were made eligible for the Export Compensation Scheme and improvements in the administration of the scheme were announced to expedite payments by exporters. Regulations for the new proposed duty exemption scheme have also been gazetted, and backdated to September 1 (targeting exporters of horticultural goods and agro-based products), and a bill establishing the legal and administrative framework for Export Processing Zones was approved by Parliament at end-October. Further progress has also been made in removing price controls; 74 items under the General Price Control Order were decontrolled in mid-March 1990, and six additional items under the General Price Control Order and nine items under the Specific Order were decontrolled in mid-June 1990.

III. Policies for the Remainder of 1990 and 1990/91

In view of the considerable weakening of Kenya's external position, a comprehensive policy package has been put in place in order to achieve a more viable external position by end-1991. This package, containing both financial and structural measures, is designed to reverse by end-1991 much of the recent loss in foreign exchange reserves and to achieve

---

1/ The target of 55 percent in the program was based on the old SITC categories. An exact mapping under the new Harmonized System (HS) of classification cannot be derived. However, the authorities confirmed that the 35 percent of HS items liberalized is equivalent to 55 percent of SITC items.

a substantial strengthening of the external current account position. Accordingly, gross official reserves, which are expected to fall to less than one month of nongovernment imports at end-1990, are targeted to increase to the equivalent of two months of nongovernment imports by end-1991. The external current account deficit (including official transfers) is slated to narrow from 5.8 percent of GDP in 1990 to 4.3 percent in 1991. Real GDP growth is expected to fall from 5 percent in 1990 to 4.5 percent in 1991, and inflation to decelerate from 12 percent at end-1990 to 8 percent at end-1991. Consistent with these objectives, gross domestic expenditure would decline in relation to GDP from 106 percent in 1990 to 104.2 percent in 1991. This would reflect a 1 percentage point decline in general government consumption, a marginal decline in private sector consumption, and a 0.5 percentage point decline in gross domestic investment (primarily by the public sector).

The stance of domestic financial policies has been tightened considerably, particularly with regard to the operations of the public sector. Measures have been taken to reduce the 1990/91 budget deficit (including grants) by 1.6 percentage points, to 2.5 percent of GDP. Increased revenue and expenditure cutbacks are expected to contribute almost equally to the adjustment. A further reduction of 0.5 percentage point of GDP is targeted for the budget deficit in 1991/92 (Chart). Priorities have been set for parastatal expenditures, particularly with regard to imports, and nonessential outlays have been trimmed. Monetary policy will be particularly restrained, reflecting substantial net repayments by the Government to the banking system, and the implementation of measures to facilitate open market operations. Domestic petroleum prices were raised in early September 1990 by 31-49 percent, compatible with an international price for crude oil of $33 a barrel (c. and f.).

With respect to external policies, the process of import liberalization will be continued despite the very difficult external circumstances, although some restraint will be exercised with regard to the items still restricted. The improvement in the external current account is expected to come from general fiscal and monetary restraint supported by exchange rate policy, together with specific actions to reduce public sector imports. In addition, Kenya Airways will not be allowed to exercise its options for the lease of planes in 1990 and 1991, and any subsequent leasing is deferred pending the restructuring of the company. Specific measures have been introduced to remove obstacles to the growth of horticultural exports. The ceiling on the contracting of public nonconcessional external loans has been halved.

Despite these courageous measures, the external reserve position will remain weak through the end of 1990, but is projected to improve to two months of nongovernment imports by end-1991. The overall policy package is expected to improve the balance of payments by some SDR 150 million by end-1991, and it is assumed that a remaining external financing requirement of some SDR 107 million can be met (see Section III.4).

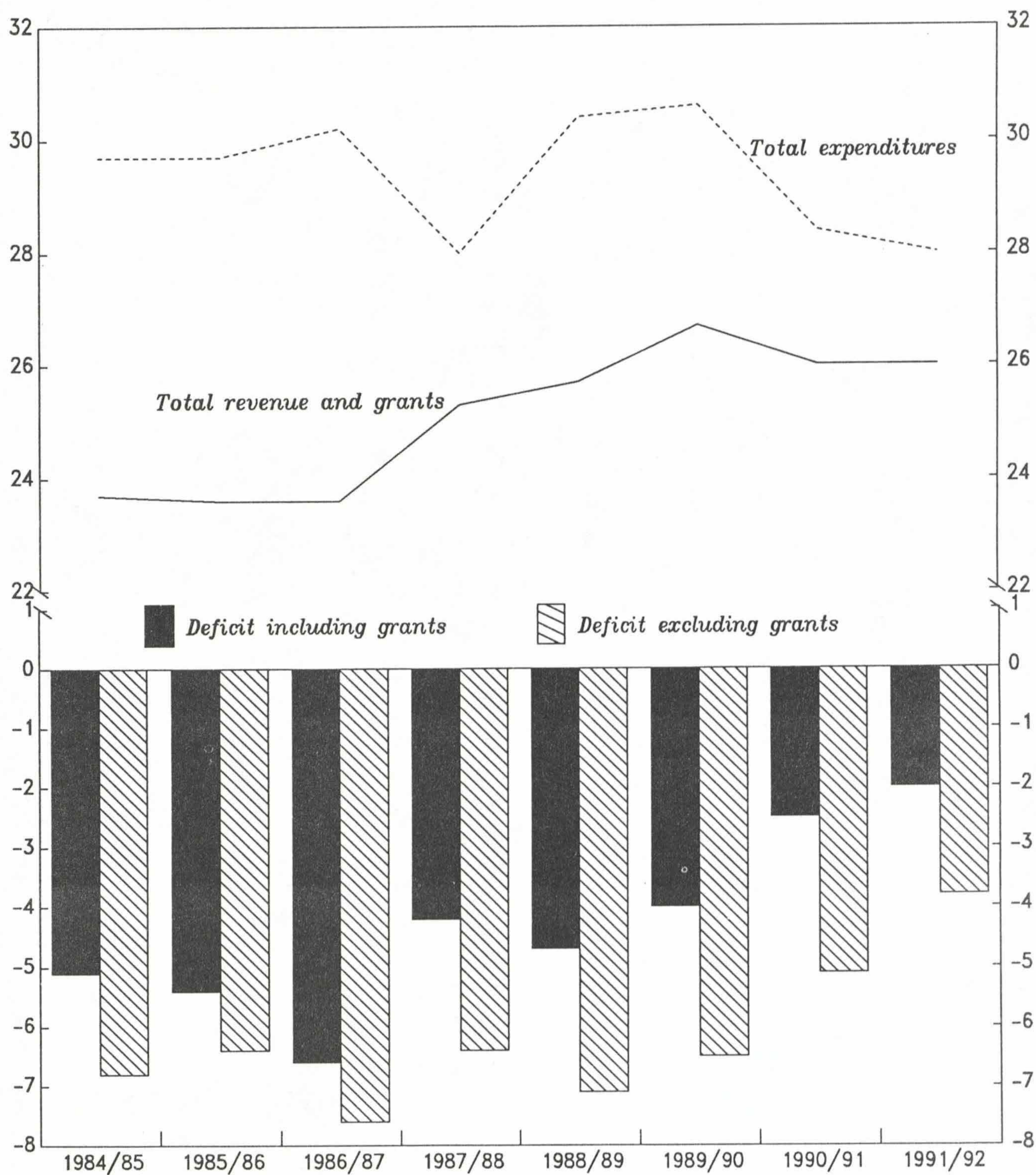
1. Fiscal policy and structural reform in the budget

In line with the original program target, the Government's budget for 1990/91 targeted a deficit including grants of 3.8 percent of GDP. The budget included several discretionary revenue measures to broaden the tax base and improve the elasticity and equity of the tax system, with a net yield of about 0.5 percent of GDP. Specifically, the corporate income tax was reduced from 42.5 percent to 40 percent, and a current system of payments is to be phased in over the next five years. Some employer-provided benefits will begin to be taxed. Tax incentives are provided for investments in the Export Processing Zones. To stimulate the development of the local capital market, the tax on dividends was lowered. Import duties were lowered and excises on cigarettes, tobacco, and beer increased. A comprehensive rationalization of the VAT rates on domestically produced and imported goods was made, and the general VAT rate was increased by 1 percentage point to 18 percent. In September 1990, the authorities adjusted petroleum product prices to reflect recent world price developments such that revenue losses will not emerge.

Despite these measures, the staff and the authorities estimated in September that revenue for the fiscal year would fall short of the budget target, suggesting that the 1990/91 budget deficit including grants would be 4.1 percent of GDP. In view of the adverse external situation, and taking account of the magnitude of current account contraction that will be necessary in the coming year, the authorities decided to reduce the 1990/91 fiscal deficit to 2.5 percent of GDP, a level previously anticipated by the authorities as achievable only in the late 1990s. Given projected external and domestic nonbank financing, it should thus be possible to achieve a net repayment by the Government to the banking system of about 1.2 percent of GDP in 1990/91. To ensure that fiscal policy has a sustained impact on aggregate demand and on the balance of payments in both 1991 and 1992, the fiscal deficit including grants will be further reduced to 2 percent of GDP in 1991/92.

To achieve this new target, the authorities have undertaken a number of strong but difficult revenue-raising and expenditure-cutting measures. The adopted tax measures were enacted in early November 1990. Yielding 0.4 percent of GDP, the measures include adjustments of excise duties, the removal of import duty exemptions on some mass-consumed items, and increases in the prices of controlled commodities subject to ad valorem taxes. Some of the additional revenue (0.4 percent of GDP) is to be obtained from larger-than-budgeted loan repayments and dividends from a number of public corporations, collections of already budgeted and past arrears of the telecommunications tax, and unbudgeted repayments of past loans by some public enterprises. The authorities have also rescinded most of the import duty exemptions granted to parastatals effective November 1, 1990. A number of steps will also be taken in the next two months to strengthen the administra-

CHART 1
KENYA
CENTRAL GOVERNMENT OPERATIONS, 1984/85-1991/92
(In percent of GDP)



tion of the recently introduced VAT, and any positive revenue impact from such improvements would provide a cushion for unanticipated revenue shortfalls from other sources. With these measures, revenue as a share of GDP is projected at 23.3 percent of GDP, lower than the 24.1 percent achieved in 1989/90, largely because of the impact of an unanticipated extra profit remittance from the Central Bank in that year (equivalent to 0.7 percent of GDP). In addition, and in order to continue the efforts to conserve energy, the Government has made a commitment not to reduce retail petroleum prices and to capture any fiscal benefits accruing from a reduction in international oil prices in 1991.

With regard to expenditure, in early-November the Cabinet agreed to reduce 1990/91 recurrent and development budget allocations by the equivalent of 0.4 percent and 0.5 percent of GDP, respectively. This decision has been reflected in a Treasury Circular issued to all concerned ministries. Taking account of these cutbacks, total expenditure and net lending is projected to decline to 28.4 percent of GDP, from 30.6 percent in 1989/90. Recurrent outlays should decline to 21.4 percent of GDP, from 23.3 percent in 1989/90; development expenditures will similarly fall to 7 percent of GDP, from 7.3 percent in 1989/90.

The recent cuts in the recurrent budget are focused on wages and salaries, transportation expenses, purchases of vehicles, and outlays on plant and equipment. Cuts in the development budget focused almost wholly on locally funded construction and low-priority investment projects. Part of the cutbacks are directed toward nonproductive expenditures in public administration and defense. However, these cuts have necessarily affected a broad swath of programs in the economic and social sectors. A noteworthy feature of the revised budgetary allocations is the decision to reduce the number of authorized civil service posts included in the 1990/91 budget by 10,400, relative to the original total increase of about 50,000. The authorities have also agreed to no further increase in the number of posts in the 1991/92 budget other than those required to meet the needs for primary school expansion. These measures should have a long-term impact on wages and salaries, which is the major component of recurrent expenditure. A small part of the expenditure savings (0.1 percent of GDP) will be offset by the higher cost of domestic interest payments arising from the decision to free the yields of treasury bills in mid-November.

The authorities have also agreed on a number of structural measures that should have a significant fiscal impact over the medium term. Taking into consideration the rising cost of university education in the budget, the intake of new students in the university system will be reduced to about 8,000 in 1991 (compared with the exceptional intake of 20,600 in 1990 and 7,036 in 1989). In-service programs for primary and secondary teachers are to be strengthened to facilitate the training of untrained teachers, who increasingly will fill new teaching posts at these education levels. In 1991, fees will be levied on university students so as to cover a significant portion of their tuition costs. Lastly, various steps are to be taken to strengthen the expenditure

control and monitoring system, in line with the recommendations of a recent FAD technical assistance mission. Effective January 1991, the Ministry of Finance will start monitoring the nonwage, nonpension, and non-interest commitments of the major ministries. To allow for the introduction of corrective budgetary measures, a high-level committee will conduct midyear and third-quarter reviews of the budget.

2. State corporations

In formulating the new policy package, the authorities reviewed the budgets of 65 state corporations in order to identify low-priority expenditures with relatively high import content that could be cut without significantly affecting enterprise operations. Accordingly, in early November the Cabinet approved cutbacks in the budgets of specific parastatals, with the focus directed toward purchases of vehicles, plant and equipment, and construction projects. In addition to a Treasury Circular formalizing this decision, implementation of these cutbacks will also be effected through the budgetary review role of the Government Investment Division of the Ministry of Finance, Treasury's representation on parastatal boards, and the decisions of the Foreign Exchange Allocation Committee.

In the next few months, several structural measures are directed toward the state corporation sector. The completion of a policy framework paper for state corporations by the end of this year will provide the criteria for designating enterprises as strategic or non-strategic, and facilitate identification of candidates for privatization in 1991. Amendments to the State Corporations Act, which are expected later this year, will require such corporations to prepare and submit their annual budgets to the Ministry of Finance, thereby increasing accountability. The authorities have also announced that the Government will no longer assume unlimited foreign debt service obligations of state corporations without an investigation as to the reasons for any default. The ability of the Government to oversee the economic and financial position of state corporations should also improve with the establishment in August 1990 of a quarterly information system for these enterprises. To facilitate a better understanding of the credit demands arising from their operations, the Ministry of Finance will commence collection of relevant financial data on the 15 largest state corporations from the commercial banking sector from December 1, 1990. Lastly, the program for restructuring of development finance institutions has been accelerated and toward this end, the services of six technical experts in the management of assets and liabilities are planned to be secured by December 1, 1990.

Measures have also been initiated to restructure Kenya Airways; 1,000 employees were retrenched in April, and some organizational and personnel changes have also been recently effected. A government-appointed committee has completed a high-level review of the company's operations, and an IDA-funded consultant is to draw up an action plan for the company's restructuring by end-March 1991. The Government has

also decided to defer the purchase or lease of any new aircraft until this action plan is implemented (with the exception of a Fokker F-50 jet that had been previously contracted).

3. Monetary policy and financial sector reform

Monetary policy during the remainder of 1990 and the first half of 1991 will seek to contain the growth of the net domestic assets of the banking system and of overall liquidity at a rate consistent with the program targets for reserve accumulation and reduced inflationary pressures. An effort will also be made to broaden the range of available financial instruments. In view of the sharp cut in the budget deficit, the recourse of the Government to the banking system during 1990/91 is expected to decline by about K Sh 2 billion, equivalent to nearly 4 percent of the stock of broad money at end-June 1990. Providing adequate credit to the private sector, this contraction will allow the growth of net domestic assets to decelerate to 4.9 percent. Taking account of the targeted foreign exchange reserve buildup, the annual growth of the money supply should decelerate sharply to less than 1 percent, implying a gradual increase in velocity through June 1991 (in line with the concomitant rise in interest rates and reduction in expected inflation).

Interest rate liberalization has been furthered by active steps to develop a market for treasury securities. Accordingly, yields on treasury bills have been fully liberalized effective November 15, 1990, allowing the price to be set by a free auction. This measure should lead to a substantial increase in the Central Bank's rediscount rate for commercial banks. The amounts to be offered in each weekly auction will be set in consultation with the Central Bank and take account of monetary policy considerations. To increase the attractiveness and marketability of treasury bonds, a new scheme is being put in place to establish an effective marketing and distribution system. By end-November 1990, the Central Bank will begin the flotation of bearer treasury bonds with maturities of one, two, and five years through the Post Office Savings Bank.

These measures will enhance the Central Bank's capacity to conduct open market operations and enable it to move gradually from the current system of quantitative credit ceilings. In order to ensure compliance by commercial banks with the ceilings set on the expansion of credit, the penalty deposit scheme of the Central Bank will be maintained.

4. Balance of payments outlook and external policies

External sector prospects for the rest of 1990 and the following year are now significantly worse than anticipated. The external current account deficit in 1990 is projected at 5.8 percent of GDP, compared with a program target of 4.4 percent. The combination of a higher deficit and lower non-import-related capital inflows is expected to reduce gross international reserves by SDR 191 million in 1990, implying a decline in reserves to the equivalent of two weeks of nongovernment

imports, instead of the programmed buildup to 2.5 months. In 1991, the deficit is projected to decline to 4.3 percent of GDP, compared with a target of 4 percent in the program, with reserves slated to rise to two months of nongovernment imports.

The trade balance in 1990 is expected to remain weak, dominated by poor performance by the major exports. Coffee values are expected to grow by some 10 percent, but only because of a large drawdown of the Coffee Board's stocks. Tea volumes are also likely to grow more slowly, as a consequence of lower prices received at the auctions and delays experienced by farmers in receiving payments. Nontraditional exports, which declined sharply in 1989, are expected to recover, although from a low base. Horticultural exports, for example, are expected to grow in aggregate by some 7 percent in volume terms as a result of better weather conditions, new duty exemptions on imported packaging, and improved transport facilities. The level of public sector imports is now slated to drop by more than 40 percent vis-à-vis earlier estimates, primarily reflecting the decision not to exercise the option for airplane leases. In addition, some imports by both Government and parastatals will be canceled or postponed in light of the severity of the external position. The recent increase in domestic petroleum prices should lower private and public demand, and oil import volumes are now expected to be unchanged for the year, compared with an earlier projection of 2 percent growth. Nevertheless, oil import costs are expected to rise by 20 percent in 1990.

Net service receipts are estimated to be fairly close to programmed levels, with somewhat higher interest payments on foreign loans (from a short-term loan to the Coffee Board and some increase in government interest payments) to be offset by higher travel receipts. Receipts from tourism rose by 24 percent in the first half of 1990, relative to the same period in 1989, and with the tourist season nearly over, the forecast 6.4 percent annual growth may prove conservative.

Net official capital inflows (including transfers) for 1990 are expected to be almost 4 percentage points of GDP lower than anticipated. This is partly a matter of timing as two IDA credits (for export promotion and the agricultural sector) of some SDR 70 million are being processed more slowly than foreseen and are now, with associated cofinancing, expected to be disbursed in early 1991 instead of late 1990. Disbursements on projects to the Government and parastatals (some SDR 120 million) have also been postponed (these include the leases on the Kenya Airways planes). In addition, some cofinancing that was anticipated did not materialize. The timing of program inflows has created particular problems for reserve management in 1990. No program loans were received in the first half of the year, compared with about SDR 63 million in the first six months of 1989, while program grants were some 60 percent lower. For the remainder of the year, both program loans and grants are expected to be some 40 percent below 1989 levels.

Given the pessimistic prospects for the major exports and much higher oil import prices, 1/ the measures taken by the Government to narrow the current account deficit in the remainder of 1990, but most importantly in 1991, focus primarily on demand restraint exercised through tight fiscal and monetary policies. These measures should result in a reduction in the demand for foreign goods by the public and the private sectors estimated at about SDR 120 million by end-1991. The 1991 current account deficit is now forecast to fall to 4.3 percent of GDP, compared with 4.0 percent in the original program.

Almost 1 percentage point of the current account deficit is expected to derive from higher oil import costs. Given the authorities' policy of raising domestic petroleum prices in line with import costs, oil import volumes are expected to fall by 2 percent next year (Table 7). Even so, under current price assumptions, oil import values will rise by more than 10 percent in 1991. Public sector imports should decline by a further 4 percent in 1991. Credit restraint and higher prices are expected to result in private imports declining slightly to 19 percent of GDP. Private sector non-oil demand will be restrained by the new tax measures discussed earlier and tightened monetary policy. The authorities remain committed to their schedule of full import liberalization by mid-1991.

On the receipts side, export performance is likely to continue to be dominated by a further deterioration in the international prices for Kenya's major exports. Receipts from the traditional exports of coffee, tea, and petroleum are expected to remain low in 1991. Continued low international coffee prices, together with low stocks at the Coffee Board and evidence of inadequate usage of inputs by farmers, are expected to lead to a 20 percent fall in coffee export volumes. Continued inefficiencies at the oil refinery have led to high costs; lower orders from regional markets are likely to reduce petroleum export volumes by 10 percent. The export volume for tea is expected to rise in 1991 by only 5 percent following an 18 percent volume increase in 1990; this partly reflects an 8 percent price decline this year and a further drop anticipated for 1991, as tea formerly sold in the Middle East is supplied to other markets. Past delays in effecting payments to tea farmers have also adversely affected export volume; recent efforts to redress these difficulties are not likely to have an impact on volume until mid-1991 at the earliest.

Horticulture and manufactured export volumes are forecast to rise by about 10 percent in 1991 in response to recent export promotion measures. Net service receipts are expected to continue to strengthen the current account in 1991. Travel receipts are expected to grow by

---

1/ Average oil import prices for 1990 are estimated at US$25.10 (c. and f.) per barrel, based on f.o.b. prices of US$31 a barrel for mid-September-December; for 1991, average prices (c. and f.) are forecast at US$29.6.

Table 7. Kenya: Impact of Oil Price Increases, 1989-91

(In millions of U.S. dollars and SDRs)

	Baseline 1/			Revised Scenario 2/			Additional Costs	
	Q	P	Value	Q	P	Value	($)	SDR
Calendar years								
1989								
Imports	17.3	19.7	340.1					
Exports 3/	5.3	23.3	123.3					
Net ($)			216.8					
Net (SDR)			169.1					
1990								
Imports	17.3	20.9	361.7	17.3	25.1	433.6		
Exports 3/	4.6	27.3	124.6	4.9	27.3	135.1		
Net ($)			237.1			298.5	61.4	
Net (SDR)			180.9			221.6		40.7
1991								
Imports	17.6	21.7	382.9	16.9	29.6	500.2		
Exports 3/	4.7	28.6	132.8	4.9	31.0	151.0		
Net ($)			250.1			349.2	99.1	
Net (SDR)			188.2			250.3		62.1
Fiscal year								
1990/1991 4/								
Imports	17.5	21.3	372.4	17.1	29.3	501.3		
Exports 3/	4.6	27.9	128.1	4.9	31.3	153.2		
Net ($)			244.3			348.1	103.8	
Net (SDR)			185.1			250.4		65.3

Source: Staff projections.

Note: Q = quantity in millions of barrels; P = price per barrel.

1/ EBS/90/64 (3/30/90); revised data for 1989; WEO projections (1/18/90).
2/ Midterm review projections (second annual ESAF arrangement), October 1990; WEO projections (10/4/90).
3/ Refined petroleum exports plus aircraft and ship refueling sales.
4/ July 1990-June 1991.

over 11 percent, with no evidence of capacity limitations in hotels or game parks. Other service receipts related to travel are also expected to grow strongly, particularly airport and port earnings.

Net capital inflows plus official transfers in 1991 are expected to be 4.5 percent of GDP, significantly below the 9.5 percent recorded in 1989. Nevertheless, with the disbursement of the IDA credits due in 1990 and with no further leases planned for Kenya Airways, official inflows in 1991 are expected to be some 40 percent above 1990 levels. With some short-term capital outflows (as the Coffee Board loan is repaid), and targeting a reserve accumulation of SDR 200 million to allow gross reserves to recover to two months of nongovernment imports, the additional financing requirement for 1991 is likely to be some SDR 226 million. If policy requirements are met, the disbursements of the second tranches of IDA credits, new IDA credits, and cofinancing are likely to reduce this to SDR 107 million. It is reasonable to expect that commitments of additional assistance covering the remaining financing requirement will be forthcoming at the Consultative Group meeting in mid-November. Should these funds not become available, additional adjustment would be required.

To monitor the overall impact on reserves of the policy package, and to signal any need for further actions, the Central Bank of Kenya and the Ministry of Finance have jointly prepared a foreign exchange budget, with indicative quarterly ceilings on foreign exchange spending by the Central Government and parastatals that are consistent with the reserve target set for end-1991.

Kenya's development strategy will continue to be based on the promotion of the tradable goods sector. To this end, financial policies and structural reform measures will aim at improving domestic incentives for the production of tradable goods. The progressive reduction of inflationary pressures through fiscal and monetary restraint and continued trade liberalization are expected to strengthen the incentives for export activities and to improve the efficiency of the tradeable goods sector as a whole. Since the mid-1980's, the ratio of prices of exportables to home goods has declined by some 20 percent. Moreover, there has been a marked decline in the terms of trade over the past two years, and the foreign reserve position has dropped to an uncomfortably low level. In these circumstances, and given the authorities firm commitment to continuing the process of import liberalization, the aim of exchange rate policy will be to help in reversing the recent decline in the domestic relative price incentives for tradeable goods production. In this context, account will be taken of the efficiency gains that could be derived from structural reforms.

To control debt-servicing costs over the medium term, public sector contracting of nonconcessional borrowing with maturities of 1-15 years will be reduced from US$155 million in 1990 to US$77.5 million in 1991, of which US$55 million has been earmarked for the Nzoia Sugar Project.

On the structural side, the measures announced to promote a quick response from existing export enterprises will be implemented as soon as feasible. The regulations for the exemption scheme noted above for refunding VAT and import duties paid on imported inputs to exporters of horticultural goods and agro-based products have been gazetted and backdated to September 1990. Two measures are planned to alleviate the capacity constraint on air freight for horticultural exports. First, to reduce shipping costs, the handling of air cargo at Jomo Kenyatta Airport will be demonopolized by mid-December 1990. Second, to provide incentives for chartering cargo flights, the base for the calculation of the duty rate on imports delivered by air will be reduced, effective in the first half of 1991, from 50 percent of the air freight cost to 10 percent. This will place air and sea freight charges on a more equal footing. The bill establishing the Export Processing Zones was approved by Parliament at end-October and is expected to be enacted by the end of 1990. Two of these zones and the general area of the third have been identified; the private zone in Nairobi is ready for occupancy and is expected to be in production by early 1991. Infrastructure work on the government zone in Nairobi, at Athi River, is to commence shortly, and this zone is expected to be in production by mid-1992.

The domestic textile sector is still protected, but the IDA-financed study of the sector has been submitted and discussed with the Government, which is to formulate a strategy for restructuring the sector by end-January 1991. This strategy should address the main constraints identified by the report--the inefficiency of publicly owned firms and cotton availability and quality--prior to removing present controls on textile imports. The budget has already announced measures to overcome bottlenecks to the availability of cotton; an auction system is to be introduced, ginneries are to be restructured, and private ownership will be encouraged.

The long-term scenario for Kenya (Table 8) has been prepared utilizing the most recent WEO assumptions for foreign demand, commodity prices, and interest rates. It is predicated on a continuation of appropriate domestic policies including a targeted increase in reserves to about three and one half months of imports by the end of the decade. This path is consistent with real GDP growth of 5.5 percent per annum with an external current account deficit that declines to 4 percent of GDP (including official transfers). On this basis, the debt service ratio would fall to 16.5 percent of exports and service receipts, while the debt to export ratio also declines steadily to 155 percent of exports. In the near term, ratios of current account deficits to GDP (excluding transfers) remain at over 6 percent during 1991-93 before declining to about 4 percent by 1997. These deficits are expected to be financed by donors at concessional terms (at least 10-year grace periods and 3 percent average interest).

The alternative scenario (Scenario B) was prepared as a sensitivity analysis. This alternative is based on lower financing in 1991 and a further terms of trade deterioration in 1991 of 6 percent, equivalent to

Table 8. Kenya: Long-Term Balance of Payments Scenarios, 1991-2001

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Scenario A											
Current account deficit 1/											
(In millions of SDRs)	301	339	348	276	302	279	281	304	331	365	387
(As a percent of GDP)	6.3	6.3	6.1	4.8	4.8	4.3	4.1	4.1	4.1	4.1	4.0
Change in terms of trade	-1.3	1.7	0.3	1.0	-1.0	—	—	—	—	—	—
Export volume growth	2.5	11.6	10.3	4.4	4.5	6.0	6.0	6.0	6.0	6.0	6.0
Import volume growth	-4.9	10.5	6.9	3.1	4.3	4.3	5.7	6.2	6.5	6.8	6.5
Inflows plus official transfers (as a percent of GDP)	7.7	6.3	6.3	5.1	4.2	4.2	4.2	4.3	4.3	4.3	4.4
Gross reserves											
In millions of SDRs	264	309	376	518	563	635	722	822	936	1,069	1,239
In months of nongovernment imports	2.0	2.2	2.5	3.2	3.2	3.4	3.6	3.8	4.0	4.2	4.5
In months of total imports	1.8	1.9	2.1	2.7	2.7	2.9	3.1	3.3	3.4	3.6	3.9
Debt service/exports of goods and services	29.6	29.0	25.6	22.0	21.9	21.6	21.1	20.4	19.4	18.2	17.0
Debt/exports of goods and services	226	215	206	202	195	189	183	178	174	171	169
Net use of Fund credit											
(In millions of SDRs) 2/	31	-59	-44	-10	-26	-42	-54	-51	-44	-28	-12
Scenario B											
Current account deficit 1/											
(In millions of SDRs)	187	226	193	169	213	176	166	176	188	206	209
(As a percent of GDP)	4.7	4.8	4.1	3.6	3.9	3.3	3.1	3.0	3.0	3.0	2.9
Change in terms of trade	-6.0	2.1	0.3	1.0	-1.0	—	—	—	—	—	—
Export volume growth	2.5	11.6	10.3	4.4	4.5	6.0	6.0	6.0	6.0	6.0	6.0
Import volume growth	-15.3	11.8	5.3	5.3	4.3	4.3	5.7	6.2	6.5	6.8	6.5
Inflows plus official transfers (as a percent of GDP)	4.5	4.8	4.3	2.9	3.1	3.2	3.3	3.3	3.1	3.3	3.1
Gross reserves											
In millions of SDRs	151	196	263	326	353	435	530	640	742	886	1,034
In months of nongovernment imports	1.1	1.4	1.7	1.9	1.9	2.2	2.5	2.8	3.0	3.3	3.5
In months of total imports	1.1	1.3	1.6	1.8	1.8	2.1	2.4	2.7	2.9	3.2	3.4
Debt service/exports of goods and services	29.4	28.7	25.1	20.7	20.5	20.2	19.6	18.9	17.9	16.7	15.5
Debt/exports of goods and services	214	198	184	174	166	158	151	145	139	135	131

Sources: Staff projections.

1/ Excluding official transfers. For 1991-93 trade assumptions are consistent with the Commodity Division's projections for Scenario A, and are as described in the text for Scenario B.

2/ Assumes zero Fund disbursements after 1991. Fund credit outstanding is zero by end-2001.

an oil import price of US$31 a barrel through 1991, rather than the October WEO average price projection of US$26.2 a barrel. Higher oil prices add SDR 65 million to import costs. If, in addition, only half the SDR 226 million financing requirement is met in 1991, the authorities are envisaged to respond with appropriately strengthened policies that reduce imports by SDR 180 million while gross international reserves would increase only modestly, remaining at about one month of the lower level of imports. The net impact of the terms of trade effect and greater adjustment would be to reduce 1991 imports to 7 percent below baseline levels. This would mean sharply curtailing parastatal and private imports, and would reduce real investment and growth. If financing continued to be tight during 1992 and 1993, import volumes would remain stagnant in 1991-93, compared with a cumulative growth of 13 percent under the baseline scenario. Reserves would rise to the 1991 baseline target of two months of imports only after 1993.

More pessimistic assumptions on other variables also lead to a sizable need for import adjustment in addition to that already contained in the program. Each additional US$1 in the oil price in the first quarter of 1991 would add SDR 4 million to 1991 import costs. If coffee prices in 1991 remain at their 1990 levels in dollar terms, rather than rising by 8 percent (in SDR terms), an additional SDR 16 million in financing would be needed. If exporters of nontraditional goods are slow to respond to new incentives, such that the growth in export volumes of these goods declines from 15 percent to 10 percent in 1991 (which would not be inconsistent with historical performance), additional financing of SDR 18 million would be required.

5. Capacity to repay the Fund

Kenya has met its financial obligations to the Fund promptly, despite occasions of foreign exchange difficulty (e.g., in 1981 and 1987). Sound financial and debt management has enabled Kenya to maintain its excellent record of servicing its debts.

As a result of frequent arrangements to use Fund resources, Kenya has relatively high Fund credit outstanding as a percentage of its present quota, which will reach a peak at 260 percent of quota with the projected purchase under the third-year ESAF in 1991. Repurchases are also sizable, peaking at SDR 59 million in 1992; after 1994, exposure falls rapidly as repurchases of the 1988 stand-by arrangement are completed (Table 9 and Table 10).

Debt service to the Fund averages about 1.5 percent of exports of goods and services during 1991-2001 in the baseline scenario (Scenario A). The peak years will be in 1991-93, when repayments to the Fund are also high in relation to gross official international reserves (at 22 percent in 1992). Most debt service ratios fall off quite steeply by the end of the decade, particularly in relation to reserves, which the authorities are assumed to target at over four months of non-government imports by 2000. However, debt service to the Fund remains

Table 9. Kenya: Indicators of Fund Credit, 1991-2001

(In percent)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Scenario A											
Outstanding Fund credit/GDP	5.2	4.2	3.4	3.0	2.5	1.9	1.2	0.7	0.3	0.1	—
Outstanding Fund credit/quota	260	219	187	181	162	133	95	59	28	8	—
Debt service to the Fund/ exports of goods, nonfactor services, and private transfers	2.3	3.3	2.1	0.4	1.0	1.5	1.8	1.5	1.2	0.7	0.3
Debt service to the Fund/ total debt service	7.8	11.4	8.3	2.1	4.8	7.1	8.6	7.8	6.6	4.1	1.8
Debt service to IFIs/ total debt service 1/	41.8	26.6	26.0	26.5	22.6	19.9	17.7	15.5	14.4	14.2	21.3
Debt service to IFIs/ international reserves 1/	85.7	51.1	40.4	27.8	23.5	19.4	16.0	12.8	10.7	9.4	12.2
Debt service to the Fund/ nonreschedulable debt service	18.6	42.9	31.9	7.6	20.4	34.8	47.5	49.1	44.6	28.2	8.0
Debt service to the Fund/ gross official international reserves	15.9	21.9	12.9	2.1	4.8	6.8	7.6	6.3	4.8	2.6	1.0
Scenario B											
Debt service to the Fund/ exports of goods, nonfactor services, and private transfers	2.3	3.3	2.1	0.4	1.0	1.5	1.8	1.5	1.2	0.7	0.3
Debt service to the Fund/ total debt service	7.8	11.6	8.4	2.2	4.9	7.4	9.0	8.2	7.0	4.4	1.9
Debt service to IFIs/ total debt service 1/	41.6	26.9	26.3	28.1	24.2	21.3	19.0	16.7	15.6	15.5	23.5
Debt service to IFIs/ international reserves 1/	147.9	80.2	57.5	44.1	37.3	28.4	21.7	16.4	13.5	11.3	14.6
Debt service to the Fund/ nonreschedulable debt service	18.8	43.1	32.0	7.6	20.4	34.8	47.5	49.1	44.6	28.2	8.0
Debt service to the Fund/ gross official international reserves	27.9	34.6	18.4	3.4	7.6	9.9	10.3	8.1	6.0	3.2	1.2

Sources: Staff projections.

1/ IFI—international financial institutions.

Table 10. Kenya: Projected Payments to the Fund, 1990-99

(In millions of SDRs)

	1990 Nov.-Dec.	1991	1992	1993	1994	1995	1996	1997	1998	1999	Remaining Period	Total
Obligations from outstanding use of resources												
Principal												
Repurchases	15.7	29.1	58.8	41.5	--	--	--	--	--	--	--	145.1
ESAF/SAF repayments	--	--	--	2.8	9.7	25.8	29.8	29.8	27.0	20.1	4.0	149.0
Trust Fund repayments	--	0.2	--	--	--	--	--	--	--	--	--	0.2
Charges and interest 1/	3.9	15.7	11.0	5.5	3.1	3.0	2.8	2.7	2.5	2.4	1.2	53.8
Total	19.6	45.0	69.8	49.8	12.8	28.8	32.6	32.5	29.5	22.5	5.2	348.1
(Percent of quota)	13.8	31.7	49.2	35.1	9.0	20.3	23.0	22.9	20.8	15.8	3.7	245.1
Obligations from prospective use of resources												
Principal												
Repurchases	--	--	--	--	--	--	--	--	--	--	--	--
ESAF/SAF repayments	--	--	--	--	--	--	15.0	24.0	24.0	24.1	33.6	120.7
Charges and interest 1/	--	0.4	0.6	0.6	0.6	0.6	0.6	0.5	0.4	0.2	0.2	4.7
Total	--	0.4	0.6	0.6	0.6	0.6	15.6	24.5	24.4	24.3	33.8	125.4
(Percent of quota)	--	0.3	0.4	0.4	0.4	0.4	11.0	17.3	17.2	17.1	23.8	88.3
Cumulative (outstanding and prospective)												
Principal												
Repurchases	15.7	29.1	58.8	41.5	--	--	--	--	--	--	--	145.1
ESAF/SAF repayments	--	--	--	2.8	9.7	25.8	44.8	53.8	51.0	44.2	37.6	269.7
Trust Fund repayments	--	0.2	--	--	--	--	--	--	--	--	--	0.2
Charges and interest 1/	3.9	16.1	11.6	6.1	3.7	3.6	3.4	3.2	2.9	2.6	1.4	58.5
Total	19.6	45.4	70.4	50.4	13.4	29.4	48.2	57.0	53.9	46.8	38.5	473.5
(Percent of quota)	13.8	32.0	49.6	35.5	9.4	20.7	33.9	40.1	38.0	33.0	27.1	333.5

Source: Staff estimates.

1/ Projections are based on current rates of charge, including burden-sharing adjustments where applicable, for purchases in the General Resources Account; current interest rates for ESAF/SAF and Trust Fund; and current SDR interest rate of net use of SDRs.

high as a percentage of nonreschedulable debt service through the end of the decade. Debt service payments to international financial institutions also represent a substantial share of total debt service payments.

If external developments and capital inflows are less favorable than anticipated, as discussed in the previous section, the near-term ratios of debt service to the Fund would deteriorate. In particular, the ratio of Fund debt service payments to gross reserves in 1992 would reach 35 percent--some 13 percentage points higher than under the baseline scenario. Total debt service payments to the international financial institutions would be equivalent to 58 percent of reserves in 1993. From 1994 onwards, debt service payments to the Fund and to international financial institutions as a ratio of foreign reserves follow a similar path to that in Scenario A. Fund debt service in relation to the total and to exports also follow a similar trend to the previous scenario.

Since the ratios of repayments to the Fund are at their highest levels during the remainder of the ESAF program period and in the following two years, shortfalls in export earnings and capital outflows during this period would be of particular concern. Lower project aid would have a commensurate effect on imports and therefore would not immediately affect the overall payments position, although longer-term economic growth rates would be affected. However, if aid directly financing export production or cash disbursements from donors were cut, as Scenario B assumes, foreign exchange available for nonaid-related imports and debt service would be reduced. (Most of the quick-disbursing financing incorporated in the 1991 program is related to IDA credits, which are due to be approved by the World Bank in early 1991.) Despite the tighter adjustment policies, the lower reserve levels incorporated in the scenario result in significantly higher ratios of Fund debt service to reserves. This factor as well as the higher share of the Fund in nonreschedulable debt service entail greater risks for the Fund.

IV. Social and Environmental Impact of the Program

Recognizing that the policy package could have adverse social effects, a conscious effort has been made to minimize any such effects on the disadvantaged groups. Special care has been taken to insulate outlays directed at the more vulnerable groups. For instance, no cutbacks were made in the provision for transport expenses (primarily for ambulances) of the Ministry of Health. In the area of user charges for medical care, efforts have been made to strengthen the institutional mechanism for the granting of waivers to the more vulnerable groups (e.g., special forms and stamps required for applications for waivers have now been made readily available). The authorities indicated that some of the suspended medical fees (maternity fees were reduced in

January and more recently, outpatient charges were abolished for all users) will be reintroduced, pending an examination to ensure that the quality of services is improved.

With regard to the environment, with the assistance of IDA and other donors, progress continues to be made in strengthening forestry policies and institutional support for reforestation, arid and semi-arid lands, and wildlife resources. In particular, in an attempt to protect the forests from being decimated by the growing demand for paper products, the 1990/91 budget introduced a measure lowering the duty on imported wood pulp from 20 percent to 10 percent.

V. Staff Appraisal

During 1989, the period of the first annual arrangement under the ESAF, Kenya demonstrated its commitment to economic adjustment and structural reform. However, rapid monetary expansion, together with a deterioration in the external terms of trade and the impact of the import liberalization program, resulted in a much worse external current account position than originally programmed. Although the policy stance contained in the program for 1990 was tightened, it is now apparent from the revised estimates on the 1989 external outturn and the unanticipated external shocks during the course of 1990 that a significantly tighter policy stance would have been more appropriate.

Moreover, while the authorities implemented many of the elements of the program, there were some important policy slippages. In particular, the performance criterion on net domestic assets was not met and the program has gone off track in terms of its external objectives, as reflected in the failure to meet the quantitative benchmark on net official reserves. The gross official reserve position has deteriorated to less than one month of nongovernment imports, and it is evident that without corrective policies, the external financing requirement for the remainder of 1990 and 1991 cannot be met.

The authorities recognize the seriousness of their external position and have agreed to implement a decisive and strong package of policy measures, including significant prior actions, to redress past slippages and to close a sizable portion of the external financing gap. The policy package includes a very significant reduction in the budget deficit, sizable cutbacks in parastatal expenditures and imports, further liberalization of interest rates, actions to strengthen external competitiveness, and a commitment to pass through fully any further petroleum price increases. The staff believes that this strong policy package, if fully and properly implemented as scheduled, should lead to a significant reduction in the external current account deficit and facilitate a return to a viable external payments position by end-1991.

The program objectives for the second and third years under the ESAF arrangement have necessarily been revised in view of past and prospective developments, particularly the recent increases in the prices of oil and the reduction in aggregate demand implied by the program. Real growth rate targets for 1990 and 1991 have been scaled down to 5.0 percent and 4.5 percent, respectively. Inflation has been revised upward to 12.0 percent at end-1990 and 8.0 percent at end-1991. The external current account deficit is expected to decline in 1990 to 5.8 percent of GDP and fall more sharply in 1991 to 4.3 percent, largely as a result of broad demand control measures and cutbacks in government and parastatal imports. The external reserve position will remain very weak through the end of 1990, but is expected to improve to two months of nongovernment imports by end-1991, provided that the remaining external financing requirement of some SDR 107 million can be met.

A crucial element of the program is strong fiscal adjustment by the Central Government and the state corporation sector. The 1990/91 budget deficit (including grants) of the Central Government is projected to decline to 2.5 percent of GDP, significantly below the program target, reflecting an increase in revenue and cutbacks in expenditure, each amounting to about 0.8 percent of GDP. In order to ensure full implementation of these difficult undertakings, the revenue measures were put in place by early November 1990, and the expenditure cuts relating to the Central Government and state corporations were also fully identified and approved by the Cabinet in early-November. The expenditure cuts were designed to have a significant impact on the balance of payments. A conscious effort was made to protect the more vulnerable groups from any adverse effects. In addition to these measures, Kenya Airways will not be allowed to purchase or lease any additional aircraft in 1990 and 1991.

A noteworthy feature of some of the budgetary measures is their structural nature. In particular, the Government's decision to reduce the growth in the number of authorized civil service posts, to severely limit the increase in posts in next year's budget, and to restrict the intake of new university students, should all have a significant impact on the fiscal position over the medium term.

In view of past expenditure overruns in some of the larger spending ministries, there is a need for continuous and intensive monitoring of expenditure commitments and control over the creation of new posts by ministries. Continued budgetary retrenchment in 1991/92, through a further reduction in the budget deficit to 2 percent of GDP, is also necessary if the impact on the balance of payments is to be sustained. As with the Central Government, the importance of continued tight expenditure policies by the state corporation sector through 1992 cannot be overemphasized, in order to achieve a durable impact on the balance of payments. There is also a need for an intensive and heightened monitoring of state corporation activities.

The stance of monetary policy has been tightened considerably. Higher treasury bill yields should raise the Central Bank's rediscount rate substantially, and the continuation of the penalty deposit scheme for commercial banks that exceed their credit targets should help to ensure full adherence to the program's ambitious monetary targets. Noteworthy are the freeing of the auction on treasury bills and the introduction of new bearer treasury bonds, both of which represent important structural benchmarks flowing from the recommendations of recent technical assistance of the Central Banking Department. The staff believes that these measures will significantly enhance the capacity of the Central Bank to conduct open market operations.

In the external area, the authorities intend to continue the process of import liberalization despite the very difficult external circumstances. In addition to the reduction in government and parastatal imports, and the suspension of options on the leases for aircraft, the limits on the contracting of public nonconcessional external loans have been substantially tightened. The overall ceiling has been reduced by half to $77.5 million, and the authorities have agreed to earmark $55 million of the ceiling for the Nzoia Sugar Project, which the World Bank has indicated is an economically justified project.

A number of specific measures have been taken and more are planned to promote nontraditional exports, and some positive response is expected during 1991. Since the last exchange rate action, the profitability of the export sector has been eroded further due to deteriorating export prices. Moreover, the reserve situation has become uncomfortably tight. Given the need to continue the import liberalization effort, it is important to achieve export growth. Thus, the aim of exchange rate policy is to help restore the profitability of the export sector. To the extent that efficiency gains from other policies are not sufficient, further exchange rate action is required.

The authorities accept the exigencies posed by the external situation, are aware of the policy challenges that lie ahead, and are committed to taking the necessary actions required for full implementation, including structural and institutional reforms. However, the authorities have also underscored the significant burden entailed by these policies, and the implied acceleration of Kenya's own timetable for structural adjustment, as indicated in their Sessional Paper No. 1 of 1986, which called for a budget deficit of 2.5 percent of GDP only by the end of the century. The authorities have expressed the hope that in the event of an improvement in external prospects, the Fund would accept a return by Kenya to the slower adjustment path for which the Government had achieved a significant domestic political consensus. It may be noted in this context that the reserve objectives discussed in the present policy package are less ambitious than the original targets under the ESAF arrangement, and that a significant improvement in the external position would be necessary before any relaxation of adjustment policies could be contemplated.

The staff believes that the policy package has been substantially strengthened in response to the oil price shock and to ensure a return to a viable external position by end-1991. The measures being implemented should also help to achieve the objectives of the program for 1990/91. As such, and in view of the need to provide for some strengthening of the foreign reserve position and to ensure that the program is fully financed, Kenya continues to deserve the strong support of the international donor community and the Fund in the context of the current ESAF arrangement.

In light of the above the staff supports the Kenyan authorities requests for a waiver of the performance criterion on net domestic assets for end-June 1990, and for an increase in the amount of the second disbursement under the ESAF arrangement by the equivalent of SDR 20 million, to the equivalent of SDR 60.2 million. It would be important for the international donor community to also make additional efforts to support Kenya's strengthened adjustment effort.

VI. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. Paragraph 1(b) of the second annual arrangement for Kenya under the enhanced structural adjustment facility (EBS/90/64, Sup. 2, 5/3/90) is amended by increasing the amount of the second loan to the equivalent of SDR 60,233,333.

2. The Fund determines that the midterm review specified in paragraph 2(c) of the second annual arrangement for Kenya under the enhanced structural adjustment facility has been completed, and that, notwithstanding paragraph 2(a)(i), Kenya may proceed to request the disbursement of the second loan under the arrangement.

Nairobi
November 12, 1990

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. Camdessus:

1. We have recently held discussions with the Fund staff on the midterm review of Kenya's programme of structural and financial adjustment for 1990, which is supported by the second annual arrangement under the enhanced structural adjustment facility (ESAF) that was approved by the Executive Board of the Fund on April 30, 1990. The discussions focused on the progress made under the programme for 1990, as well as on the objectives and policies to be pursued for the remainder of the period. All performance criteria for end-June 1990 were met except for the one on net domestic assets for which the Government of Kenya hereby requests a waiver. In view of a worsening external environment and the sharp deterioration in Kenya's external position, important and difficult policy actions have been taken which will have significant short-term costs to the Kenyan economy. Against this backdrop, we have formulated the indicative quantitative targets for end-March and end-June 1991 as specified in the annex. In this context, we wish to request an increase of the amount to be made available for the second disbursement under the current arrangement to the equivalent of SDR 60.2 million.

2. The economic growth target for 1990, which had been set at 5.2 percent, has now been scaled down to about 5.0 percent. Favorable weather for major crops combined with a strengthening in international tea prices as well as the enhancement of production incentives in the early part of the year have played an important role in mitigating the impact of the new "oil shock." The inflation rate of 10.6 percent at end-September however, was higher than the end-1989 level, reflecting the rapid monetary expansion of the second half of 1989 and early 1990, and the initial impact of the 31-49 percent increase in domestic oil prices of early September 1990. Notwithstanding the tighter financial policies currently in place, the inflation rate, which was expected to decelerate to 7.5 percent by year-end, is now projected at 12 percent, largely as a result of the oil price increase and new tax measures. The overall balance of payments for the first six months of 1990 is estimated to have been in deficit. As a result, net official reserves declined by SDR 86 million compared with a targeted increase of SDR 14 million, and gross reserves fell to less than one month of nongovernment imports.

3. While the programme had anticipated a surplus similar to that in 1989, the balance of payments for 1990 is now expected to lead to a reserve loss of some SDR 191 million. The current account deficit is projected at 5.8 percent of GDP, compared with 4.4 percent in the programme. (This deficit excludes the planned leases of two planes by Kenya Airways, which the Government has postponed pending the restructuring of the company.) This deterioration follows a weaker trade position than estimated in 1989, which contributed to a current account deficit of 7.4 percent of GDP, 1.5 percentage points higher than estimated. Net capital inflows are forecast at 3.8 percent of GDP, compared with 9.5 percent in 1989.

Part of the weak payments position in 1990 can be explained by the worsening trade account from continued adverse movement in the terms of trade. After a deterioration (in SDR terms) of some 9 percent in 1989, the terms of trade are estimated to decline by a further 8 percent during 1990, with falling coffee and tea prices and a sharp dip after August as oil prices rose. Other problems continued to affect exports. The volume of nontraditional exports fell substantially in 1989, in large part due to a 30 percent drop in horticultural export volume as a result of heavy rains at the turn of the year, problems with air freight capacity, difficulties with importing packaging materials, and the nonrenewal of one large trial order for pineapples. Recovery from this low base has been slow, although the Government has begun to address the removal of some institutional constraints on horticultural exports. The aftermath of vigorous import growth in 1989 also undermined the trade account during the early part of this year. Trade liberalization contributed to a structural increase in the demand for imports in the second half of 1989, including a buildup of inventories with continuing effects in 1990. An equally important source of the higher deficit was strong domestic demand, particularly by the public and parastatal sectors. Finally, the reserve loss in 1990 also reflects lower-than-expected inflows of cash assistance and import financing.

4. The overall budget deficit for 1989/90 of 4.0 percent of GDP was lower than the target of 4.2 percent, despite a significant shortfall in some components of revenue. However, the overall deficit, excluding grants, at 6.5 percent of GDP was marginally higher than in the programme reflecting larger-than-projected external grants in the first half of the fiscal year. Revenues from two new taxes--the presumptive tax on agricultural produce and the value-added tax--were lower by K Sh 1.7 billion (0.9 percent of GDP). However, this was offset chiefly by better than envisaged nontax receipts, including an interim dividend from 1990/91 of K Sh 1.3 billion in central bank profits. Notwithstanding, the revenue to GDP ratio was higher at 24.1 percent against the programme target of 23.7 percent. User charges relating to agriculture, livestock, roads, health, and education services, which are intended to increasingly finance recurrent expenditures in the future, amounted to 1 percent of GDP.

Recurrent expenditure in relation to GDP was somewhat higher than in the programme, partly because of supplementary appropriations in April for the financing of higher salaries for the defense forces, increased enrollment in the universities, higher expenditures on national security, and greater than envisaged outlays on domestic interest. Because of strong pressures for employment growth, primarily to meet the demand for additional trained teachers with the implementation of the new 8-4-4 education system, as well as the decision of the Government to grant wage increases to the defense forces in April 1990, the structural benchmark to limit the wage and salary bill growth to 7.5 percent is estimated to have been exceeded. Mirroring partly the larger than programmed inflow of external grants, development expenditures also rose to 7.3 percent of GDP in contrast with the programme target of 7.1 percent. Dependence on domestic sources for financing the deficit was lower than envisaged in the programme, with net repayment to the banking system of 0.2 percent of GDP. Reflecting continuing difficulties in controlling and monitoring expenditures, the value of unpresented cheques at the end of 1989/90 exceeded the programme target of K Sh 1.1 billion by K Sh 0.2 billion.

5. Overall domestic credit developments through the first half of 1990 were more expansionary than envisaged in the programme. During the second quarter of 1990, steps were taken to tighten the stance of monetary policy. Accordingly, the ceilings on interest rates on deposits and on short- and long-term commercial banks loans were raised by one percentage point, effective April 1, 1990, to 13.5 percent, 16.5 percent, and 19.0 percent, respectively; the ceiling on short-term loan rates was raised by a further 0.5 percentage points to 17.0 percent before end-August, 1990. Furthermore, the legal requirement that loan interest rates subject to ceilings be inclusive of all lending-related fees and charges was removed, thus allowing effective interest rates to exceed significantly the formal ceilings and, in effect, to be market-determined. Also, in order better to control money and credit aggregates and to ensure compliance by the commercial banks with credit ceilings, the Central Bank of Kenya in May introduced an additional cash deposit scheme for commercial banks that exceed their credit ceilings. This deposit scheme should encourage the banks to place excess funds in government securities, and pave the way for the full implementation of open market operations.

These measures notwithstanding, the recent change in the ceiling from domestic credit to net domestic assets (NDA) created monitoring difficulties for a number of large commercial banks; as a result, the NDA ceiling for end-June 1990 was exceeded by K Sh 1.6 billion, equivalent to 3.3 percent of the stock of broad money at end-June 1989. Net domestic assets of the banking system grew by 13 percent in 1989/90 (July-June) compared with 11.2 percent in the programme. Net credit to the Government increased by 5.7 percent during this period, in contrast to the targeted 9.7 percent. Net foreign assets were substantially

lower than targeted; as a result, broad money expanded by 8.7 percent in 1989/90, in contrast to the 10.4 percent growth expected under the programme.

6. External sector policies during the first half of 1990 were in line with the original programme, although the worse outturn for 1989, once it was identified, has now required stronger measures for the last quarter of the year. The exchange rate was managed flexibly, depreciating by 11.8 percent in real effective terms between end-December 1989 and end-September 1990, broadly in line with the terms of trade. Nonconcessional external borrowing contracted by the public sector in the 1-15 year maturity range (as defined in Table 1) was US$150 million by mid-October, consistent with the programme limit of US$155 million for the year. This included three 13-year maturity loans, of a combined amount of US$124 million, which had been mostly negotiated in the previous year when the maturity limit, for the purpose of the programme ceiling, was 12 years.

7. The structural measures in the programme were also implemented as anticipated and the structural performance criteria relating to export promotion and import liberalization were both met. The 1990/91 budget, which was presented to Parliament in June, represents a strong commitment for the promotion of exports, particularly of nontraditional industrial goods. One element of the strategy is to open the trading system to promote competition. In line with the performance criterion under the second annual arrangement under the ESAF, quantitative restrictions on 35.4 percent of eligible imports still subject to controls (according to the new classification system) were shifted to the liberalized category, and are now protected only by tariffs. The number of exports eligible for the Export Compensation Scheme was increased by nine new items, and improvements in the administration of the scheme have been announced to expedite payments. An exemption scheme for refunding duty paid on imported inputs to eligible exporters (targeting exporters of horticultural goods and agro-based products) has been gazetted and is backdated to be effective from September 1, 1990.

Rules relating to the duty/VAT exemption scheme have recently been gazetted. A bill establishing the legal and administrative framework for Export Processing Zones has been tabled and is expected to be enacted by the end of 1990. Two of these zones have been identified as well as the general area of the third; the private zone in Nairobi is ready for occupancy and is expected to be in production by early 1991. Infrastructure work on the government zone in Nairobi, at Athi River, is to commence shortly and this zone is expected to be in production by mid-1992.

Two measures are planned in an effort to alleviate the capacity constraint on airfreight for horticultural exports. First, the handling of air cargo at Jomo Kenyatta airport will be demonopolized by mid-December 1990, thus allowing the cost of handling horticultural shipments to decline. Second, the base for the calculation of the import

duty rate on imports delivered by air will be reduced, effective in the first half of 1991, from 50 percent of the air freight cost to 10 percent. The latter measure will put air and sea freight costs on a more equal footing, thus providing a greater incentive for the chartering of cargo flights for horticultural exports.

The IDA-financed study of the textile sector has been submitted and discussed with the Government, which is to adopt an action plan for the restructuring of the sector by no later than end-January, 1991. This strategy should address the main constraints identified by the report--the inefficiency of publicly owned firms and cotton availability and quality--prior to removing constraints on textile imports. The budget has already announced measures to overcome bottlenecks to the availability of cotton; an auction system is to be introduced, ginneries are to be restructured and private ownership will be encouraged. Further progress was made in the removal of price controls, as 74 items under the General Price Control Order were decontrolled in mid-March 1990, and 6 additional items under the General Price Control Order and 9 items under the Specific Order were decontrolled in mid-June, 1990.

8. The Government has continued its financial sector reform supported by a credit from IDA, that aims to increase the role of market forces in allocating financial resources and implementing monetary policy. Real interest rates continued to be positive during the first half of 1990. As part of the effort to strengthen the financial system, ten financial institutions were merged into the Consolidated Bank of Kenya in May, with financial backing by the Deposit Protection Fund. Stronger regulations on capital adequacy for banks and nonbank financial institutions have been issued by the Central Bank which would go into effect in early 1991. To encourage the expansion of equity markets, the Capital Market Authority was established in January to review the activities of the Stock Exchange and to establish rules to encourage more active trading. A Unit Trust (Amendment) Bill was tabled in June to encourage share trading by improving the tax treatment of purchases of unit trusts.

9. In line with its policy to improve the efficiency of the agricultural sector, producer prices for coffee and tea will continue to be based on auctions, and committees established to expedite payments to farmers after delivery have led to the elimination of payment delays. It is the policy of the Government to ensure that payment delays to farmers will not occur in the future. The Coffee Board has developed a strategy for handling and financing its stocks.

Policies for 1990/91

10. In the face of a sharp deterioration in the balance of payments and the substantially weaker external reserve position during 1990, the Kenyan Government has recently introduced a package of far-reaching and difficult policy measures, financial and structural, which should lead to the re-establishment of a more sustainable external

position. In addition to a large increase in domestic petroleum prices in early September 1990--ranging from 31-49 percent--the measures include a very sizable reduction in the budget deficit for 1990/91, sharp cuts in parastastal imports, a freeing of the treasury bill rate in order to enhance the Central Bank's capacity to conduct open-market operations, actions to strengthen tax administration, and measures to increase accountability of public enterprises. The Government will maintain this restrictive policy stance throughout the following fiscal year if the external situation continues to remain weak and the reserve position tight.

In the external area, the Government is committed to continue the pace of trade liberalization, despite the very difficult external circumstances. Priorities will be established to reduce the level of government and parastatal imports for the remainder of 1990 and for 1991 in the context of a foreign exchange budget with indicative quarterly ceilings. The options on the leases for planes due to be delivered to Kenyan Airways in 1990 and 1991 will be postponed pending the restructuring of the company. The Government has also decided to limit the contracting of public borrowing on nonconcessional terms in 1991 to US$77.5 million (half the limit for 1990). With these policies and the more restrictive fiscal and monetary measures, the current account deficit should fall to some 5.8 percent in 1990, and 4.3 percent in 1991. While the reserve position will remain very difficult through the end of 1990 (at two weeks of nongovernment imports), reserves are targeted to rise to two months of nongovernment imports by the end of 1991.

Fiscal policy

11. In view of Kenya's unusually adverse external position, fiscal policy will aim at reducing the 1990/91 budget deficit from the original programme target of 3.8 percent of GDP (5.6 percent, excluding grants) to 2.5 percent of GDP (5.1 percent, excluding grants), and further to 2 percent of GDP in 1991/92 (3.8 percent, excluding grants), relative to 3.4 percent in the original 1990 programme. In 1990/91, revenue as a share of GDP is projected at 23.3 percent, while total expenditure and net lending is now expected to decline to 28.4 percent (relative to 30.6 percent of GDP in 1989/90), reflecting a significant cutback from the approved budget estimates for both recurrent spending and locally-financed development expenditures. The budget deficit is to be financed from domestic nonbank and foreign concessional sources, with a repayment by the Government to the banking system of K Sh 2.5 billion (1.2 percent of GDP). The level of unpresented cheques at the end of 1990/91 will remain unchanged at the end-June 1990 estimate of K Sh 1.3 billion.

12. As part of the 1990/91 budget (presented in June 1990), a number of discretionary revenue measures, with a net yield of K Sh 1,068 million (0.5 percent of GDP), have already been implemented to broaden the tax base and enhance the elasticity and equity of the tax system. The bulk of the revenue from new measures was anticipated from

higher excise duties on cigarettes, tobacco, and beer, some adjustments in the value-added tax (including raising the general rate from 17 percent to 18 percent and a higher tax rate on beer), and changes in income and profit tax bases. The revenue gain from these measures will be partially offset by the lowering and rationalization of import duty rates, as part of the ongoing reform of the tariff structure.

Some major changes were also introduced in the area of taxes on income and profits; a current payment system for business income is to be phased in over five years, eventually requiring businesses to pay 75 percent of the estimated annual tax at the end of the third quarter or end of the ninth month of a firm's financial year; the corporate income tax rate has been lowered further from 42.5 percent to 40 percent; tax holidays for ten years are being offered to attract foreign investment in the Export Processing Zones; and the tax on dividends has been lowered to promote the development of the capital market, in particular Unit Trusts.

More recently, to achieve the revised budget deficit target, numerous nontax measures have been implemented that would yield an additional K Sh 650 million (0.3 percent of GDP). The revenue from nontax sources will increase with higher-than-budgeted loan repayments and dividends by certain public corporations (K Sh 217 million), the partial recovery of tax arrears pertaining to telecommunication revenue (K Sh 250 million), and previously unbudgeted repayments of past loans by some public enterprises (K Sh 184 million). In addition, certain discretionary tax measures, to be implemented by mid-November, will generate net revenue of about K Sh 900 million (0.4 percent of GDP).

In line with recent developments in the international oil market, the Government was prompt in adjusting the prices of petroleum products by 31 to 49 percent in early September. In order to continue the efforts to conserve energy, the Government is committed to not reducing retail petroleum prices and to capture any fiscal benefits accruing from a reduction in international oil prices in 1991. Should oil prices rise above the levels foreseen for the remainder of 1990 and for 1991, the Government intends to pass them rapidly through to the consumers. The Government has limited the revenue loss from import duty exemptions by canceling those in existence for more than five years, with the exception of some granted on a case-by-case basis to diplomats, aid agencies (with respect to projects), charitable institutions, religious bodies, and handicapped persons. Most exemptions granted to parastatals will be eliminated immediately.

13. The Government has moved rapidly to implement the new Value Added Tax (VAT) law. Despite the achievements to date, there is a need to address some remaining difficulties so as to further enhance VAT revenue generation. During the next two months, it intends to fill outstanding vacancies in middle management, and provide adequate accommodations and training facilities and the full complement of equipment and vehicles. With respect to computerization, the Government intends

to finalize contractual arrangements for further computerization of the VAT Department by December 15. With respect to VAT enforcement, the Government will move in the next two weeks to establish an operating VAT tribunal. By end-December, it will begin to prosecute VAT defaulters (including parastatal enterprises) and those that have failed to register under the VAT Act and will take the enforcement actions required under the law.

14. In order to ease the pressure on the external current account, the Government, following a careful review of the budgetary allocations of the different ministries, has decided to cut both recurrent and locally funded development allocations by K Sh 766 million and K Sh 1,135 million, respectively. These expenditure savings measures are expected to reduce demand for foreign exchange by about SDR 32 million in 1990/91, either directly or indirectly through their impact on private sector imports. A Treasury Circular has been issued to each affected Ministry to give effect to these budgetary cutbacks prior to the submission of the Supplementary Budget in February 1991. The Government is committed to staying within the agreed programme limits and will not approve any supplementary expenditures in 1990/91, particularly of an ongoing nature, without a fully offsetting increase in tax effort, user charges, and/or cuts on other expenditure items.

The overall share of recurrent expenditures is targeted to decline to 21.4 percent of GDP, compared to 23.3 percent in 1989/90. In part, this reflects the Government's efforts to reduce the provision for transportation expenses, and the purchases of vehicles, plant and equipment included in the recurrent budget. A part of these cutbacks have been directed at public administration and defence expenditure and some effort has been made to insulate outlays directed at the more vulnerable groups (e.g., no cutbacks in the Ministry of Health's budget for transportation expenses).

To limit the rate of growth of central government employment, the Government has recently issued a Treasury Circular to limit the unauthorized creation of new posts as well as the upgrading of positions and to freeze all vacancies unfilled for more than six months. The Government has also recently reduced the number of authorized posts included in the 1990/91 budget by 10,400 positions, which should result in budgetary savings of about K Sh 314 million. In its 1991/92 budget, the Government intends to provide no further increase in the number of posts, other than those relating to the expansion of primary school teachers. Consistent with the Government's commitment to stabilize the level of civil service and teaching employment within the next few years, the Government will hire no more than 1,500 new graduates from the 1990 graduating class of the university system, and training institutions run by ministries will begin to limit their activities to in-service training. In order to ensure that the personnel expenditure targets are being adhered to, cash limits on the wage bill will be set and enforced for each ministry and the Teachers' Service Commission by end-1990. The recommendations of the Salary Review Commission appointed in July 1990

are expected in December 1990. The salary revision emanating from the Commission's recommendations will be made effective from July 1, 1991, and phased in over a three-year period.

As a result of cutbacks in budgeted locally financed development outlays of about 16 percent, total development outlays will decline to 7.0 percent of GDP, relative to 7.3 percent in 1989/90. Considerable efforts are also under way to strengthen the budgeting and implementation of development outlays. A detailed ministry-by-ministry project list is being prepared for the first time for 1990/91 and will be ready by December 1990. A similar exercise will be carried out for the 1991/92 budget. A forward budget for the outlays for the period 1990/91-1991/92 will be prepared, which will improve the quality of selection of development projects. A comparable project list is being prepared for the major nonfinancial state corporations for 1991/92. In the preparation of the 1991/92 budget, the Government will seek external assistance in reviewing and assessing the relative economic merits of the major projects to be included in the public investment programme. In this connection, the Government will prepare, with the assistance of IDA, a public investment programme consisting of the capital expenditures of the Central Government and gradually increasing its coverage to a larger number of major nonfinancial state corporations.

15. University education has claimed an increasing share of budgetary resources and is crowding out funds for both other levels of education as well as for the implementation of the Government's development strategy. To limit this growth in coming years, the Government intends to move from the present open-ended system of direct budgetary allocations to individual universities to a system whereby a flat grant is provided to an autonomous university commission fiscally responsible for the planning, management, and financing of the university system. In the interim, to limit the cost of university education to the budget, the intake to the university system will be restricted to 8,000 in 1991. The Government intends to strengthen its existing in-service programmes in primary and secondary education, so as to ensure that as teaching posts at these educational levels are primarily filled with untrained teachers, the quality of education continues to be maintained at a high level. No teacher's training colleges will be established beyond those agreed with the World Bank.

16. In the course of 1990, some changes were made to the plans for increasing user charges for health and education services. In the health sector, maternity fees were reduced in January and civil servants were exempted from paying outpatient charges in April. In August, outpatient charges were abolished. However, the Government remains committed to the progressive strengthening of the role of user charges, consistent with an improved quality of medical care. With regard to education, in 1991 fees will be levied so as to cover a significant portion of the tuition of university students, and a policy will be implemented to strengthen substantially the collection of loans from university graduates.

17. In order to strengthen the expenditure control and monitoring system, and as recommended by a recent technical assistance mission of the Fund, the Budget Department of the Office of Vice President and Ministry of Finance, effective from January 1991, will start monitoring non-wage, non-pension, and non-interest commitments of the major ministries. The coverage will encompass recurrent local and foreign purchase orders and development expenditures. The Department will also ensure that the different ministries adhere to the number of authorized posts agreed with the Fund. In addition, midyear and third-quarter reviews of the budget will be conducted to facilitate the introduction of corrective measures by a review committee.

State corporations

18. In August 1990, a major effort was initiated to establish an information system and database for all state corporations, that is, to provide regularly quarterly and annual indicators of economic and financial performance. On the basis of the information collected, the Government will extend the number of monitored state corporations from 10 to 20 by December 1990. In order to improve the financial control and discipline of state corporations, the Government has further announced that it is no longer prepared to assume the defaulted foreign debt obligations of public enterprises without an investigation of the circumstances behind the payment default. For any state corporations that defaults in its foreign debt obligation, the Government will take appropriate action with respect to addressing the payments difficulties of this corporation.

Furthermore, financial data from commercial banks with respect to an initial sample of 15 state corporations (as agreed with the Fund staff) will be collected by the Office of the Vice President and Ministry of Finance, with a copy sent to the Central Bank, beginning December 1. Each commercial bank will report on outstanding credit and loan payments due to it, loan payments received each month, deposit balance, overdraft position, and level of outstanding nonperforming debt. In addition, a UNDP-funded expert has been appointed to quantify, on a quarterly basis, the level of commitments and payments of debt owed by state corporations to the Government and to categorize loans that are performing and nonperforming.

A draft policy framework paper for state corporations is under consideration and will be finalized by December 1990. This policy paper, besides setting forth the Government's policy, will facilitate designation of state corporations as either strategic or nonstrategic, and will identify candidates for privatization in 1991. Progress in the restructuring of the DFIs will be accelerated and the contracts with the six technical assistance experts on the management of assets and liabilities will be signed by December 1, 1990. Some amendments to the State Corporations Act have been proposed and will be submitted to Parliament by mid-November 1990 for ratification. Under the amended Act, the state

corporations will be required to prepare and submit to the Office of the Vice President and Ministry of Finance annual budgets and exemption from the Act will be granted only on a case-by-case basis.

19. As a part of the commitment to reduce imports and to correct external imbalances, the Office of the Vice President and Ministry of Finance has issued a Circular instructing all state corporations to cut back on self-financed imports, such as motor vehicles, acquired directly from abroad and from local sources during the remaining part of 1990 and in 1991. It will enforce the implementation of this measure through a Treasury Circular identifying the reductions, through a review by the Government Investment Division of the draft budgets of state corporations, and by the Treasury's participation on the boards of all state corporations. In this respect, the Foreign Exchange Allocation Committee, responsible for clearing foreign exchange requirements will not allow any low-priority imports of state corporations. It is estimated that these steps will reduce imports by about SDR 29 million during 1990/91 and the policy will be maintained during the remainder of 1991 to prevent a resurgence of imports by state corporations.

20. During 1989/90, the Government had taken several steps to strengthen the financial position of Kenya Airways. Toward this end, in December 1989 Kenya Airways purchased/leased two new aircraft and laid off 1,000 permanent employees in early 1990. An assessment of the financial and management operations of the airline was completed by an internationally reputable accounting firm in early 1990. Since then, a government-appointed committee has also studied the issues pertaining to the restructuring of the airline. An IDA-funded consultant has been asked to prepare an action plan for the restructuring of the airline by March 1991, to be implemented in April 1991. Purchases of aircraft in 1992 will take account of the consultant's recommendations and will be subject to prior consultations with the Fund staff. Some additional measures have been initiated to strengthen the functioning of the company. Two experts on finance have been recruited internationally, some organizational changes have been effected, a UNDP-funded project is providing training to the staff, and some routes have been rationalized.

Monetary policy

21. During the remainder of 1990, the Government will continue its reform of the financial system, with a view to improving the efficiency of resource mobilization and allocation and to broadening the range of financial instruments available to savers and investors. Interest rate liberalization will be furthered by active steps to develop a market for treasury securities. Accordingly, yields on treasury bills have been fully liberalized, effective November 15, 1990, allowing price to be set by a true and proper auction, thereby making these instruments attractive to investors. The amounts to be offered will be set in consultation with the Central Bank and take account of monetary policy considerations.

The results of each treasury bill auction will be published in Reuters, indicating the amounts to be issued and redeemed, the range of rates accepted, and the weighted average rate.

As regards treasury bonds, immediate efforts will be undertaken to establish an effective marketing and distribution system capable of broadening this market. Thus, the Central Bank will begin the flotation of bearer treasury bonds with maturities of one, two, and five years through the Post Office Savings Bank before end-November, 1990, and will also begin to issue bearer bonds denominated in foreign exchange. With the liberalization of treasury bill and bond markets, the Central Bank intends to gradually move away from quantitative credit ceilings toward open-market operations as a more efficient means of controlling monetary aggregates. To facilitate the development of short-term money markets, secondary trading in treasury securities will be encouraged. In order to enhance the effectiveness of monetary policy, nonbank financial institutions (NBFIs) will be required to reduce the current three-month lag in submitting their financial returns to the Central Bank of Kenya to no more than two months.

22. Monetary policy in the period ahead will seek to maintain growth of domestic credit and liquidity, consistent with reducing inflationary pressures, and building up of reserves. In order to ensure compliance with the limits on the expansion of credit, the additional cash deposit ratio on the amount by which banks exceed their ceiling on NDA will be maintained at 20 percent. Credit targets for the first half of 1991 will be as indicated in attached Table 1. These indicative targets, which will be reviewed at the time of the elaboration of the third annual arrangement under the ESAF in early 1991, are projected to be consistent with a stock of broad money at end-June 1991 virtually unchanged from the end-June 1990 level.

External and industrial policies

23. The weak reserve position, coupled with no expected improvement in the terms of trade, has led the Government to take strong actions to improve the payments position through the end of 1991. Most of the burden of the higher current deficit and weaker capital account in 1990 is expected to result in a drawdown of reserves. The current account deficit is estimated at 5.8 percent of GDP, compared with 7.4 percent in 1989--an improvement of 1.5 percent of GDP similar to that originally programmed--and at 4.3 percent in 1991.

The main impetus for improvement is expected to come from lower imports, both from strong restraint of direct and indirect imports by the public sector and from tight credit policies limiting private sector expenditures. Exports are expected to remain sluggish after the setback in 1989. Some improvement in the domestic competitiveness of nontraditional export production is to be achieved during 1991 from efforts to reduce domestic costs, from the continued flexible management of the exchange rate, and from the specific export incentives noted in

paragraph 7. In particular, duty exemptions on imported packaging, participation in the Export Processing Zone, and the removal of such institutional constraints as limited air freight capacity, are expected to reverse the decline in horticultural export volumes and to lead to a 10 percent growth in 1991. But the overall growth of the export sector will be dominated by weak international demand for coffee and tea, which is expected to contribute to a slackening in the volume of exports by domestic producers.

As domestic currency prices for imports are likely to continue to be high and monetary and fiscal policies constrain demand, import volumes are expected to be significantly lower than earlier anticipated. First, as a result of the increase in domestic prices of petroleum products in early September, and significant demand contraction, zero growth of oil import volumes is expected for 1990, with a 2 percent decline in the following year. Zero growth for 1990 would represent a considerable achievement given that the value of oil import approvals in the first half of the year was 24 percent higher than that for the first six months of 1989, when annual imports grew by 3.1 percent.

Second, in order to increase the efficiency of public investment as well as to reduce pressure on the payments position, the Government has taken a number of steps to ensure that expenditures by the Central Government and state corporations are consistent with the foreign exchange constraint, given long-term investment needs (as also discussed in paragraph 14); the measures being implemented should result in total savings of some SDR 116 million for 1990 and 1991.

Third, the planned leases of aircraft by Kenya Airways will not be made in 1990 and 1991, and future leases will be reconsidered in light of the restructuring report which is due in early 1991. Fourth, while the liberalization of private imports will be maintained, some restraint on still-restricted items will be exercised until full liberalization in June 1991.

With tourism continuing to grow strongly--rates of 10-11 percent in travel receipts (in SDR terms) are expected this year--the improved current account position will be largely financed by concessional official capital inflows. To reduce debt-servicing costs, commercial borrowing will be reduced, while imports contingent on some already contracted loans will be delayed where related investments do not receive priority.

To monitor the impact of these steps, and signal the need for further actions when necessary, a foreign exchange budget has been prepared with indicative quarterly ceilings on foreign exchange spending by the Central Government and state corporations, consistent with a reserve accumulation target of some SDR 200 million during 1991. Achievement of this target will bring gross foreign exchange reserves to two months of nongovernment imports by the end of the year. The Government will

monitor the movement in gross official reserves closely and in the event that the reserve position deteriorates significantly from the reserve accumulation path targeted under the programme, the Government will promptly consult with the Fund staff.

24. Most of the improvement in the payments position is expected to come from restraint on demand, particularly by the public sector. However, exchange rate policy will be combined with supportive fiscal and monetary policies to strengthen the domestic incentives for export production in conjunction with the measures taken to reduce anti-export bias. As noted above, given the current foreign exchange constraint and the need to reduce future debt-servicing costs, the Government has decided to limit the contracting of public borrowing on nonconcessional terms in 1991 to US$77.5 million (of which US$55 million is earmarked for the Nzoia Sugar Project). In the event of a serious deterioration in the external security situation, the Government intends to consult with the Fund staff to review the nonconcessional debt ceiling.

Sincerely yours,

/s/	/s/
Professor George Saitoti Vice-President and Minister of Finance	Eric C. Kotut Governor Central Bank of Kenya

Attachment: Annex

Table. Kenya: Performance Criteria and Benchmarks of the Second Annual Arrangement Under the Enhanced Structural Adjustment Facility

	1989	1990			1991	
	December actual	June actual	September 1/	December 1/ revised	March indicative target	June indicative target
Quantitative performance criteria/benchmarks			(In millions of Kenya shillings)			
Net domestic assets 2/ 3/	54,428	58,150	58,610	62,300	60,700	61,300
Net bank credit to the Government 3/ 4/	12,671	15,143	17,110	21,729	17,729	13,229
Memorandum items:						
Net bank credit to the Government in monetary survey	17,481	20,414	21,920	27,000	23,000	18,500
Less: CSFC	4,040	3,847	4,040	3,847	3,847	3,847
Less: Debt assumed from parastatals	770	1,424	770	1,424	1,424	1,424
New nonconcessional external loans or leases contracted or guaranteed by the Government 5/ (cumulative per calendar year)			(In millions of U.S. dollars)			
a. 1-15 years' maturity	167.0	71.0	155.0	150.2	77.5	77.5
b. Short-term credits of less than one year's maturity 6/	--	--	--	--	--	--
Quantitative benchmark			(In millions of SDRs)			
Minimum stock of net official international reserves 7/	-60.3	-146.6	-55.3	-240.0	-215.0	-205.0

Source: Memorandum attached to the letter of request of Kenyan authorities of March 28, 1990.

1/ Quantitative benchmarks.
2/ Net domestic assets of the banking system is broad money minus net foreign assets of the banking system.
3/ This target will be adjusted downward to the extent that net external financing of the deficit during the July 1990-June 1991 period, excluding A-in-A financing, exceeds K Sh 3,900 million, or to the extent that domestic nonbank financing exceeds K Sh 1,300 million. Such net external financing is defined to include all cash loans received by the Paymaster General's Account during this period.
4/ Net credit to the Government is net credit to the Government from the banking sector. The ceiling excludes the operations of the Cereals and Sugar Finance Corporation (CSFC) (K Sh 3,847 million), and the amount of public enterprise debt (K Sh 1,424 million) assumed by the Government by June 1990 and reclassified from outstanding private sector credit. For the purpose of the calculations of this ceiling, these amounts of K Sh 3,847 million and K Sh 1,424 million will be assumed as constant through the programme period ending June 1991.
5/ In addition to nonconcessional borrowing contracted or guaranteed by the Government, this ceiling also applies to the borrowing of all state corporations (including cases where their borrowing is associated with a "letter of awareness" from the Government), as well as leases. For the purposes of this definition, a loan or lease is nonconcessional if it has a grant equivalent of less than 25 percent. Grant equivalence shall be determined by reference to published DAC tables and is a function of the interest rate, grace period, and maturity. "Maturity" is defined as the sum of the grace period and the terms of payment. For purposes of converting new nonconcessional external loans into U.S. dollars, the U.S. dollar exchange rates cabled to the Central Bank of Kenya from the Federal Reserve Bank of New York for January 2, 1990, will be used. For 1991, this ceiling assumes that US$55 million is earmarked for the Nzoia Sugar project.
6/ Other than normal import-related credits, this limit also excludes nonguaranteed borrowing by the Coffee Board of Kenya associated with short-term trade financing.
7/ Net official international reserves are defined as the Central Bank of Kenya's foreign reserve assets (SDRs, gold, and foreign exchange holdings) plus government foreign exchange holdings with Crown Agents; plus Kenya's reserve position with IMF; less CBK liabilities to external banks; less net use of Fund resources.

KENYA - Relations with the Fund
(As of October 31, 1990)

I. Membership Status

(a) Date of membership	February 3, 1964
(b) Status	Article XIV

A. Financial Relations

II. General Department

(a) General Resources Account:

(i) Quota	SDR 142.0 million
(ii) Total Fund holdings of Kenya's currency	SDR 274.83 million (193.54 percent of quota)
(iii) Fund holdings of Kenya's currency subject to repurchase	SDR 145.04 million (102.13 percent of quota)
Of which: credit tranche	SDR 63.67 million (44.83 percent of quota)
EAR	SDR 36.63 million (25.79 percent of quota)
CFF - cereal	SDR 4.74 million (3.33 percent of quota)
CFF - export	SDR 40.00 million (28.16 percent of quota)
(iv) Reserve tranche	SDR 12.22 million (8.60 percent of quota)

Kenya - Relations with the Fund (continued)

(b) Special Disbursement Account:

(i) Structural adjustment facility	SDR 28.40 million (20 percent of quota)
(ii) Enhanced structural adjustment facility 1/	SDR 56.80 million (40 percent of quota)

III. Current or Previous Stand-By Arrangements and Special Facilities

(a) Previous arrangements:

One extended arrangement approved in July 1975, and seven stand-by arrangements approved, respectively, in November 1978, August 1979, October 1980, January 1982, March 1983, February 1985, and February 1988. Amounts range from SDR 17.25 million to SDR 241.50 million. Cumulative purchases made under these arrangements amounted to SDR 521.0 million.

(b) Special facilities:

(i) Under the compensatory financing facility for export shortfalls and cereal imports, Kenya made purchases of SDR 60.4 million (58 percent of then quota) in June 1982, SDR 37.9 million (27 percent of quota) in December 1985, and SDR 40.0 million (28 percent of quota) in October 1988.

(ii) The first annual arrangement under the structural adjustment facility became effective on February 1, 1988. The first loan of SDR 28.4 million was disbursed on February 4, 1988. The arrangement was replaced by an ESAF on May 15, 1989.

(iii) A 36-month enhanced structural adjustment facility arrangement totaling SDR 241.4 million became effective on May 15, 1989. Under the first annual arrangement loans of SDR 40.23 million each were disbursed on May 31, 1989 and November 30, 1989, respectively. Under the second annual arrangement a loan of SDR 40.23 million was disbursed on May 15, 1990.

1/ Utilization of outstanding ESAF arrangement loan comprises SDR 56.80 million from the Special Disbursement Account (SDA) and SDR 63.90 million from the ESAF Trust.

Kenya - Relations with the Fund (continued)

IV. SDR Department

(a) Net cumulative allocation - SDR 36.99 million
(b) Holdings: amount to SDR 10.86 million or 29.35 percent of net cumulative allocation

V. Administered Accounts

(a) Trust Fund Loans:

(i) Disbursed - SDR 46.91 million
(ii) Outstanding - SDR 0.18 million

(b) SFF Subsidy Account:

(i) Payments by Fund - SDR 13.84 million

(c) ESAF loans: Trust Account

(i) Disbursed - SDR 63.90 million
(ii) Outstanding - SDR 63.90 million

VI. Financial Obligations to the Fund

See text table 10.

B. Nonfinancial Relations

VII. Exchange System

Pegged to composite. At end-October 1990 the exchange rate was K Sh 23.2170 = US$1

VIII. Last Article IV Consultation

The 1990 Article IV consultation (EBS/90/64, 3/30/90, and SM/90/64, 4/16/90) was concluded by the Executive Board on April 30, 1990. The following decision was adopted:

1. The Fund takes this decision relating to Kenya's exchange measures subject to Article VIII, Section 2(a), in the light of the 1990 Article IV consultation with Kenya conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Kenya maintains restrictions on payments and transfers for current international transactions subject to Fund approval under Article VIII, Section 2(a), in the form of limits for remittances of

Kenya - Relations with the Fund (concluded)

rental income of nonresidents and of a foreign exchange budget on the basis of which licenses for nonliberalized import items are issued. In the circumstances of Kenya, the Fund grants approval for their retention until June 30, 1991, or the conclusion of the next Article IV consultation with Kenya, whichever is earlier.

Kenya is on the standard 12-month cycle for Article IV consultations.

IX. Technical Assistance

CBD: Technical assistance missions on Kenya's financial system (March and May-June 1984), on bank supervision procedures (June 1988), and on the operational aspects of monetary policy implementation (November 1988). Advisor on Open Market Operations, from CBD panel of experts, began assisting the Central Bank of Kenya in November 1989. Technical assistance mission on reserve money management (March 1990), and on capital markets development (Sept./Oct. 1990).

FAD: Technical assistance in fiscal field (1981). Technical assistance mission on public enterprises (January-February 1990). Technical assistance mission on expenditure control (April, 1990).

BUR: Technical assistance mission on money and banking statistics (November 1987).

Relations with the World Bank Group

The World Bank has a large ongoing program in Kenya. As of June 30, 1990, it had committed US$2.3 billion, of which US$1.8 billion had been fully disbursed (Table 1). Investments by IFC totaled US$146 million, of which US$128 million had been fully disbursed.

1. Agriculture

The Bank's assistance to agriculture is centered around a policy reform program supported by a quick-disbursing sector adjustment credit which was approved in June 1986. Among the components of this program are (i) measures to increase the availability and distribution of agricultural inputs (especially fertilizer); (ii) movement toward price flexibility and deregulation; (iii) rationalization of government expenditure in the sector; (iv) the divesting of some agricultural parastatals and the restructuring of others in the context of better defined policies on parastatals; and (v) improvements in agriculture credit programs.

These policy measures are complemented by ongoing investment projects in coffee rehabilitation, forestry, agriculture research, rehabilitation of animal health services and the provision of countrywide extension services.

In the near term, Bank assistance to the sector will continue to emphasize adjustment lending with a view to broadening and consolidating a policy framework that is conducive to a more vigorous contribution to economic growth. Investment lending will continue to complement the policy reforms with greater attention being given to extension support and to implementing the results from pilot projects in the areas of agriculture credit, livestock development, land and environmental management and arid and semiarid agricultural techniques. The Bank is currently developing and testing new methodologies or approaches in these areas in order to ensure replicability before embarking on large-scale national investments.

2. Energy

The Bank's efforts in this sector are concentrating on lessening Kenya's dependence on imported oil through hydroelectric development, geothermal development, and petroleum exploration promotion. While future lending will be consistent with the least cost recommendations of the recently completed power study, greater attention will be focused on alleviating policy constraints (e.g., pricing and distribution) to attain a more efficient and integrated energy sector.

Kenya - Relations with the World Bank Group (continued)

Table 1. The Status of Bank Group Operations in Kenya

A. Statement of Bank Loans and IDA Credits as of June 30, 1990

Amount (less cancellations)

(In millions of U.S. dollars)

Loan or Credit No.	Fiscal Year	Borrower	Purpose	Bank	IDA	Undisbursed
Forty one (41) loans and forty-one (41) credits fully disbursed Of which: SECALs, SALs and program loans 1/				826.82	633.65	—
Cr. A021	1986	Kenya	Agriculture Sector	--	40.00	—
Cr. 1717	1986	Kenya	Agriculture Sector	--	20.00	--
Cr. A036	1988	Kenya	Industrial Sector Operation	--	10.00	—
			Subtotal	—	70.00	--
Cr. 1927-0 2/	1988	Kenya	Industrial Sector Operation	--	102.00	—
Cr. 1927-1 2/	1989	Kenya	Industrial Sctor Operation	--	53.70	--
Cr. 2049-0 2/	1989	Kenya	Financial Sector Operation	--	120.00	52.82
Cr. 2049-1 2/	1990	Kenya	Financial Sector Operation	--	44.00	--
Cr. 1107	1981	Kenya	Fifth Education	—	40.00	9.79
Ln. 2098	1982	Kenya	Forestry III	11.50	--	2.93
Cr. 1237	1982	Kenya	Cotton Processing and Marketing	--	22.00	2.36
Cr. 1238	1982	Kenya	Integrated Rural Health and Family Planning	--	23.00	6.61
Cr. 1387	1983	Kenya	National Extension	--	15.00	6.23
Ln. 2319	1983	Kenya	Secondary Towns	0.02	—	—
Cr. 1390	1983	Kenya	Secondary Towns	--	22.00	11.68
Ln. 2359	1984	Kenya	Kiambere Hydroelectric	80.00	--	2.32
Ln. 2409	1984	Kenya	Second Highway Sector	5.00	--	3.31
Cr. F017	1984	Kenya	Second Highway Sector	--	40.00	33.54
Cr. 1486	1984	Kenya	Geothermal Exploration	--	24.50	0.28
Cr. 1566	1985	Kenya	Water Engineering	--	6.00	1.12
Ln. 2574	1985	Kenya	Third Telecommunications	17.60	--	3.60
Cr. 1673	1986	Kenya	Sixth Education	—	37.50	31.57
Cr. 1675	1986	Kenya	Petroleum Exploration Technical Assistance	--	6.00	2.95
Cr. 1718	1986	Kenya	Agricultural Sector Management	--	11.50	4.78
Cr. 1738	1987	Kenya	KIE 2nd Small Scale Industry	—	6.00	6.45
Cr. 1758	1987	Kenya	Animal Health Services	--	15.00	13.99
Cr. 1820	1987	Kenya	Second Railway	—	28.00	12.56
Cr. 1849	1988	Kenya	Agriculture Research	—	19.60	18.89
Cr. 1904	1988	Kenya	Population III	—	12.20	10.90
Cr. 1973	1989	Kenya	Geothermal Development	--	40.70	33.27
Cr. 1974	1989	Kenya	Rural Services	--	20.80	16.62
Cr. 2058	1990	Kenya	TA	--	5.00	4.86
Cr. 2060	1990	Kenya	Third Nairobi Water Supply Project	—	64.80	59.94
Cr. 2062 3/	1990	Kenya	Coffee II	—	46.80	48.32
Cr. 2011 3/	1990	Kenya	Population IV		35.00	34.82
Cr. 2147 3/	1990	Kenya	TA-DFI Res/Exp. Prom		6.00	6.22
			Total	940.94	1,345.05	442.73
			Of which: repaid	355.43	19.06	--
			Total held by Bank and IDA	585.51	1,325.99	—
			Amount sold 11.74	11.74	--	--
			Of which: repaid 11.74	11.74	--	—
			Total undisbursed			442.73

Source: The World Bank.

1/ Approved after FY80.
2/ SAL, SECAL or Program Loan.
3/ Not yet effective.

Kenya - Relations with the World Bank (continued)

Table 1. The Status of Bank Group Operations in Kenya (concluded)

B. Statement of IFC Investments in Kenya as of June 30, 1990

Fiscal Year	Obligor	Type of Business	Amount in Millions of U.S. Dollars		
			Loan	Equity	Total
1967) 1968) 1973)	Kenya Hotel Properties	Hotels	5.2	0.7	5.9
1970) 1974) 1977) 1979) 1981) 1988) 1989)	Pan African Paper Mills	Pulp and Paper	40.7	6.3	47.0
1972	Tourism Promotion Services	Hotels	2.4	-- 1/	2.4
1976	Rift Valley Textiles Limited	Textiles	6.3	2.8	9.1
1977	Kenya Commercial Bank Limited	Capital Market	2.0	--	2.0
1980)) 1984)	Development Finance Company of Kenya Limited	Development Finance	5.1	1.3	6.4
1981	Kenya Commercial Finance	Money and Capital Market	5.0	--	5.0
1982	Bamburi Portland Cement Company Limited	Cement and Construction Material	4.4	--	4.[illegible]
1982	Diamond Trust of Kenya Limited	Money and Capital Market	--	0.8	0.8
1982)) 1987)	Industrial Promotion Services (Kenya) Limited	Money and Capital Market	--	2.0	2.0
1983	Tetra Pak Converters Limited	Pulp and Paper Products	2.2	0.4	2.6
1984	Leather Industries of Kenya Limited	Tanning	2.1	0.6	2.7
1986	Madhu Paper International Limited	Pulp and Paper Products	37.1	2.0	39.1
1986	Equatorial Beach Properties	Tourism	5.6	--	5.6
1986	Oil Crop Development Limited		9.7	1.4	11.1
	Total gross commitments		127.8	18.3	146.1
	Less cancellations, terminations, repayments and sales		92.9	9.0	101.9
	Total commitments now held by IFC		34.9	9.3	44.2
	Total undisbursed		6.0	1.2	7.2

Source: The World Bank.

1/ US$44,937.

Kenya - Relations with the World Bank Group (continued)

3. Industry/finance

Until recently, Kenya's industry has obtained World Bank lending through development finance intermediaries. In support of an industrial reform program, IDA approved an industrial sector adjustment credit for US$112 million in June 1988. An additional US$53.7 million was subsequently provided for this operation. In order to stimulate investment, promote export production, and make industries more efficient, the reform program covered areas such as trade liberalization, tariffs, price controls, export promotion, corporate taxation, financial sector policies, and industrial public enterprises. A complementary financial sector adjustment operation is currently being implemented. It addresses inter alia interest rate reforms, rationalization of the banking regulatory framework, restructuring of depository institutions, and the development of capital and money markets. Meanwhile, a more sharply focused export development program is under preparation.

4. Infrastructure

Highway projects and the promotion of railways have accounted for most of the lending to date. A major water supply project for Nairobi was approved by the Board in 1990. In addition, the Bank is preparing an urban development project whose main feature will be to enhance the financing and management capacity of municipal authorities.

5. Population

The third IDA-financed project to help the Government promote fertility control was approved in 1988 and is now being implemented. To help meet the growing demand for contraceptives and maintain the momentum of recent progress, IDA approved a fourth Population Project in 1990.

6. Education and health

The Bank's attention is currently directed at developing viable financing and management capacity in both sectors. Lending operations designed to promote more efficient utilization of resources and to implement appropriate mechanisms to increase cost sharing are being prepared.

7. Adjustment lending

The World Bank negotiated and fully disbursed two structural adjustment loans (SAL) to Kenya. The first, negotiated in March 1980, was for US$70 million and was fully disbursed by September 1980. The second, negotiated in July 1982 for SDR 130 million, was disbursed in two tranches: in September 1982 and January 1984. The SAL programs were implemented under adverse external circumstances which negatively affected Kenya's performance. The protracted balance of payments crises of 1981 and 1982, as well as the coup attempt in August 1982, forced

Kenya - Relations with the World Bank Group (concluded)

adjustments in the Government's policies and led to delays and reversals in policy initiatives included in the SAL programs. The speed of implementation was also affected by a shortage of technical personnel and the preoccupation of the authorities with short-term stabilization efforts.

It has been agreed between the Bank and the Government that, for the near future, Bank financial support for the Government's structural adjustment efforts will take the form of sector adjustment credits rather than the comprehensive SAL. Sector adjustment credits in agriculture and industry have been completed and fully disbursed. Further sector adjustment operations are planned in agriculture, export development, education, and health.

Kenya--Selected Social and Demographic Indicators 1/

Area	
Total land area (square kilometers)	580,000
Population and vital statistics	
Total population (mid-1988, in millions)	22.4
Population growth rate (1980-1988 average, in percent)	3.8
Urban population (percent of total)	22
Population density (per sq. km.)	38.6
Population age structure (in percent)	
0-14 years	50.9
15-64 years	46.1
65 and above	3
Crude birth rate (per thousand)	47
Crude death rate (per thousand)	11
Infant mortality rate (per thousand)	70
Life expectancy at birth (years)	59
Health and nutrition	
Access to safe water (in percent of population)	
Urban	61
Rural	21
Population per physician (in thousands) (1984)	10
Per capita supply of	
Calories (per day)	2,060
Proteins (grams per day)	58
Labor force	
Total wage employment (in millions)	1.3
Participation rate (in percent)	
Total	17.9
Male	13.8
Female	4.1
Education	
Enrollment rates (in percent)	
Primary	96
Secondary	23
Teacher-pupil ratio	
Primary (1989)	33
Secondary (1989)	23

Source: The World Bank, World Development Report, 1990.

1/ Unless otherwise mentioned, estimates refer to the latest available data for 1988.

Kenya, 1794

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

EBS/89/196

CONFIDENTIAL

October 16, 1989

To: Members of the Executive Board

From: The Secretary

Subject: Kenya - Midterm Review of the First Annual Arrangement Under the Enhanced Structural Adjustment Facility

Attached for consideration by the Executive Directors is the staff report for the midterm review under the first annual arrangement under the enhanced structural adjustment facility for Kenya, which will be brought to the agenda for discussion on a date to be announced. A draft decision appears on page 26.

Mr. Heller (ext. 8353) or Ms. Calika (ext. 6948) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

KENYA

Staff Report for the Midterm Review of the First Annual Arrangement Under the Enhanced Structural Adjustment Facility

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 Mamoudou Touré and A. Basu

October 13, 1989

I. Introduction

On May 15, 1989, the Fund approved for Kenya a three-year arrangement under the enhanced structural adjustment facility (ESAF), in support of an economic and financial program covering the calendar years 1989-91, and the first annual arrangement thereunder, in support of the program for 1989 (EBS/89/84, 4/27/89). Total access under the ESAF arrangement, which replaced Kenya's arrangement under the structural adjustment facility (SAF) and the 18-month stand-by arrangement (canceled at the request of the authorities), is equivalent to SDR 241.4 million (170 percent of Kenya's quota), with annual access amounting to SDR 80.5 million (56.7 percent of quota) under each of the three annual arrangements. The first semiannual disbursement equivalent to SDR 40.2 million was made on May 31, 1989, and the second semiannual disbursement will be available after October 31, 1989, subject to compliance with the end-September 1989 performance criteria and completion of the midterm review.

The discussions on the midterm review of the first annual arrangement under the ESAF were conducted by a staff mission that visited Nairobi during August 28-September 11, 1989. 1/ In the attached letter to the Managing Director from the Vice President and Minister for Finance and the Governor of the Central Bank dated September 26, 1989 (Appendix I), the authorities review progress in policy implementation

---

1/ The mission comprised Mr. P.S. Heller (head-AFR), Ms. J. Horne (FAD), Ms. N. Calika (AFR), Mr. R. Feldman (ETR), Mr. J. Hiwatashi (AFR), and Mrs. L. Duffield-Sorkowitz (secretary-ETR). Mr. E.L. Bornemann (AFR) joined the mission during the second week. Mr. T. Allen from the World Bank mission in Nairobi participated in some of the discussions.

under the first annual ESAF arrangement and economic and financial developments through September 1989, and describe the policies that they intend to pursue for the remainder of the year.

As of September 30, 1989 total Fund credit outstanding to Kenya was equivalent to SDR 305.7 million, or 215.3 percent of quota (Table 1). Taking account of scheduled repurchases and the prospective second semiannual disbursement under the ESAF, total outstanding Fund credit at end-December 1989 would amount to SDR 314.5 million, or 221.5 percent of quota. By end-December 1991, when all the disbursements under the three-year ESAF arrangement would have taken place, total outstanding Fund credit would amount to SDR 370.1 million, or 260.6 percent of quota.

Summaries of Kenya's relations with the Fund and the World Bank Group are presented in Appendices II and III, respectively.

II. Background

In the face of deteriorating financial and economic conditions, in late 1987 Kenya adopted a major stabilization and structural adjustment program. The program, which was supported by an 18-month stand-by arrangement and arrangements under the SAF (both of which became effective on February 1, 1988), aimed at maintaining the real growth rate, containing the rate of inflation, and reducing the current account deficit to a sustainable level. To attain these objectives, the Kenyan Government adopted a tight fiscal and monetary stance and initiated a flexible exchange rate policy, as well as a phased introduction of structural reforms in agriculture, industry, the financial sector, public enterprises, and government expenditure policy. The major elements of the adjustment program were successfully implemented during 1988 and, as a consequence, the objectives of the program with regard to growth, financial stability, and the external sector were to a large extent achieved (Table 2). 1/

In early 1989 the Kenyan authorities requested support under arrangements under the ESAF for their 1989-91 program, which was designed to broaden and reinforce the adjustment process. 2/ The program aims to achieve a real GDP growth rate higher than the population growth rate, to reduce the rate of inflation to the average of Kenya's main trading partners, to curtail substantially the external current account deficit, and to build up Kenya's net official inter-

---

1/ For details see Staff Report for the 1989 Article IV Consultation and Request for Arrangements Under the Enhanced Structural Adjustment Facility (EBS/89/84, 4/27/89).

2/ For details see EBS/89/84 (4/27/89) and Enhanced Structural Adjustment Facility Policy Framework Paper for 1989-91 (EBD/89/123, 4/26/89).

Table 1. Kenya: Use of Fund Credit, September 1989-December 1991

	Outstanding Sept. 30, 1989	1989 Oct.-Dec.	1990 Jan.-March	1990 April-June	1990 July-Sept.	1990 Oct.-Dec.	1991 Jan.-March	1991 April-June	1991 July-Sept.	1991 Oct.-Dec.
					(In millions of SDRs)					
Total transactions (net)		8.82	-19.25	15.12	28.61	-20.26	35.48	-8.29	31.56	-7.38
Transactions under tranche policies (net)		-26.67	-14.51	-20.38	-6.89	-15.52	-4.76	-8.29	-8.67	-7.38
Repurchases		26.67	14.51	20.38	6.89	15.52	4.76	8.29	8.67	7.38
Ordinary resources		(5.33)	(5.33)	(3.46)	(2.13)	(2.13)	(—)	(1.96)	(3.91)	(3.91)
Borrowed resources		(21.34)	(9.19)	(16.91)	(4.76)	(13.39)	(4.76)	(6.34)	(4.76)	(3.46)
Transactions under special facilities (net)		-4.74	-4.74	-4.74	-4.74	-4.74	—	—	—	—
CFF (net)		(-4.74)	(-4.74)	(-4.74)	(-4.74)	(-4.74)	(—)	(—)	(—)	(—)
ESAF loans		40.23	—	40.23	40.23	—	40.23	—	40.23	—
Total Fund credit outstanding 1/	305.65	314.48	295.23	310.35	338.96	318.70	354.18	345.89	377.45	370.07
Under tranche policies	(173.33)	(146.66)	(132.15)	(111.77)	(104.88)	(89.36)	(84.60)	(76.31)	(67.64)	(60.27)
Under special facilities	(63.69)	(58.95)	(54.21)	(49.48)	(44.74)	(40.00)	(40.00)	(40.00)	(40.00)	(40.00)
Under SAF	(28.40)	(28.40)	(28.40)	(28.40)	(28.40)	(28.40)	(28.40)	(28.40)	(28.40)	(28.40)
Under ESAF 1/	(40.23)	(80.47)	(80.47)	(120.70)	(160.93)	(160.93)	(201.17)	(201.17)	(241.40)	(241.40)
					(As percent of quota)					
Total Fund credit outstanding 1/	215.25	221.46	207.91	218.56	238.70	224.44	249.42	243.58	265.81	260.62
Under tranche policies	(122.07)	(103.28)	(93.06)	(78.71)	(73.86)	(62.93)	(59.58)	(53.74)	(47.63)	(42.44)
Under special facilities	(44.85)	(41.51)	(38.18)	(34.85)	(31.51)	(28.17)	(28.17)	(28.17)	(28.17)	(28.17)
Under SAF	(20.00)	(20.00)	(20.00)	(20.00)	(20.00)	(20.00)	(20.00)	(20.00)	(20.00)	(20.00)
Under ESAF 1/	(28.33)	(56.67)	(56.67)	(85.00)	(113.33)	(113.33)	(141.67)	(141.67)	(170.00)	(170.00)

Sources: IMF, Treasurer's Department; and staff estimates.

1/ Includes use of ESAF Trust resources.

Table 2. Kenya: Selected Economic and Financial Indicators, 1985-90 1/

	1985	1986	1987	1988	1989		1990	
					Program 2/	Projection	Program 2/	Revised program
	(Annual percent changes, unless otherwise specified)							
National income and prices								
GDP at constant prices	4.9	5.5	4.8	5.2	5.1	4.9	5.2	5.2
GDP deflator	9.3	9.3	6.1	9.7	7.2	8.2	6.5	6.5
Consumer prices	10.5	4.3	6.6	10.4	8.0	8.8	7.5	7.5
External sector (on the basis of SDRs)								
Exports, f.o.b.	-8.0	7.5	-29.7	7.8	8.8	4.0	5.5	13.0
Imports, c.i.f.	-4.4	-0.8	1.5	6.9	4.1	7.6	4.7	4.2
Non-oil imports, c.i.f.	-6.3	18.7	0.7	13.1	2.8	6.0	4.4	3.4
Export volume	4.2	15.2	-3.5	5.5	5.7	6.4	4.5	7.9
Import volume	-7.5	17.4	5.0	12.3	—	1.3	1.8	0.7
Terms of trade (deterioration -)	-16.4	12.0	-17.5	3.5	-1.1	-8.0	-1.9	1.3
Nominal effective exchange rate (depreciation -) 3/	-16.9	-6.7	-15.8	-7.3	...	-6.6	...	...
Real effective exchange rate (depreciation -) 3/	-11.9	-4.4	-13.0	-2.2	...	-4.9	...	...
Government budget 4/								
Revenue and grants	15.0	16.7	20.3	16.5	13.8	18.3	12.5	11.7
Total expenditure	15.7	24.5	0.2	20.0	12.6	18.8	10.5	9.8
Money and credit								
Domestic credit	12.5	29.0	20.5	7.2	10.3	10.3	8.3	5.3
Government	10.2	53.7	29.7	-6.7	13.3	17.4	1.6	-6.6
Other sectors	13.6	17.7	14.9	16.7	8.7	6.4	12.1	12.4
Money and quasi-money (M2)	10.2	27.6	12.4	8.3	11.6	11.6	12.0	8.4
Velocity (GDP relative to M2) 5/	3.5	3.2	3.2	3.5	3.4	3.5	3.4	3.6
Interest rate (annual rate) 5/								
Savings deposit (minimum)	11.0	11.0	11.0	10.0	...	12.5	...	...
Average time deposit	11.5	11.5	9.8	12.4	...	...	...	...
Maximum lending rate	14.0	14.0	14.0	15.0	...	18.0	...	...
	(In percent of GDP)							
Government budget 4/								
Revenue and grants	23.4	23.9	25.1	25.5	26.6	26.7	26.9	26.8
Total expenditure	29.5	32.1	28.0	29.3	30.8	30.9	30.6	30.5
Overall deficit 6/								
Including grants	5.4	7.6	4.0	3.9	4.2	4.2	3.7	3.7
Excluding grants	6.4	8.9	6.1	6.1	6.7	6.8	6.3	6.4
Domestic bank financing	1.8	4.8	-0.1	0.1	0.6	0.6	0.4	0.4
Nonbank financing	4.5	2.4	3.0	0.9	0.5	0.5	0.6	0.6
Foreign financing	-0.9	0.4	1.1	2.8	2.5	3.1	2.0	1.7
Financing gap	—	—	—	—	0.6	—	0.7	0.9
Gross domestic investment	25.8	18.8	24.8	25.6	24.3	25.7	24.7	25.7
Gross domestic savings	24.8	18.9	19.7	20.5	20.1	20.1	20.9	21.4
External current account deficit								
Including grants	1.5	0.5	6.3	5.3	4.0	5.5	3.7	4.1
Excluding grants	3.3	2.5	8.1	8.3	7.0	8.8	6.6	7.4
External debt								
External debt inclusive of Fund credit	51	54	56	59	58	58	62	64
Debt service ratio 7/	29	29	34	29	30	31	28	28
Interest payments 7/	11	11	12	12	11	11	10	10
	(In millions of SDRs, unless otherwise specified)							
Overall balance of payments	-91	76	-76	-43	8	57	-38	-47
Additional financing requirement	—	—	—	—	50	—	83	93
Gross official reserves (months of imports) 8/	3.4	3.7	2.1	2.1	2.3	2.2	2.6	2.5
External payments arrears	—	—	—	—	—	—	—	—

Sources: Data provided by the Kenyan authorities; and staff estimates.

1/ The data reflects revised GDP figures starting with 1985. The revisions had the impact of changing nominal GDP at market prices by +1.6 percent in 1985, +0.2 percent in 1986, -0.8 percent in 1987, +1.9 percent in 1988, and +2.6 percent each in 1989 and 1990.

2/ As shown in EBS/89/84.

3/ December-to-December variations; for 1989, December 1988 to August 1989 variation.

4/ Fiscal year beginning July 1.

5/ Level in percent.

6/ Figures do not add up because of adjustment to cash basis.

7/ In percent of exports of goods, nonfactor services, and private transfers.

8/ In months of nongovernment imports.

national reserves. To attain these targets, the program for 1989-91 stresses further tightening of the fiscal stance, tackling structural issues related to the budget, implementing a financial sector restructuring program and key reforms in the trade and industrial sectors, and pursuing flexible exchange and interest rate policies, as well as other market-oriented domestic policies. The reforms in the financial and industrial sectors are also being supported by the IDA through sector adjustment credits 1/ and by cofinancing by other multilateral and bilateral donors.

Within the context of the program's overall medium-term objectives, the first annual program under the ESAF targeted a rate of growth of 5.1 percent in real GDP, deceleration in the rate of inflation to 8 percent (from 10.4 percent in 1988), a reduction in the external current account deficit (including official transfers) to 4.0 percent (from 4.5 percent in 1988), and a buildup of SDR 58 million in net official international reserves.

III. Program Implementation in 1988/89

In 1989 considerable progress has been made in implementing the program, which remains essentially on track. The quantitative and structural benchmarks for June 1989 were observed, in some cases by a wide margin (Table 3).

After a rise of 5.2 percent in real terms in 1988, owing primarily to favorable weather conditions and the impact of the agricultural structural measures implemented over the last few years, the real GDP growth rate in 1989 is expected to decelerate slightly, reflecting less favorable weather conditions at the beginning of 1989, lower-than-anticipated coffee production, and higher oil prices. During the first half of 1989 the inflation rate exceeded 10 percent, considerably above the target of 8 percent for end-1989, owing to increases in producer and consumer prices early in the year and a somewhat-greater-than-expected growth in broad money.

The overall budget deficit on a cash basis in 1988/89 (July/June), at 3.9 percent of GDP, was well below the 4.5 percent target (4.4 percent in terms of revised GDP) 2/ originally programmed (Table 4).

1/ The Industrial Sector Adjustment Credit (ISAC) was approved by the World Bank in mid-1988 for US$112 million, and the Financial Sector Adjustment Credit (FSAC) and Financial Sector Technical Credit (FSTC) were approved in mid-1989 for US$125 million.

2/ The Kenyan authorities have revised their GDP figures for the past several years. As a consequence, the current GDP figure for 1988/89 is 2.3 percent higher than initially estimated. In the remainder of this paper, program targets in terms of GDP are (unless stated otherwise) those presented in EBS/89/84 and do not reflect the revised GDP figures.

Table 3. Kenya: Performance Under the First Annual Arrangement Under the Enhanced Structural Adjustment Facility

	1989 June
	(In millions of Kenya shillings)
Quantitative benchmarks	
Total domestic credit 1/	
Ceiling	55,044
Actual	52,422
Net bank credit to the Government 2/	
Ceiling	15,620
Banking system	(19,321)
CSFC	(-3,701)
Actual	13,670
Banking system	(17,510)
CSFC	(-3,840)
	(In millions of U.S. dollars)
New nonconcessional external loans contracted or guaranteed by the Government 3/ (cumulative per calendar year)	
a. 1-12 years' maturity	
Ceiling	100.0
Actual	56.4
b. Short-term credits of less than one year's maturity 4/	
Ceiling	--
Actual	--
Minimum cumulative increase in net official international reserves from end-December 1988 5/	(In millions of SDRs)
Benchmark	42
Actual	80
Structural benchmarks	**Status**
Implement the import liberalization program and provide on monthly basis, data on import license applications, approvals, and corresponding foreign exchange allocation by end-September 1989.	Done
Adopt fiscal measures, including user charges in health, education, and other sectors beginning July 1989.	On target
Confine the growth of the Government's personnel wage bill to 7.5 percent beginning July 1989.	On target
Maintain positive real interest rates throughout 1989.	On target

Sources: Memorandum of economic and financial policies attached to the letter of April 18, 1989; letter of intent dated September 26, 1989; and data provided by the Central Bank of Kenya and the Ministry of Finance.

1/ Total domestic credit of the banking system is the sum of net credit to the Government, other public sector credit, and private sector credit. It includes bank credit utilized by the Cereals and Sugar Finance Corporation (CSFC).

2/ Net credit to the Government is net credit to the Government from the banking sector. The ceiling excludes the operations of the CSFC.

3/ In conformity with existing regulations, no public enterprise will borrow on nonconcessional terms without government guarantee.

4/ Other than related to imports.

5/ Net official international reserves are defined as the Central Bank of Kenya's net foreign reserve assets (SDRs, gold, and foreign exchange holdings) minus its short-term deposit liabilities to foreigners; plus the Central Government's net foreign reserve assets (excluding those related to Fund transactions); plus Kenya's reserve position in the Fund; minus Kenya's net use of Fund credit.

Table 4. Kenya: Government Finances, 1986/87-1989/90

	1986/87	1987/88 Prelim. Actuals	1988/89 Program 1/	1988/89 Prelim. Actuals	1989/90 Program 1/	1989/90 Revised Program
	(In millions of Kenya shillings)					
Revenue and grants	29,614	35,637	41,816	41,506	47,591	49,118
Revenue	27,999	32,710	37,980	37,892	43,073	44,219
Grants	1,615	2,927	3,836	3,614	4,518	4,899
Expenditure and net lending	39,755	39,815	48,967	47,768	55,117	56,765
Recurrent expenditure	29,511	30,646 2/	37,040	36,426	41,588	42,719
Of which: wage bill	(9,874)	(11,508)	(12,632)	(13,352)	(13,579)	(14,353)
Development expenditure and net lending	10,244	9,169 2/	11,927	11,342	13,529	14,046
Overall deficit (treasury accounts)	-10,141	-4,178	-7,151	-6,262	-7,526	-7,647
Adjustment to cash basis 3/	716	-1,505 4/	—	-58 5/	—	—
Overall cash deficit	-9,425	-5,683	-7,151	-6,320	-7,526	-7,647
Financing	9,425	5,683	7,151	6,320	6,529	7,647
Foreign financing	542	1,522	3,893	4,567	4,560	5,626
Domestic financing	8,883	4,161	3,258	1,753	1,969	2,021
Of which: banking system and CSFC	(5,923)	(-78)	(2,200)	(219)	(1,074)	(1,102)
Financing gap	—	—	—	—	997	—
Overall cash deficit (excluding grants)	-11,040	-8,610	-10,987	-9,876	-12,044	-12,546
	(In percent of GDP)					
Memorandum items:						
Revenue and grants	23.9	25.1	26.2	25.5	26.6	26.7
Revenue	22.6	23.0	23.8	23.2	24.1	24.1
Grants	1.3	2.1	2.4	2.2	2.5	2.7
Expenditure and net lending	32.1	28.0	30.7	29.3	30.8	30.9
Recurrent expenditure	23.8	21.6	23.2	22.3	23.2	23.3
Of which: wage bill	(8.0)	(8.1)	(7.9)	(8.2)	(7.6)	(7.8)
Development expenditure and net lending	8.3	6.5	7.5	6.9	7.6	7.6
Overall cash deficit	-7.6	-4.0	-4.5	-3.9	-4.2	-4.2
Overall cash deficit (excluding grants)	-8.9	-6.1	-6.9	-6.1	-6.7	-6.8
Foreign financing	0.4	1.1	2.4	2.8	2.5	3.1
Domestic financing	7.2	2.9	2.0	1.1	1.1	1.1
Of which: banking system and CSFC	(4.8)	(-0.1)	(1.4)	(0.1)	(0.6)	(0.6)
Financing gap	—	—	—	—	0.6	—

Sources: Data provided by the Kenyan authorities; and staff estimates.

1/ As presented in EBS/89/84 (4/27/89), as revised program.

2/ Excludes an estimated amount of K Sh 2,000 million in recurrent and development expenditures, for which the issue of checks had been delayed into 1988/89.

3/ The adjustment factor arises partly because financing data are derived from sources other than revenue and expenditure data. It also includes a float element resulting from differences between checks issued and checks cashed and statistical discrepancies.

4/ Includes the counterpart to the reduction in the check float of K Sh 1,700 million during 1987/88.

5/ Includes an estimated increase in the check float of K Sh 1,840 million during 1988/89.

Excluding grants, the deficit remained at its 1987/88 level of 6.1 percent of GDP, rather than the 6.9 percent originally targeted. The fiscal outcome reflected primarily a better-than-programmed performance of both recurrent and development outlays, with total expenditures remaining at K Sh 1.2 billion (0.7 percent of revised GDP) less than previously anticipated. The preliminary data indicate that while recurrent expenditure was about K Sh 600 million (0.4 percent of GDP) below its programmed level, the projected wage bill was higher by about K Sh 720 million (owing to more-than-anticipated wage increases), implying a growth of 16 percent, well above the projected growth of 9.8 percent. Total revenue was slightly below the program target, reflecting mainly lower-than-programmed receipts from import duties and from the sales tax on imports.

Financing of the deficit was largely from external and domestic nonbank sources. Net foreign financing amounted to K Sh 4.6 billion (2.8 percent of GDP), compared with K Sh 3.9 billion in the program, while the bulk of the K Sh 1.8 billion in domestic financing, in contrast to the program, was from nonbank sources. Net bank credit to the Government at end-June 1989 was about K Sh 400 million above its June 1988 level (1.0 percent of the beginning-of-period broad money stock), compared with the programmed increase of K Sh 2.2 billion (5.5 percent of beginning broad money) (Table 5). As a result, bank financing of the deficit (excluding the Cereals and Sugar Finance Corporation) was K Sh 2.0 billion (1.2 percent of GDP) below the end-June 1989 program benchmark. As in the previous fiscal year, this development was largely due to the authorities' postponement of cash payments toward year-end, as reflected in a buildup of K Sh 1.8 billion in the stock of unpresented checks at end-June 1989.

During 1988/89, total domestic credit rose by only 8.3 percent, in sharp contrast to the programmed 13.7 percent. As a consequence, total domestic credit at end-June 1989 was K Sh 2.6 billion below the programmed ceiling. During the fiscal year ended June 1989, net credit to the Government expanded by 2.3 percent compared with 12.8 percent in the program, and credit to the nongovernment sector rose by 11.6 percent instead of the targeted 14.2 percent. As a result, net domestic assets rose during the year by 1 percent less than the 15.2 percent in the program. Broad money, however, increased in 1988/89 by 17.8 percent, more than the 17.0 percent programmed, reflecting a higher-than-projected increase in net foreign assets.

In the external sector, the current account deficit in 1988 narrowed to 5.3 percent of GDP from 6.3 percent in the previous year, as the deterioration in the merchandise trade deficit was more than offset

Table 5. Kenya: Monetary Survey, June 1985-June 1990 1/

	1985 June	1985 Dec.	1986 June	1986 Dec.	1987 June	1987 Dec.	1988 March	1988 June	1988 Sept.	1988 Dec.	1989 March Actual	1989 June Prog. 2/	1989 June Actual	1989 Sept. Program 2/	1989 Dec. Program 2/	1990 March Prog. 3/	1990 June Prog. 2/	1990 June Prog. 3/
	Actual																	
(In millions of Kenya shillings)																		
Net foreign assets	-427	-1,759	-408	-255	-759	-2,367	-2,590	-3,143	-3,327	-3,627	-2,517	-2,921	-2,162	-3,132	-2,691	-1,181	-1,465	-1,464
Total domestic credit	28,113	31,600	34,259	40,775	43,916	49,114	48,063	48,401	49,337	52,666	51,636	55,044	52,422	56,897	58,080	57,371	59,432	57,712
Government (net)	8,108	9,954	10,728	15,301	17,109	19,846	17,717	17,121	16,889	18,512	17,775	19,321	17,510	21,891	21,741	20,241	21,165	19,382
Other	20,005	21,645	23,532	25,474	26,807	29,268	30,346	31,280	32,448	34,154	33,861	35,723	34,912	35,006	36,339	37,130	38,267	38,330
Other items (net)	-1,847	-1,438	-2,374	-4,289	-4,911	-6,013	-4,836	-5,469	-5,520	-4,944	-3,341	-5,579	-3,386	-5,583	-6,197	-5,563	-5,698	-5,510
Money and quasi-money	25,838	28,404	31,477	36,230	38,246	40,734	40,637	39,788	40,489	44,095	45,778	46,544	46,875	48,182	49,192	50,627	52,269	50,738
(Annual change in percent)																		
Total domestic credit	12.3	12.5	21.9	29.0	28.2	20.5	11.2	10.2	2.7	7.2	7.4	13.7	8.3	15.3	10.3	11.1	...	10.1
Government (net)	12.7	10.2	32.3	53.7	59.5	29.7	6.0	0.1	-15.3	-6.7	0.3	12.8	2.3	29.6	17.4	13.9	...	10.7
Other	12.2	13.6	17.6	17.7	13.9	14.9	14.5	16.7	15.6	16.7	11.6	14.2	11.6	7.9	6.4	9.7	...	9.8
Money and quasi-money	11.7	10.2	21.8	27.6	21.5	12.4	7.3	4.0	2.2	8.3	12.7	17.0	17.8	19.0	11.6	10.6	...	8.2
Velocity	3.63	3.52	3.44	3.23	3.24	3.22	3.36	3.57	3.64	3.46	3.45	3.50	3.48	3.49	3.52	3.53	...	3.62

Sources: Central Bank of Kenya; and staff estimates.

1/ The claims of the National Bank of Kenya on the public entities and the private sector guaranteed by the Government are shown beginning in June 1988 as part of credit to the nongovernment sector. Before that date they were shown as part of credit to the Government. Beginning September 1989, net credit to Government includes K Sh 770 million debt of public enterprises that was assumed by the Government; previously this debt was classified under outstanding credit of the nongovernment sector.

2/ As presented in EBS/89/84 with the exceptions that the distribution of credit between the Government and the nongovernment sectors has been revised to reflect the change introduced in September 1989 described in footnote 1, and also the revised GDP figures.

3/ EBS/89/84 did not contain program figures for March 1990; the June 1990 figures reflect revised program targets.

by higher, mostly official, transfers (Table 6). 1/ Net services were essentially unchanged. The overall balance of payments deficit was about half the size of the previous year's deficit. Gross foreign reserves rose by SDR 20 million in 1988, while net international reserves fell by SDR 43 million; net credit from the Fund was SDR 64 million, which included a purchase in October 1988 equivalent to SDR 40 million under the compensatory financing provisions of the CCFF. 2/

During the first half of 1989, external sector policies were in line with the program. The exchange rate was flexibly managed, depreciating by 2.7 percent in real effective terms during this period, compared with 2.2 percent in calendar year 1988 (Chart 1). Official external borrowing on nonconcessional terms was reported to have been confined during the first half of 1989 to US$56.4 million for loans in the 1- to 12-year maturity range. The available trade data for the first half of the year suggest that the growth in receipts from tourism and "other exports," 3/ when compared with the same period in the previous year, has been strong; the growth in tea receipts has been more moderate and in coffee receipts, about flat. Non-oil import growth has also been strong.

Net official reserves during the first half of 1989 increased by SDR 80 million, in part reflecting SDR 50 million of external borrowing in April by the Coffee Board of Kenya; excluding this external borrowing, net official reserves increased by SDR 30 million, compared with a target of SDR 42 million. It should be noted that the Coffee Board borrowed to finance large inventories of coffee that had built up when export quotas were in effect and to facilitate payment to producers. This loan, which will be repaid in less than one year from when the funds were received, and with payments starting in October 1989, was not guaranteed by the Government; it was backed by collateral in the form of

---

1/ The current account deficit for 1988 had been previously estimated to be SDR 283 million (or 4.5 percent of GDP in EBS/89/84), compared with most recent data showing a deficit of SDR 340 million. The merchandise trade deficit is now SDR 20 million larger than the earlier estimate, while net service receipts are SDR 31 million lower and mainly reflect revisions to investment income receipts, port earnings, and receipts from embassies and international organizations.

2/ The purchase was based on a net shortfall in merchandise exports and cereal imports for the year ended April 1988. CCFF, compensatory and contingency financing facility.

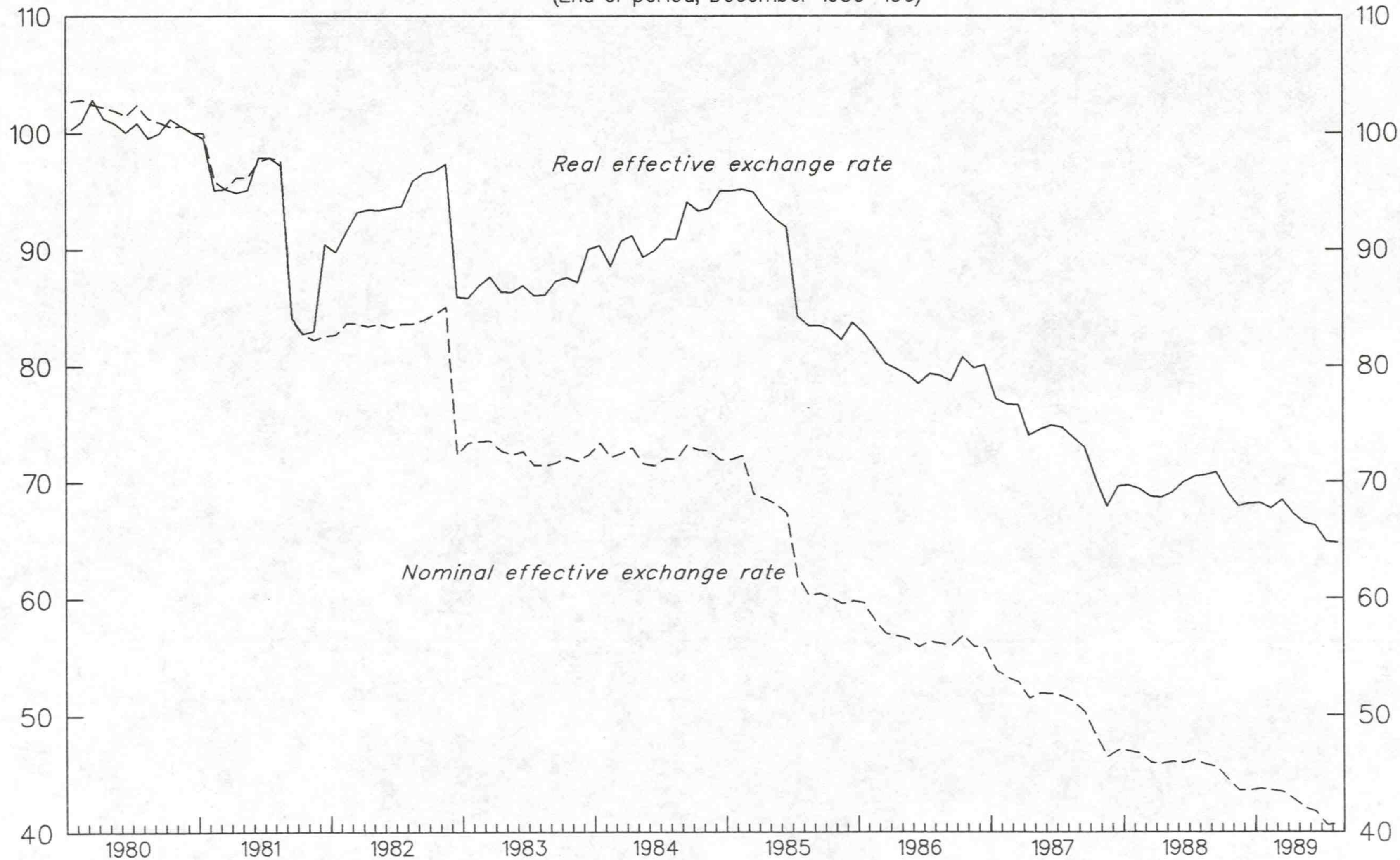
3/ Total export receipts excluding coffee, tea, and oil products.

CHART 1

KENYA

NOMINAL AND REAL EFFECTIVE EXCHANGE RATES, JANUARY 1980–AUGUST 1989

(End of period; December 1980=100)



Sources: IMF, Economic Information System; and data provided by Kenyan authorities.

Table 6. Kenya: Medium-Term Balance of Payments, 1985-90

	1985	1986	1987	1988	1989		1990	
					Prog. 1/	Rev.	Prog. 1/	Rev.
	(In millions of SDRs)							
Current account	-89	-29	-387	-340	31 2/	-78 2/	-236	-266
Exports, f.o.b.	928	998	702	757	825	787	870	889
Coffee	277	408	183	205	210	180	201	218
Tea	230	182	154	155	175	177	195	201
Oil products 3/	117	78	60	63	70	60	70	64
Other	305	330	307	334	370	370	405	407
Imports. c.i.f.	-1,447	-1,435	-1,457	-1,557	-1,601	-1,676	-1,676	-1,746
Government 4/	-92	-247	-282	-266	-238	-253	-230	-237
Oil	-454	-256	-270	-215	-260	-254	-276	-275
Other	-901	-932	-906	-1,075	-1,103	-1,169	-1,170	-1,234
Trade balance	-520	-438	-755	-800	-776	-889	-805	-857
Services (net)	242	232	202	203	272	244	321	302
Of which: Travel	230	240	256	276	301	297	331	327
Private transfers	80	50	56	66	63	69	68	77
Official transfers	108	127	110	191	473 5/	499 5/	180	212
Capital account	-2	106	311	297	27	135	198	219
Long term (net)	-77	109	185	234	12	92	178	227
Official	-55	73	192	249	2	82	158	207
Inflows 6/ 7/	(162)	(289)	(406)	(443)	(492)	(572)	(383)	(432)
Outflows	(-217)	(-217)	(-214)	(-194)	(-490) 8/	(-490) 8/	(-225)	(-225)
Private 9/	-22	36	-8	-15	10	10	20	20
Short term (net) 10/ 11/ 12/	75	-4	126	62	15	43	20	-8
Overall balance	-91	76	-76	-43	58	57	-38	-47
Financing	91	-76	76	43	-58	-57	38	47
Gross reserves	36	18	161	-20	-40	-40	-50	-50
IMF credit (net)	53	-90	-84	64	-18	-18	4	4
Other assets (net)	1	-5	—	-1	—	—	—	—
Additional financing requirements	—	—	—	—	—	—	83	93
Memorandum items:								
Gross reserves (end of period)	381	362	202	222	262	262	312	312
Gross reserves								
In months of nongovernment imports	3.4	3.7	2.1	2.1	2.3	2.2	2.6	2.5
In months of total imports	3.2	3.0	1.7	1.7	2.0	1.9	2.2	2.1
	(In percent of GDP)							
Current account deficit								
Including official transfers	1.5	0.5	6.3	5.3	4.0 2/	5.5 2/	3.7	4.1
Excluding official transfers	3.3	2.5	8.1	8.3	7.0	8.8	6.6	7.4
Net official capital inflows plus official transfers	0.9	3.2	4.9	6.9	6.7	8.8	5.4	6.5

Sources: Data provided by the Kenyan authorities; and staff estimates.

1/ EBS/89/84 (4/27/89).

2/ Excluding the cancellation of Government debt owed to the Federal Republic of Germany as described in footnote 5 below, the projected current account in 1989 would be in deficit by SDR 254 million (4 percent of GDP, Program) and SDR 363 million (5.5 percent of GDP, Revised).

3/ Prior to 1987, customs data included bunkering fees collected on transit shipment destined to neighboring countries. The data for 1986 were adjusted, and the counterpart was included in errors and omissions. Data for earlier years are under revision.

4/ Beginning in 1986, data include special imports of defense-related equipment and civilian aircraft. They amounted to SDR 117 million in 1986, SDR 162 million in 1987, an estimated SDR 76 million in 1988, and are projected to amount to SDR 51 million in 1989 and SDR 50 million in 1990.

5/ Excluding in 1989 the cancellation announced on February 9, 1989 of DM 696 (SDR 285) million of amortization payments on Government debt owed to the Federal Republic of Germany, official transfers would be SDR 188 million (Program) and SDR 214 million (Revised).

6/ Includes loans financing imports of defense-related equipment described in footnote 4.

7/ Includes in 1987 and in 1988 counterpart (SDR 43 million in each year) for imports of defense-related equipment purchased in earlier years but shipped in those years. Includes IDA funds in 1989-90 under the Financial Sector Adjustment Credit.

8/ Including the counterpart for the cancellation of debt described in footnote 5.

9/ Series revised to reflect previously unincorporated data from the Central Bank.

10/ Includes in 1989 Eurodollar loan of $62 million contracted by the Coffee Board of Kenya.

11/ Takes into account in 1989-90 the amortization of the Eurodollar loan described in footnote 9.

12/ Includes errors and omissions and valuation adjustments (1985-88).

the Coffee Board's coffee stocks. 1/ Given the short-term nature of the coffee borrowing, it will have no permanent effect on the stock of debt after April 1990; the interest payments will amount to about 0.25 percent of the average annual current account receipts for 1988-89.

On the structural side, the authorities made significant progress in 1989 in implementing the program's measures. Producer prices were raised in February and July to enhance agricultural production. The organizational and financial restructuring of the National Cereals and Produce Board (NCPB) proceeded essentially as scheduled. New NCPB staff began to be recruited, training within the NCPB was strengthened, and a system of monitoring the availability and distribution of food grains was initiated. The financial restructuring of the NCPB was completed with the write-off of K Sh 5.3 billion in the 1988/89 budget and the conversion of the Cereals and Finance Corporation's outstanding loans to the NCPB into equity or irredeemable non-interest-bearing capital from the Government.

A number of fiscal structural reforms were announced at the presentation of the 1989/90 budget involving discretionary tax measures, user charges, and expenditure rationalization (see Section IV.3 below for details). Further steps were taken in 1989 to restructure public enterprises and to monitor and define their financial relations with the Central Government. In particular, the Government allowed Kenya Railways to begin operating on commercial principles, and continued its financial restructuring of both the Railways and the South Nyanza Sugar Company. The Government started monitoring the financial performance and flow of funds of ten nonfinancial public enterprises (selected on the basis of size and reliability of data) and initiated work with technical assistance from the United Nations Development Program (UNDP) to formulate a policy framework for public enterprises. Market rates of interest on direct loans from the Government to the public enterprises began to be charged. Moreover, work commenced on the systematic categorization of the Government's portfolio of loans to public

---

1/ At the time of the formulation of the 1989 program, it had been indicated, for purposes of setting the quantitative benchmarks on net international reserves and the ceiling on nonconcessional external borrowing, that no public enterprise could borrow on nonconcessional terms without government guarantee. Although the Coffee Board had already just signed the loan agreement when the negotiations for the program were taking place at the Fund in April, the authorities present at the discussions were unaware of this occurrence. The authorities have subsequently explained that there are a few public enterprises which can borrow on commercial terms without government guarantee based on their own collateral (e.g., the Coffee Board, Kenya Post and Telecommunications Corporation, National Oil Company, and Kenya Pipeline Company); the authorities have recently assured the staff that there are no plans for such enterprises to borrow on this basis for the rest of 1989.

enterprises, with the intention of clarifying the Government's position as net creditor to public enterprises and strictly enforcing the collection of loans. A study of development finance institutions was completed in June 1989 and Cabinet approval was obtained on the principles and guidelines for the financial and organizational restructuring of such institutions.

The implementation of the industrial sector adjustment program, particularly the measures associated with the external sector, has continued in 1989. On the import side, the structural performance criterion relating to the implementation of the import liberalization program and the development of an effective system for monitoring its operations has been observed. In this regard, the import licensing system has been streamlined and the new monitoring system indicates that there has been a considerable shortening of the interval between the application for an import license and the acquisition of the corresponding foreign exchange. Furthermore, the quantitative restrictions on import items in Schedule IIIB were lifted in mid-1989 as planned (thereby raising the value of imports licensed without restrictions to about 94 percent of the value of total 1986/87 imports), and replaced by tariffs as the sole form of protection. The tariff categories for all import schedules were also rationalized in the process of reducing the number of these categories from 17 to 12. At the same time, the weighted average tariff for items in Schedules I, II, and IIIA combined were reduced as programmed. Although average tariffs were raised for items in Schedule IIIB, the actual increases, with only three exceptions, were smaller than those proposed by the recent study on tariff equivalents. Finally, the Government has investigated whether dumping has been a serious problem in Kenya and has concluded that anti-dumping legislation is not required.

In addition to the import measures cited above, which will help encourage investment and nontraditional exports, progress has also been made in 1989 in enhancing export prospects. Three additional manufacturing-in-bond facilities have been approved. A study was completed on export incentives for Kenyan industry. While the insufficient level of detail in the study precluded the immediate development of an action program for a medium-term export promotion scheme, the study did provide helpful comparative analysis along with policy guidelines and recommendations, and was very useful for garnering support for Kenya's outward-looking policies. On the investment side, important measures to strengthen the functioning of the investment approval process were taken. To help remove some bottlenecks, a high-level Cabinet Sub-Committee on Investment, headed by the Vice President, was established. The management of the Investment Promotion Center was strengthened, with the expectation of significantly reducing project approval delays, and investment guidelines were published in May 1989. In line with the objective of improving the efficiency and competitiveness of the industrial sector, in September 1989 the number of items under the Price Control (General) Order was reduced to 19 with the decontrol of the prices of animal feeds and animal salts.

In the context of the Government's financial sector adjustment program and in line with the policy of maintaining positive real interest rates, the minimum savings deposit rate for commercial banks was raised 2 percentage points in April, to 12 percent. Moreover, with a view to encouraging commercial banks to make longer-term loans and in pursuit of the eventual objective of market-determined interest rates, the maximum lending rate for loans with maturities greater than four years was raised by 3 percentage points to 18 percent. To help remove inefficiencies in the financial system, a revised Banking Bill was presented in mid-1989 to Parliament and subsequently passed. The Act strengthens the supervisory role of the Central Bank by allowing it to intervene in institutions--prior to insolvency--to restructure, effect mergers, or liquidate as appropriate. The Act also limits advances to insiders and redefines exposure and capital adequacy requirements. During 1989 the Central Bank strengthened its supervisory capability by developing standardized financial reporting formats, written examination and inspection procedures, and appropriate provisioning guidelines. The Bank also prepared restructuring programs for ten weak financial institutions. To facilitate the promotion, development, and regulation of the securities market, a bill to establish the Capital Markets Authority was presented to Parliament in mid-1989.

IV. Policies for the Remainder of 1989 and 1989/90

In addition to the assessment of economic and financial developments in 1988 and the first half of 1989, the midterm review discussions concentrated on the prospects for the remainder of 1989 and 1989/90, with special emphasis on the adequacy of policy implementation for achieving the growth, inflation, and balance of payments targets of the program. In view of the unexpectedly difficult external environment as well as the inflationary pressures early in 1989, the authorities have decided on the adoption of a more restrictive monetary and credit stance, including higher real interest rates, and an exchange rate policy that attempts to address the more difficult external situation.

1. Economic overview

In view of developments during the first half of 1989, real GDP growth in 1989 is estimated to be 4.9 percent, slightly less than the targeted 5.1 percent. This outcome, compared with the targeted growth for 1989, may be attributed primarily to the less favorable performance of the agricultural, transport, and trade sectors and the more favorable performance of the finance, building and construction, and ownership of dwellings sectors. The manufacturing and government sectors are expected to perform as initially envisaged.

The domestic resource balance, or savings-investment balance, is expected to deteriorate marginally in 1989. Total consumption (at current prices) is projected to increase slightly, from 79.5 percent of GDP in 1988 to 79.9 percent in 1989, reflecting an increase in private

consumption. The domestic savings ratio will fall commensurately, largely owing to the projected decline in private savings, while government savings is expected to improve. The decline in private savings in 1989, due in part to the fall in real interest rates at the beginning of the year with the high inflation rate, is expected to be reversed, aided by the planned monetary policy measures in late 1989 and in early 1990. Gross investment relative to GDP is likely to increase slightly in 1989, in part because of the favorable impact of import liberalization on private investment.

The month-on-month inflation rate, which began to decelerate after May 1989 and was about 9 percent in August 1989, is anticipated to remain at about 9 percent at end-1989, compared with the targeted 8 percent. The expected slowdown in inflation during the second half of 1989 reflects in part the tighter monetary stance.

2. Balance of payments outlook and external policies

The external sector outlook for 1989 and 1990 appears less favorable than initially projected. 1/ For 1989, the current account deficit is now expected to widen slightly, from 5.3 percent of GDP in 1988 to 5.5 percent in 1989, rather than narrowing to 4.0 percent of GDP from 4.5 percent of GDP as envisaged in the program. External capital inflows, however, are likely to be substantially higher than originally projected, such that the programmed buildup in net official reserves of SDR 58 million by the end of 1989 is still expected.

The current account deterioration in 1989 is largely due to a higher trade deficit. The original program had assumed almost no change in SDR terms in the average export price of Kenyan coffee in 1989, whereas these coffee prices are currently expected to be 24 percent lower than in the previous year, reflecting the drop in world coffee prices in the wake of the collapse of the quota system under the International Coffee Agreement. Mostly because of this revision, 1989 coffee export receipts are now likely to be SDR 30 million below the level assumed in the program. Oil export projections have also been lowered to reflect reduced sales to neighboring countries. Imports are expected to be higher than previously envisaged, because of both higher government imports as well as the strong demand thus far in 1989 for nongovernment imports, which reflects in part a stronger-than-

---

1/ Revised balance of payments projections, presented in Table 6, are based on discussions with the Kenyan authorities and broadly reflect the most recent commodity price projections from the Fund's Research Department at the time of the mission, but with coffee and tea prices at somewhat lower levels. Consistent with these latter projections--which have average coffee prices rising by about 20 percent by the fourth quarter of 1990 from their level in the third quarter of the previous year--there is to be a significant rebound from the prevailing low level of current coffee prices.

anticipated impact of import liberalization. Meanwhile, estimates of net service receipts have been reduced. This reduction results from the interest payments on the Coffee Board loan and lower airport services receipts following an increase in the minimum jet fuel price to a level above world prices. Receipts from tourism are expected to be only modestly lower than in the program, as recent incidents in the game parks appear not to have had much of an overall adverse effect on bookings.

The higher capital inflows in 1989 largely reflect developments under the ISAC as well as the Coffee Board borrowing discussed earlier. The second tranche of the ISAC from IDA is expected to be disbursed before the end of 1989, as scheduled. However, the amount of associated cofinancing, which already had accounted for a significant amount of programmed inflows, is now expected to be even higher than previously anticipated, because of both additional funds and some speeding up of disbursements. Under the FSAC from IDA, about SDR 50 million will be disbursed in 1989, in line with expectations.

The deterioration in the current account observed in 1989 should be reversed in 1990. A significant decline in the deficit to 4.1 percent of GDP is now projected for 1990, against the somewhat smaller deficit of 3.7 percent of GDP originally targeted. Coffee exports are projected to rebound in 1990 because of both higher prices, expected to increase by 5 percent in SDR terms in 1990 from the previous year's level, and higher volume; the anticipated 15 percent rise in volume reflects declining inventories, higher production, the Coffee Board's projected sales program, and the quality premium on Kenyan coffee. The value of coffee exports, as a result, is above the original projection. 1/ Tea exports will benefit from unexpectedly higher prices while the remaining categories of exports are little changed. On the import side, the growth in nongovernment, non-oil, imports is expected to decelerate from about 5 percent in real terms in 1989 to half that in 1990, in line with cautious macroeconomic policies and the assumed drawdown of imported inventories accumulated during the previous phases of the import liberalization program. With little change in import prices, the growth rate still implies that the value of these imports in 1990 will be about 5 percent higher than earlier projected. In the services account, tourism is expected to remain a buoyant source of foreign exchange earnings, although projected net services receipts have been scaled back.

With net capital inflows only somewhat higher than previously projected and insufficient to offset a wider-than-programmed current account deficit, current indications suggest that the financing gap for 1990 has grown moderately to SDR 93 million, taking into account the

---

1/ Should coffee prices not rebound but remain at about their fourth quarter 1989 level, the value of coffee exports in 1990 would stay around its level in the previous year. Clearly, less robust export volume growth would also put pressure on the external position.

unchanged reserve target. There are reasonable prospects that the 1990 financing gap will be filled by cofinancing of the FSAC, IDA reflow funds, and additional aid inflows. Moreover, some official bilateral creditors are expected to write off their loans to Kenya.

To support Kenya's adjustment effort, a flexible exchange rate policy will continue to be pursued. This is particularly necessary in light of the unexpectedly less favorable external environment, the need to support the trade reforms being implemented, and the goal of expanding and diversifying the export base. In this regard, the real effective exchange rate was depreciated by an additional 2.2 percent in July and August, so that the depreciation in the first eight months of 1989 amounted to 4.9 percent. 1/

On the structural side, more detailed work has begun on assessing the impact on domestic industries of unrestricted import licensing, which will be ultimately directed toward the preparation of an action program for restructuring viable public enterprises adversely affected by liberalization. A proposal to study and recommend policies for restructuring the textile industry has been approved by IDA for funding through its Project Preparation Facility. As regards the export compensation scheme, the Government clearly recognizes the need to improve administrative arrangements to ensure prompt payment of export compensation; the aim is to reduce delays in obtaining compensation, with one month targeted as the maximum time for obtaining compensation. Further work on a comprehensive medium-term export promotion program is currently under way, with the expectation that a program for export processing zones will be formulated by June 1990. In this connection, an initial study has been commissioned to evaluate the enabling environment for an export processing zone near Mombasa, which should be completed before the end of the year. Another study, which is to be financed through the World Bank Special Project Preparation Facility and Special Project Facility, and which is to be commissioned by the end of the year for completion by mid-1990, will evaluate the enabling environment for an export processing zone near Nairobi; further detailed and technical work will be undertaken as needed.

3. Fiscal policy and structural reforms in the budget

In line with the medium-term fiscal and macroeconomic objectives, the fiscal program for 1989/90 provides for the containment of the overall cash deficit at 4.2 percent of GDP (6.8 percent excluding grants) and includes structural revenue and expenditure reforms. This program target, although representing an increase in the cash deficit of 0.3 percentage point above the estimated 1988/89 outcome, is to be held

---

1/ Calculations of the real effective exchange rate are based on data (on country coverage, price indices, exchange rates, etc.) agreed with the Kenyan authorities, and not the same as the data utilized in the Fund's Information Notice System.

close to the 4.2 percent budget deficit (4.1 percent in terms of revised GDP) originally targeted in order to accommodate the programmed inflow of concessional external resources amounting to 3.1 percent of GDP while maintaining the programmed domestic financing of the deficit. The 1989/90 budget, as presented to Parliament, also allows for the possible absorption of additional highly concessional external financing (equaling about 0.8 percent of GDP) of meritorious projects supportive of growth, should this not jeopardize the achievement of the macroeconomic targets.

To achieve the deficit target, total revenue and grants are programmed to increase to 26.7 percent of GDP in 1989/90, 1.2 percentage points above the 1988/89 level. Foreign grants are targeted to increase by about 0.5 percent of GDP. Total revenue in 1989/90 is projected to rise by 0.9 percentage point, to 24.1 percent of GDP. Targeted additional revenue from the introduction of user charges is anticipated to amount to about 0.4 percent of GDP, with the remaining receipts projected to come primarily from additional tax revenue from import duties and the sales tax on imports. As in the previous fiscal year, about 0.6 percent of GDP (K Sh 1.2 billion) is expected to be raised from new discretionary tax measures introduced in the 1989/90 budget. About K Sh 500 million, or 43 percent of this amount, is projected to come from the increase in the sales tax on beer introduced earlier in 1989 and the sales tax/value-added tax (VAT) reform. The raising of excise duties on cigarettes and tobacco in April 1989 is expected to bring in additional revenue of K Sh 300 million (26 percent), while changes in the existing tariff structure (to replace quantitative restrictions) are anticipated to yield K Sh 200 million (17 percent), with the remaining receipts coming from income tax and miscellaneous other measures. In particular, the introduction of a presumptive tax of 5 percent on the value of gross sales of agricultural produce is expected to yield revenue of about K Sh 812 million. Additional taxation measures include the lowering of the effective corporate tax rate and the top rate of personal income tax, a widening of personal income tax brackets, and an increase in income tax personal exemptions. The net effect on revenue from the new income tax measures and miscellaneous taxes is about K Sh 160 million (14 percent), allowing for a projected loss in receipts of about K Sh 510 million from the elimination of the export tax on coffee and tea.

On January 1, 1990, the manufacturing sales tax will be replaced by a VAT that retains the multiple rate structure, while a uniform 17 percent VAT will be levied on business services. The net receipts from the sales tax/VAT reform, allowing for reduced sales tax rates on some goods under the 1989/90 budget, should yield K Sh 180 million (0.1 percent of GDP) in 1989/90. Moreover, in line with the program's objective of financing a rising share of recurrent expenditures through user charges on health, education, and other public services, about K Sh 860 million will be raised from newly introduced charges. In the health sector, K Sh 228 million will be raised from the introduction of fees for hospital services in district and provincial hospitals, as well as at

the Kenyatta National Hospital. In the education sector, higher fees for tuition and boarding at the universities, reduced allowances at the teacher training colleges, and the netting out of existing charges to parents from secondary school budgetary grants, will yield K Sh 564 million.

Government expenditure is targeted at 30.9 percent of GDP in 1989/90, close to the 30.8 percent originally programmed (30.0 percent in terms of revised GDP). The upward revision of expenditure in terms of revised GDP reflects primarily an increase in development spending that is higher than initially programmed as a result of the Appropriations-in-Aid (A-in-A) development grants of K Sh 764 million (0.4 percent of GDP), and an upward revision in some recurrent outlays, including external interest payments and personnel expenditures. Taking into account the lower-than-expected expenditure outturn for 1988/89 and the presently programmed outlays for 1989/90, the annual average total expenditure in terms of GDP for the two fiscal years is projected to be about 30 percent, as originally programmed.

An important element of the 1989/90 program is the introduction of a ceiling of 7.5 percent on the growth of the wage bill (total personal emoluments in all ministries, including the Ministry of Education) to help restrain total expenditures and to correct the imbalance between government wages and nonwage and maintenance outlays. The Government has introduced a number of measures to curtail growth in civil service employment, including: (1) the freezing of all posts that had been vacant for more than six months as of end-April 1989; (2) a ban on the further upgrading or creation of posts during 1989/90, except with specific authority from the Treasury; (3) the extension of control over recruitment at lower grade job levels; (4) the withdrawal of guaranteed government employment for trainees from government training institutions; and (5) a reduction in the number of untrained teachers employed without Government approval. The authorities believe that these measures should be sufficient to meet the program's target for the growth in the wage bill.

In conformity with the budget rationalization program, the 1989/90 budget limits capital expenditures to a small number of high priority projects and provides for real increases in operations and maintenance expenditures in priority sectors, including education, health, road maintenance, water supply, and agricultural services. A monthly monitoring system of wage bill developments and operations and maintenance outlays will be implemented in 1989. To increase the effectiveness of the process of government expenditure planning, the Government will prepare a public sector project list in December 1989, distinguishing ongoing from new projects and classifying projects according to budgetary subheads. Additionally, a public fixed investment program will also be formulated, embracing the capital expenditure of both the Central Government and selected nonfinancial public enterprises.

The program provides for an increase in external financing of 0.3 percentage point, to 3.1 percent of GDP in 1989/90, in line with Kenya's greater recourse to concessional external resources. Domestic financing of the deficit remains as programmed, at 1.1 percent of GDP, with the increase in bank credit limited to 0.6 percent so as to provide sufficient room for credit expansion to the private sector. In the event that net external financing (excluding A-in-A financing) or domestic nonbank financing of the deficit exceeds that programmed, the target for net credit to the Government during 1989/90 (as measured at the end of June 1990) will be adjusted downward by the amount of the excess (Table 7). The programmed financing of the 1989/90 cash deficit also excludes recourse to delayed payments by the Government, consistent with the program's aim of limiting the size of the float. The level of unpresented checks at the end of June 1990 will not exceed their end-June 1989 level of K Sh 2.9 billion.

In the medium term, the Government seeks to reduce the overall budgetary deficit to a level compatible with available foreign financing and noninflationary domestic financing. The Government aims at reducing the overall cash deficit from 4.2 percent of GDP in 1989/90 (6.8 percent excluding grants) to 3.7 percent of GDP in 1990/91 and 3.2 percent of GDP (5.8 percent excluding grants) in 1991/92. Attainment of these targets will require the implementation of structural measures to raise total revenue by 0.5 percentage point, to 24.6 percent of GDP by 1991/92, and to reduce the expenditure/GDP ratio by about 0.5 percentage point, to 30.4 percent of GDP in 1991/92. Moreover, by 1991/92, almost all additional domestic bank credit will be channeled to the private sector. Structural reforms in taxation policy will further broaden the tax base and increase the elasticity of the tax system, and will include the extension of the proposed manufacturing and business services VAT to the retail sector by 1991/92, the modernization and strengthening of tax administration in the revenue-collecting department, and improved tax policy formulation capabilities of the Treasury. An increasing share of recurrent costs will be financed by user charges for educational and medical services. On the expenditure side, the Government remains committed to reducing gradually the share of the budget claimed by personnel expenditure, through annual ceilings on the growth in the wage bill, while increasing real nonwage operating outlays in priority sectors. Beginning in the next annual budget and the 1990/91-1992/93 forward budget exercise, the Government will present an economic classification of expenditures and also distinguish between ongoing and new development projects.

4. Public enterprise reform

In the course of 1989/90, the Government intends to pursue further its efforts toward public enterprise reform, with the overall objective of increasing their efficiency and financial viability. The Government will continue the ongoing program of organizational reform of the NCPB and the financial restructuring of the Kenya Railways and the South Nyanza Sugar Company. The monitoring of the financial performance and

Table 7. Kenya: Performance Criteria and Benchmarks of the First Annual Arrangement Under the Enhanced Structural Adjustment Facility

	1989 June Actual	1989 Sept. 1/	1989 Dec. 2/	1990 March 3/	1990 June 3/
Quantitative Performance Criteria					
	(In millions of Kenya shillings)				
Total domestic credit 4/	52,422	56,897	58,080	57,371	57,712
Net bank credit to the Government 5/	13,670	17,420	17,270	15,631	14,772 6/
Banking system	(17,510)	(21,891)	(21,741)	(20,241)	(19,382)
CSFC	(-3,840)	(-3,701)	(-3,701)	(-3,840)	(-3,840)
Debt assumed from parastatals	(—)	(-770)	(-770)	(-770)	(-770)
	(In millions of U.S. dollars)				
New nonconcessional external loans contracted or guaranteed by the Government (cumulative per calendar year) 7/					
a. 1-12 years' maturity	56.4	100.0	100.0	...	...
b. Short-term credits of less than one year's maturity 8/	—	—	—	...	...
Quantitative Benchmark					
	(In millions of SDRs)				
Minimum cumulative increase in net official international reserves from end-December 1988 9/	80	37	58	...	...

Nonquantitative Performance Criteria

Review: A midterm review will be completed by end-October 1989 to assess implementation of structural measures, the 1989/90 budget, exchange and interest rate policies, the financing of the 1989 balance of payments, and the benchmarks and performance criteria during first half of 1989/90.

Trade and Payments Restrictions:
The Government of Kenya will continue to maintain a liberal exchange and trade system and will not introduce any new, or intensify existing, restrictions.

Structural Performance Criterion	Target Date
Implement the import liberalization program and provide on monthly basis data on import license applications, approvals, and corresponding foreign exchange allocation.	End-September 1989.
Structural Benchmarks	
Maintain positive real interest rates.	Throughout 1989.

Source: Memorandum attached to the letter of request of Kenyan authorities of April 18, 1989; and the letter of intent dated September 26, 1989.

1/ Performance criteria.
2/ Quantitative benchmarks.
3/ Indicative targets.
4/ Total domestic credit of the banking system is the sum of net credit to the Government, other public sector credit, and private sector credit. It includes bank credit utilized by the Cereals and Sugar Finance Corporation (CSFC).
5/ Net credit to the Government is net credit to the Government from the banking sector. The ceiling excludes the operations of the CSFC, and the amount of public enterprise debt assumed by the Government and reclassified from outstanding private sector credit.
6/ This target will be adjusted downward to the extent that net external financing of the deficit during the July 1989-June 1990 period, excluding A-in-A financing, exceeds K Sh 204 million, or to the extent that domestic nonbank financing exceeds K Sh 0.9 billion.
7/ In conformity with existing regulations, no public enterprise will borrow on nonconcessional terms without Government guarantee. For purposes of converting new nonconcessional external loans into U.S. dollars, the U.S. dollar exchange rates cabled to the Central Bank of Kenya from the Federal Reserve Bank of New York for January 3, 1989 will be used.
8/ Other than related to imports.
9/ Net official international reserves are defined as the Central Bank of Kenya's net foreign reserve assets (SDRs, gold, and foreign exchange holdings) minus its short-term deposit liabilities to foreigners; plus the Central Government's net foreign reserve assets (excluding those related to Fund transactions); plus Kenya's reserve position in the Fund; minus Kenya's net use of Fund credit.

flow of funds of selected nonfinancial public enterprises will be further expanded and refined in 1989/90. The draft policy framework paper on public enterprises should be completed by December 1989. Moreover, preliminary action in restructuring the Industrial Development Bank and the Industrial and Commercial Development Corporation is expected by the end of 1989; by June 1990 action is to be taken as to which subsidiaries of these institutions will be privatized, restructured, or liquidated. In the course of 1989/90, the Government will begin to address the need for a major re-equipping and organizational restructuring of Kenya Airways and its likely borrowing requirements over the course of the three-year program. The Government has indicated that it will seek the assistance of the Fund and the World Bank in evaluating the investment program of Kenya Airways and ensuring that the program can be undertaken within the framework of the macroeconomic program.

5. Monetary policy and financial sector reform

During the remainder of 1989 and the first half of 1990, monetary policy will seek to reduce inflationary pressures and support external adjustment. Total domestic bank credit is programmed to increase by 10.1 percent in 1989/90, with net credit to the Government expanding by 10.7 percent. 1/ This target for credit expansion is consistent with an expansion of 8.2 percent in broad money and an increase in velocity, from 3.48 at end-June 1989 to 3.62 at end-June 1990. This is a tighter monetary stance than in the original program, which targeted broad money to expand by more than 12 percent, and reflects concerns with inflationary pressures as well as the unexpectedly less favorable external current account positions for 1989 and 1990.

Financial sector reform will continue during the remainder of 1989. In line with the objective of achieving eventual market determination of interest rates and in view of inflationary pressures thus far during 1989, certain adjustments in the interest rate structure will be undertaken. By October 15, 1989, the minimum savings deposit rate for commercial banks will be raised from 12.0 percent to 12.5 percent, the commercial banks' maximum lending rate for maturities of three years or less will be raised to 15.5 percent from 15.0 percent, and those for more than three years will be raised to 18.0 percent. At the present time the 18.0 percent maximum lending rate applies only to maturities greater than four years. Moreover, should the inflation rate during the remainder of 1989 be higher than currently envisaged, additional interest rate action will be taken at the beginning of 1990.

1/ In the comparison of the program targets with the original program targets, account needs to be taken of the fact that in September 1989 the Government assumed K Sh 770 million of the liabilities of the public enterprises to the banking system. Until then the liabilities had been recorded as bank claims on the nongovernment sector.

During the last quarter of 1989, progress is expected in the introduction of monetary programming. Although the Monetary Policy Committee has been actively meeting and handling a variety of issues, the introduction of reserve money management and the active use of available monetary policy instruments have been somewhat delayed owing to unavoidable delays in securing technical assistance to the Central Bank. Fund technical assistance, in the form of an Advisor on Open Market Operations to the Central Bank, is expected to be available in October 1989. Regarding the development of the capital market, it is anticipated that the Capital Markets Authority will be established soon after Parliament approves its legislation.

V. Social Implications of Program

The potential social impact of the structural measures being implemented in Kenya in relation to most other African countries is relatively small since the economic distortions and imbalances in the country are comparatively much less. The adverse effects of some of the programmed measures are also being minimized in Kenya by their gradual application and by the Government's active efforts to ameliorate their impact. Thus, the introduction of higher fees at the university has been accompanied by a loan program through the commercial banks to assist needy students. The introduction of fees in the hospitals is being matched by an effort to raise the quality of care provided as well as a program to strengthen services at health centers and dispensaries, which provide much of the care for the most vulnerable groups. In 1989, the Government also established a Ministry of Reclamation and Development of Arid, Semi-Arid and Wasteland in order to help transform those areas from being recipients of welfare to being providers of employment, surplus food, and growth. Moreover, plans are under way for the Government to launch a Small-Scale Enterprise Program to help create additional jobs, particularly in the growing urban centers outside Nairobi.

VI. Staff Appraisal

Kenya's 1989 program, supported by the first annual arrangement under the ESAF, remains essentially on track. The quantitative and structural benchmarks for mid-1989 were all observed, in some cases with a wide margin. Moreover, the structural performance criterion relating to the implementation of the import liberalization program and import license monitoring system was met before the scheduled program date of end-September 1989. The program targets for real economic growth and international reserves are on the whole expected to be realized in 1989, but the targets for the current account deficit, owing mainly to unanticipated external developments, and for the inflation rate are likely to be exceeded.

In view of these developments, for the remainder of 1989 the authorities should maintain their present policy stance, which includes a tighter monetary and credit stance than originally programmed and the flexible management of the exchange rate. Moreover, even though the end-December credit benchmarks in the program remain as originally set, the authorities would be well advised to keep credit expansion below these benchmarks. In this connection, the authorities' plans to raise interest rates are to be commended, both in terms of the needed current monetary stance and in terms of the medium-term objectives of the program.

The cash budget deficit for 1988/89 was below the program target. As in the previous fiscal year, however, this outcome was achieved by the postponement of cash payments and by the buildup of unpresented checks at the end of the year. The authorities' commitment to confine the level of unpresented checks at the end of 1989/90 to their end-1988/89 level is welcomed. It is essential for the authorities to be vigilant in their efforts to attain the programmed fiscal deficit target and to maintain the pace of structural fiscal reforms during 1989/90. In this regard, the authorities will need to continue their commitment to reduce the growth in personnel expenditure to the 1989/90 program target through the implementation of measures recently introduced to limit government employment and the containment of average annual salary increases to within-grade increments.

Considerable progress has been made with the implementation of the import liberalization program. The staff also commends the authorities on the exchange rate policy followed thus far in 1989 and on their commitment to continue pursuing a flexible exchange rate policy that takes into account trade reform, external developments, and the need to encourage export diversification and expansion. Such a flexible approach to policy in general is particularly important in the light of the vulnerability of Kenya's balance of payments to adverse external developments, which has once again been demonstrated in 1989. The more immediate external prospects now look weaker than previously envisaged, and without appropriate policy adjustment so will the medium term. Thus, the authorities should stand ready to accelerate the pace of the depreciation of the real effective exchange rate during the remainder of 1989 and to take stronger corrective measures if the need arises. Moreover, the authorities should adhere firmly to their policy of borrowing from abroad on concessional terms, which is essential for the attainment of the program's projected decline in the debt service ratio. At the same time, the authorities' efforts to take corrective actions and strengthen the external position will need to be supported by adequate and timely external concessional assistance.

During 1989 the programmed structural measures have been implemented essentially as envisaged, and the authorities are encouraged to continue with their structural reform efforts in the remainder of the year. In this regard, the export compensation scheme needs to be improved and the development of a medium-term export promotion program

needs to be hastened. Moreover, further progress should be achieved on the reforms scheduled in the public enterprise sector, the tax system, the financial sector, and price decontrol.

VII. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

The Fund determines that the midterm review specified in paragraph 2(c) of the first annual arrangement under the enhanced structural adjustment facility (EBS/89/84, Sup. 1, 5/26/89) has been completed.

September 26, 1989

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. Camdessus:

1. The Memorandum on Economic and Financial Policies, which accompanied our letter of April 18, 1989, outlined the structural adjustment program that the Kenyan Government intended to pursue during the three year period January 1989-December 1991, and presented in detail the objectives, policies, and measures for the first year of this program. In support of this program, on May 15, 1989 the Fund approved a three-year structural adjustment arrangement under the enhanced structural adjustment facility (ESAF) in an amount equivalent to SDR 241.4 million, 170 percent of Kenya's quota, and the first annual arrangement thereunder.

2. During the first half of 1989, considerable progress was made in program policy implementation and the program remains essentially on track. The program's fiscal target for 1988/89 (July-June) was achieved, restraint in overall credit policy was maintained, flexible exchange and interest rate policies were continued, and significant reforms were introduced under the financial sector restructuring and industrial sector adjustment programs. The program's quantitative benchmarks for end-June 1989 were observed and the structural benchmarks are being implemented as scheduled.

3. The overall economic growth target for 1989 has been reduced slightly from 5.1 percent to 4.9 percent. This reduction mainly reflects less favorable weather conditions at the beginning of 1989, lower than anticipated coffee production, and higher oil prices. The inflation rate during the first half of 1989 has remained relatively high; at the end of June 1989, the weighted month-on-month rate of inflation was 10.3 percent (viz., end-June 1989 relative to end-June, 1988). This development may be attributed to increases in producer and consumer prices in February and April, increased excise and sales tax rates brought forward from the 1989/90 budget to April 1989, and a somewhat greater-than-anticipated growth in broad money. While the inflation rate has begun to abate since the peak of 11.5 percent in May to 8.9 percent in August, the weighted month-on-month rate of inflation in 1989 is still estimated to be about 9 percent instead of the targeted 8 percent. In the external sector, net official reserves, excluding the external borrowing by the Coffee Board of Kenya, increased by SDR 30 million during the

first half of 1989, compared with the target of SDR 42 million, despite preliminary customs data which indicate strong import growth in the first five months of this year. The Coffee Board, which operates on a commercial basis, borrowed SDR 50 million in April 1989 to finance large inventories of coffee that had built up when export quotas were in effect and to facilitate payment to producers. This loan, which will be repaid in less than one year, was not guaranteed by the government, and was backed by collateral in the form of the Coffee Board's coffee stocks.

4. Based upon preliminary actual data, the 1988/89 fiscal program target of an overall cash deficit of 4.5 percent of GDP (6.9 percent excluding grants), was attained, with a cash deficit of 3.9 percent of GDP (6.1 percent excluding grants). Government revenues were K Sh 88 million below the program target, while total expenditure was K Sh 1.2 billion (0.7 percent of revised GDP) less than originally anticipated. External financing of the budget amounted to K Sh 4.6 billion (2.8 percent of GDP), compared with K Sh 3.9 billion in the program. The bulk of the K Sh 1.8 billion of domestic financing, in contrast to the program, was from nonbank sources. As a result, net bank credit to the Government at end-June 1989 was about K Sh 2.0 billion below the program benchmark. However, the stock of unpresented cheques increased from K Sh 1.1 billion at the end of June 1988 to K Sh 2.95 billion at the end of June 1989.

5. Overall domestic credit developments through the first half of 1989 were more contractionary than programmed. Net domestic credit grew by 8.3 percent in 1988/89 (July-June), compared with 13.7 percent in the program. Credit to the Government increased by only 2.3 percent during this period, in contrast to the targeted 12.8 percent, while credit to the nongovernment sector rose by 11.6 percent, compared with the programmed 14.2 percent. Broad money, however, expanded by 17.8 percent in 1988/89, in contrast to a growth of 17.0 percent in the program, while net foreign assets were higher than projected. Positive real interest rates continued to be maintained.

6. External sector policies during the first half of 1989 were in line with the program. The exchange rate was flexibly managed, depreciating by 2.7 percent in real effective terms during this period. At the same time, official external borrowing on nonconcessional terms was confined to US$56.4 million for loans in the 1-12 year maturity range at the end of June, 1989.

7. Progress was also made during the first half of 1989 in implementing the program's structural policy measures. Producer prices were raised in February for beans and in July for maize and wheat to improve the incentives for agricultural producers to expand production. In the area of parastatals, the financial and organizational restructuring of the National Cereals and Produce Board (NCPB) has proceeded essentially as scheduled. The Government also began to charge market rates of interest on direct loans to public enterprises, completed the study of development finance institutions, and began to allow Kenya Railways to operate on commercial principles. Fiscal structural reforms introduced in mid-1989 included the elimination of the export tax on coffee and tea, the lowering of the effective corporate tax rate and the top rate of personal income tax, an increase in income tax allowances,

and, to widen the income tax net, the introduction of a tax on the value of gross sales of agricultural produce.

8. Within the context of the Government's financial sector adjustment program, a number of policy actions have been taken. To ensure positive real interest rates, the minimum savings deposit rate for commercial banks was raised 2 percentage points to 12 percent in April. At the same time, with a view to encouraging commercial banks to make longer term loans, the maximum lending rate for loans with maturities greater than four years was raised from 15 percent to 18 percent. In mid-1989, a revised Banking Bill was passed by Parliament and is awaiting Presidential assent. It should strengthen the supervisory role of the Central Bank vis-à-vis the commercial banks, limit advances to insiders, and redefine exposure and capital adequacy requirements. At the same time, legislation was tabled to establish a Capital Markets Authority, a semipublic institution to promote, develop, and regulate the securities market. In support of these reforms, in June 1989 the World Bank approved for Kenya a US$125 million financial sector adjustment credit and financial sector technical credit.

9. The implementation of the industrial sector adjustment program, which came into effect in mid-1988 and is being supported by the IDA and other multilateral and bilateral donors, continued in 1989. In line with the program's aims of encouraging investment and nontraditional exports, the quantitative restrictions on import items in Schedule IIIB were removed in mid-1989, and replaced by tariffs as the sole form of protection. At the same time, the number of tariff categories for all import schedules was rationalized and reduced from 17 to 12. In the process, the weighted average of tariffs for items in Schedules I, II, and IIIA combined were reduced. While average tariffs were raised for the items in Schedule IIIB, the actual increases in these tariffs were, with only three exceptions out of a thousand, smaller than those proposed by the recent consultants' study on tariff equivalents. Moreover, the import licensing system has been streamlined; the weekly data provided by the new monitoring system indicate that the time it takes from applying for an import license to acquiring the corresponding foreign exchange has been reduced considerably and there has been an improvement in confidence in the system. As a result of these measures, the program's structural performance criterion relating to import liberalization has been met before the targeted end-September 1989 date. With an eye toward further enhancing export prospects, a study was completed on export incentives for Kenyan industry. The Government has taken several measures to strengthen the functioning of the investment approval process, which can also play an important role in enhancing export prospects through foreign participation in, for example, manufacturing-in-bond and export processing zones. A Cabinet Sub-Committee on Investment, headed by the Vice President, has been established to remove some of the bottlenecks in the investment project approval process. At the same time, the management of the Investment Promotion Centre has been strengthened. It is expected that project approval delays will be significantly reduced. With respect to the restructuring of development finance institutions (DFIs), a study on this topic was completed in June 1989. Cabinet approval was obtained on the principles and guidelines

to guide the restructuring program, and a detailed DFI action plan has been prepared and approved.

Policies for 1989/90

10. In line with the program's objectives, the program fiscal target for 1989/90 is to be confined to an overall cash deficit of K Sh 7.65 billion, or 4.2 percent of GDP (6.8 percent excluding grants). Net external financing of the program cash deficit will amount to K Sh 5.6 billion or 3.1 percent of GDP (K Sh 204 million, net of Appropriations-in-Aid (A in A) financing), while domestic financing will be about K Sh 2 billion or 1.1 percent of GDP (with K Sh 1.1 billion or 0.6 percent of GDP from the banking system). In the event that the net external financing (excluding A in A financing) or domestic nonbank financing of the budget deficit exceeds that programmed, the target for net bank credit to the Government during 1989/90 as measured at the end of June 1990 will be adjusted downward by the amount of the excess. Consistent with the Government's intention to limit the size of the float, the level of unpresented cheques at the end of June 1990 will be no larger than their end-June 1989 level. In formulating the 1990 annual program, the fiscal targets will be reviewed in the light of macroeconomic considerations, fiscal and balance of payments prospects, and the availability of additional external concessional assistance.

11. Total revenue will be raised by 0.9 percent of GDP to 24.1 percent of GDP in 1989/90; or about 0.4 percent of GDP is expected to be raised from newly introduced user charges in health, education, and other public services, while the remainder is projected to come primarily from additional tax receipts from import duties and sales tax on imports. As in the previous fiscal year, about 0.6 percent of GDP is projected to come from new discretionary tax measures, with about 40 percent of the increase in revenue from these measures from the increase in the sales tax on beer in April 1989 together with the reform of sales taxation, while the remainder is to be derived from tariffs, excises, and miscellaneous other measures. The introduction of a presumptive tax of 5 percent levied on the value of gross sales of agricultural goods is expected to yield revenue of about K Sh 812 million, and this tax will more than offset the projected loss in receipts of about K Sh 510 million from the elimination of the export tax on coffee and tea. A bill to replace the sales tax by a multiple tax rate value added tax (VAT) on manufactured goods and a 17 percent tax on business services was tabled in mid-1989, and the VAT will be implemented on January 1, 1990. The introduction of the VAT is projected to yield K Sh 180 million (0.1 percent of GDP) in net additional revenue in 1989/90. It is intended that the VAT will be extended to the retail level. Moreover, during 1989/90, K Sh 860 million will be raised from newly introduced user charges for health, education, and other public services. In particular, K Sh 228 million will be raised from the introduction of additional charges for hospital services in district and provincial hospitals as well at the Kenyatta National Hospital. In the education sector, higher fees for tuition and boarding at the universities, reduced allowances at the teacher training colleges, and the netting out of existing charges on parents from budgetary grants to some secondary schools, will yield about K Sh 564 million to the budget.

12. In terms of expenditure policy, the Government will continue with its budget rationalization program. In line with the fiscal program's aims to restrain expenditure growth and to begin to correct the prevailing imbalance between wage and nonwage operating and maintenance expenditure in recurrent outlays, the increase in the wage bill (personnel emoluments in all Ministries, including subventions to Teachers Service Commission) will be limited to 7.5 percent in 1989/90, compared with the preliminary estimate of 16 percent in 1988/89. This will require a deceleration in the growth of government employment to about 3.5 percent and a containment of average wage increases to the 4 percent normally arising from within-grade salary movements. The following measures have been introduced to help achieve this target: (1) the freezing of all posts which have been vacant for more than six months as of April 26, 1989; (2) a ban on further upgrading or creating of posts during 1989/90, except with specific authority from the Treasury; (3) control over recruitment of non-technical and lower grade job groups; (4) the withdrawal of guaranteed employment in Government for trainees from Government training institutions; and (5) a reduction in the number of untrained teachers. The Government will also provide for a real increase in outlays for operating expenses in priority sectors, including education, health, road maintenance, water supply, and agricultural services. A system for the monthly monitoring of the wage bill and operating expenses will be implemented during 1989.

13. With regard to public enterprise reform, the financial restructuring of the NCPB has been completed with a write-off of K Sh 5.3 billion in the 1988/89 budget. The ongoing organizational restructuring of the NCPB (including cereal sector reform) is expected to be completed in 1991. The financial restructuring of the Kenya Railways and the South Nyanza Sugar Company are expected to be completed by 1991/92. During 1989, the Government began to monitor the financial performance and flow of funds of 10 sample nonfinancial public enterprises with the intention of extending the coverage so as to facilitate measurement of the consolidated public sector deficit by 1990/91. The Government has also initiated work to formulate a policy framework for public enterprises with technical assistance support from the UNDP. A draft of the proposed policy paper is expected to be completed in December 1989. An action plan for restructuring (or divesting) two development finance institutions and their portfolios--the Industrial Development Bank (IDB) and the Industrial and Commercial Development Corporation (ICDC)--has been prepared. By June 1990, a decision will be taken as to the subsidiaries of these institutions that will be privatized, restructured or liquidated. Finally, the Government is concerned about the operating situation of Kenya Airways and believes that a substantial infusion of equity capital will be required in the next three years to upgrade equipment, strengthen management, and improve maintenance capacity. Additional borrowing to address these problems will be consistent with the overall program targets to be negotiated, and will be the subject of close consultation with the Fund and the World Bank in view of the heavy capital borrowing requirements.

14. During the remainder of 1989 the Government will continue with its reform of the financial system, with a view to improving the efficiency of resource

mobilization and allocation and to broadening the range of financial instruments available to savers and investors. In particular, with technical assistance from the Fund, reserve money management will be introduced gradually and active use of available monetary policy instruments through the Monetary Policy Committee will be initiated. The available monetary policy instruments will be refined. Interest rates will be maintained positive in real terms. In pursuit of the program's target of market determination of interest rates by June 1991, and in view of the recent inflationary pressures, the minimum savings deposit rate for commercial banks will be raised by one half percentage point to 12.5 percent by October 15, 1989. Simultaneously, the commercial banks' maximum lending rate for maturities of three years or less will be raised to 15.5 percent and the maximum lending rate for maturities in excess of three years will be 18 percent. This latter adjustment raises the interest rate on loans of maturities between three and four years from 15 percent to 18 percent. If at the end of November, the annual weighted average inflation rate is above 10 percent, the Government will further raise the interest rate ceiling on loans of three years or less to 16 percent by the middle of January. Interest rate policies will be reviewed further at the time of the discussions for the second annual arrangement under the ESAF. Finally, an effort will be made to remove some of the inefficiencies in the financial system by strengthening the capacity of the Central Bank's staff to supervise banking institutions. Restructuring programs have been prepared for weaker financial institutions. To encourage the development of a capital market, the Capital Market Authority will be established by early 1990 and the Capital Issues Committee's jurisdiction over the pricing of domestic equity issues will be removed shortly thereafter.

15. Monetary policy will continue to be geared toward reducing inflationary pressures and with a view toward achieving a manageable external account position. For the first half of 1990, the credit targets will be as indicated in attached Table 1. These indicative targets, which will be reviewed at the time of the elaboration of the annual program to be supported by the second annual arrangement under the ESAF in early 1990, are projected to be consistent with a 8.2 percent increase in broad money in 1989/90.

16. In the external sector, the current account deficit in 1989 is expected to be wider than originally programmed; it is now expected to widen slightly from 5.3 percent of GDP in 1988 (revised) to 5.5 percent in 1989 (rather than falling to 4.0 percent of GDP from 4.5 percent as envisaged in the program). Exports receipts are now projected to be less than originally envisaged, reflecting lower coffee exports in the light of recent trends in coffee prices in July and August following the collapse of the International Coffee Agreement, as well as lower net services receipts. It appears that import growth for the year as a whole will be higher than originally projected, in part reflecting the import liberalization measures discussed earlier but also that government imports, while falling, are higher than originally foreseen. Receipts from tourism are anticipated to be only slightly lower than programmed since recent developments appear not to have much of an adverse effect on the tourism industry. The programmed build-up in net official reserves of SDR 58 million, however, is expected to be achieved, since external capital inflows are likely to be substantially higher than originally

projected. The exchange rate will continue to be flexibly managed; by the end of July it had depreciated by 4.7 percent in real terms from its end-1988 level, based on provisional estimates.

17. Within the context of the industrial sector adjustment program, the study commissioned to calculate equivalent tariffs also contained a section examining the impact on domestic industry of unrestricted import licensing. More detailed work in this latter area has started and will be ultimately directed toward the preparation of an action program for restructuring viable public enterprises adversely affected by liberalization. A proposal to study and recommend policies for restructuring the textile industry in particular has already been approved by IDA for funding through its Project Preparation Facility. As regards the export compensation scheme, the Government clearly recognizes the need to improve administrative arrangements to ensure prompt payment of export compensation. The aim is to reduce delays in receiving compensation, targeting one month as the maximum time for receiving reimbursement. Further work contributing to a comprehensive medium-term export promotion program is currently in the pipeline. In this connection, an initial study to evaluate the enabling environment for an export processing zone near Mombasa has been commissioned and should be completed before the end of the year; another study financed through a World Bank Special Project Preparation Facility and a Project Preparation Facility to evaluate and design another export processing zone near Nairobi will be commissioned by the end of 1989 and completed by mid-1990. The Government expects to formulate a program for export processing zones by June 1990. With regard to price controls, in September, the price of animal feed was decontrolled, reducing the number of controlled items to 19 under the General Order.

18. Finally, we would like to assure you that the Government of Kenya is firmly committed to achieve the objectives set out in our structural adjustment program and will take any further measures that are necessary in this regard.

Sincerely yours,

Professor George Saitoti Vice President and Minister for Finance	Eric C. Kotut Governor Central Bank of Kenya

Attachment

Table 1. Kenya: Quantitative Performance Criteria and Benchmarks Under the First Annual Arrangement Under the Enhanced Structural Adjustment Facility 1989

Performance criteria and benchmarks	1988	1989 June Benchmark	1989 September Performance criteria	1989 December Benchmark	1990 March Indicative target	1990 June Indicative target
			(In millions of Kenya shillings)			
Total domestic credit 1/						
Ceiling	...	55,044	56,897	58,080	57,371	57,712
Actual	52,666	52,422	...	...	...	...
Net credit to the Government 2/						
Ceiling	...	15,620	17,420	17,270	15,631	14,772 5/
Banking system	...	(19,321)	(21,891)	(21,741)	(20,241)	(19,382)
CSFC	...	(-3,701)	(-3,701)	(-3,701)	(-3,840)	(-3,840)
Debt assumed of parastatals	...	...	(-770)	(-770)	(-770)	(-770)
Actual	14,811	13,670	...	...	...	...
Banking system	(18,512)	(17,510)	...	...	...	...
CSFC	(-3,701)	(-3,840)	...	...	...	...
			(In millions of U.S. dollars)			
New nonconcessional external loans contracted or guaranteed by the Government 3/ (cumulative per calendar year)						
1-12 years' maturity						
Ceiling	...	100.0	100.0	100.0		
Actual	72.8	56.4	...	...		
Less than 1 year's maturity, other than related to imports						
Ceiling	...	—	—	—		
Actual	—	—	...	...		

Benchmark	1988 December Outstanding	1989 June Benchmarks	1989 September Benchmarks	1989 December Benchmarks
			(In millions of SDRs)	
Minimum cumulative increase in net official international reserves from end-December 1988 4/				
Benchmark	...	42	37	58
Actual	-113	80	...	...

Sources: Central Bank of Kenya; and staff estimates.

1/ Total domestic credit of the banking system is the sum of net credit to the Government, other public sector credit, and private sector credit. It includes bank credit utilized by the Cereals and Sugar Finance Corporation (CSFC).

2/ Net credit to the Government is net credit to the Government from the banking sector. The ceiling excludes the operations of the CSFC and excludes the amount of public enterprise debt assumed by the Government, and reclassified from outstanding private sector credit, which as of September 30, should amount to K Sh 770 million (relating to the assumed debt of the following corporations: (i) Kenya Chemical and Food Corporation (K Sh 512 million), Kenya Furfural (K Sh 54 million), The Wheat Board (K Sh 38 million), Fluorspar (K Sh 136 million) and East African Airways (K Sh 30 million).

3/ In conformity with existing regulations, no public enterprise will borrow on nonconcessional terms without government guarantee. For purposes of converting new nonconcessional external loans into U.S. dollars, the U.S. dollar exchange rates cabled to the Central Bank of Kenya from the Federal Reserve Bank of New York for January 3, 1989 will be used.

4/ Net official international reserves are defined as Central Bank's holdings of net foreign assets (excluding use of Fund credit), the Government's holding of net foreign assets (excluding reserve position in the Fund), use of Fund credit, and reserve position in the Fund. The information for the last two items is obtained directly from the Fund.

5/ This target will be adjusted downwards to the extent that net external financing of the deficit during the July 1989 - June 1990 period, excluding A in A financing, exceeds K Sh 204 million, or to the extent that domestic nonbank financing exceeds K Sh 0.9 billion.

KENYA - Relations with the Fund

(As of September 30, 1989)

I. Membership Status:

a. Date of membership	February 3, 1964
b. Status	Article XIV

A. Financial Relations

II. General Department

a. General Resources Account:

(i)	Quota	SDR 142.0 million
(ii)	Total Fund holdings of Kenya's currency	SDR 366.82 million (258.32 percent of quota)
(iii)	Fund holdings of Kenya's currency subject to repurchase	SDR 237.02 million (166.91 percent of quota)
	Of which: credit tranche	SDR 80.98 million (57.02 percent of quota)
	EAR	SDR 92.36 million (65.04 percent of quota)
	CFF - cereal	SDR 23.69 million (16.68 percent of quota)
	CFF - export	SDR 40.00 million (28.17 percent of quota)
(iv)	Reserve tranche	SDR 12.22 million (8.60 percent of quota)

Kenya - Relations with the Fund (continued)

b. Special Disbursement Account:

(i)	Structural adjustment loan	SDR 28.40 million (20 percent of quota)
(ii)	Enhanced structural adjustment loan 1/	SDR 21.30 million (15 percent of quota)

III. Current or Previous Stand-By Arrangements and Special Facilities

(a) Previous arrangements:

One extended arrangement approved in July 1975, and seven stand-by arrangements approved, respectively, in November 1978, August 1979, October 1980, January 1982, March 1983, February 1985, and February 1988. Amounts range from SDR 17.25 million to SDR 241.50 million. Cumulative purchases made under these arrangements amounted to SDR 521.0.

(b) Special facilities:

(i) Under the compensatory financing facility for export shortfalls and cereal imports, Kenya made purchases of SDR 60.4 million (58 percent of then quota) in June 1982, SDR 37.9 million (27 percent of quota) in December 1985, and SDR 40.0 million (28 percent of quota) in October 1988.

(ii) A loan under the structural adjustment facility became effective on February 1, 1988. Purchase of SDR 28.4 million was made in February 1988. The arrangement was replaced by an ESAF on May 15, 1989.

(iii) A loan under the enhanced structural adjustment for SDR 241.4 million for 36 months became effective on May 15, 1989. Purchase of SDR 40.23 million was made on May 31, 1989.

1/ Utilization of outstanding ESAF comprises SDR 21.30 million from the Special Disbursement Account (SDA) and SDR 18.93 million from the ESAF Trust.

Kenya - Relations with the Fund (continued)

IV. SDR Department

(a) Net cumulative allocation - SDR 36.99 million
(b) Holdings: amount to SDR 6.25 million or 16.89 percent of net cumulative allocation

V. Administered Accounts

(a) Trust Fund Loans:

(i) Disbursed - SDR 46.91 million
(ii) Outstanding - SDR 2.55 million

(b) SFF Subsidy Account:

(i) Payments by Fund - SDR 13.84 million

(c) ESAF loans: Trust Account

(i) Disbursed - SDR 18.93 million
(ii) Outstanding - SDR 18.93 million

VI. Financial obligations to the Fund:

	Overdue Financial Obligations (9/30/89)	Principal and Interest Due				
		1989 1/	1990	1991	1992	1993
Principal	--	32.3	77.7	29.3	58.8	44.4
Repurchases	--	31.4	76.2	29.1	58.8	41.5
Trust Fund Repayments	--	0.9	1.5	0.2	--	--
SAF Repayments	--	--	--	--	--	2.8
Charges and interest including SDR and TF (provisional)	--	4.1	20.1	14.5	10.3	5.3
Total	--	36.4	97.7	43.8	69.1	49.7

B. Nonfinancial Relations

VII. Exchange System: Pegged to composite. At end-August 1989 the exchange rate was K Sh 21.3858 = US$1

1/ 10/1/89 - 12/31/89.

Kenya - Relations with the Fund (concluded)

VIII. Last Article IV Consultation

The 1989 Article IV consultation (EBS/89/84, 4/27/89, and SM/89/83, 5/9/89) was concluded by the Executive Board on May 15, 1989. The following decision was adopted:

1. The Fund takes this decision relating to Kenya's exchange measures subject to Article VIII, Section 2(a), in the light of the 1989 Article IV consultation with Kenya conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Kenya maintains restrictions on payments and transfers for current international transactions subject to Fund approval under Article VIII, Section 2(a), in the form of limits for remittances of rental income of nonresidents and of a foreign exchange budget on the basis of which licenses for nonliberalized import items are issued. In the circumstances of Kenya, the Fund grants approval for their retention until June 30, 1990, or the conclusion of the next Article IV consultation with Kenya, whichever is earlier.

Kenya is on the standard 12-month cycle for Article IV consultations.

IX. Technical Assistance

CBD: Technical assistance missions on Kenya's financial system (March and May-June 1984), on bank supervision procedures (June 1988), and on the operational aspects of monetary policy implementatin (November 1988).

FAD: Technical assistance in fiscal field (1981).

BUR: Technical assistance mission on money and banking statistics (November 1987).

Relations with the World Bank Group

The World Bank has a large ongoing program in Kenya. As of March 31, 1989, it had committed almost US$2.5 billion, of which US$2.0 billion had been fully disbursed (Table 1).

1. Agriculture

The Bank's assistance to agriculture is centered around a policy reform program supported by a quick-disbursing sector adjustment credit which was approved in June 1986. Among the components of this program are: (i) measures to increase the availability and distribution of agricultural inputs (especially fertilizer); (ii) movement towards price flexibility and deregulation; (iii) rationalization of government expenditure in the sector; (iv) the divesting of some agricultural parastatals and the restructuring of others in the context of better defined policies on parastatals; and (v) improvements in agriculture credit programs. Second tranche was approved in February 1988.

These policy measures are complemented by ongoing investment projects in coffee rehabilitation, forestry, agriculture research, rehabilitation of animal health services and the provision of country-wide extension services.

For the future, Bank assistance to the sector will continue to emphasize adjustment lending with a view to broadening and consolidating a policy framework that is conducive to a more vigorous contribution to growth by agriculture. Investment lending will continue to complement the policy reforms with greater attention being given to implementing the results from pilot projects in the areas of agriculture credit, livestock development, land and environmental management and arid and semi-arid agricultural techniques. The Bank is currently developing and testing new methodologies or approaches in these areas in order to ensure replicability before embarking on large scale national investments.

2. Energy

The Bank's efforts in this sector are concentrating on lessening Kenya's dependence on imported oil through hydroelectric development, geothermal development, and petroleum exploration promotion. While future lending will be consistent with the least cost recommendations of the recently completed power study, greater attention will be focussed on alleviating policy constraints (e.g. pricing and distribution) to attain a more efficient and integrated energy sector.

3. Industry/finance

Until recently, Kenya's industry has obtained World Bank lending through development finance intermediaries. In support of an industrial reform program in June 1988 an industrial sector adjustment credit for

Kenya - Relations with the World Bank Group (continued)

Table 1. The Status of Bank Group Operations in Kenya

A. Statement of Bank Loans and IDA Credits as of March 31, 1989

Amount (less cancellations)

(In millions of U.S. dollars)

Loan or credit no.	Year	Borrower	Purpose	Bank	IDA	Undisbursed
Forty three (43) loans, of which six were cancelled, thirty-six (36) credits and two (2) Third Window Loans Fully Disbursed 1/				826.82	467.95	
1107	1981	Kenya	Fifth Education		40.00	16.98
2098	1982	Kenya	Forestry III	11.50		6.80
1237	1982	Kenya	Cotton Processing and Marketing		22.00	3.50
1238	1982	Kenya	Integrated Rural Health and Family Planning		23.00	9.35
1387	1983	Kenya	National Extension		15.00	7.27
2319	1983	Kenya	Secondary Towns	7.00		6.98
1390	1983	Kenya	Secondary Towns		22.00	13.41
2359	1984	Kenya	Kiambere Hydroelectric	95.00		24.09
2409	1984	Kenya	Second Highway Sector	5.00		3.65
F017	1984	Kenya	Second Highway Sector		40.00	43.07
1486	1984	Kenya	Geothermal Exploration		24.50	5.69
1566	1985	Kenya	Water Engineering		6.00	2.64
2574	1985	Kenya	Third Telecommunications	32.60		21.00
1673	1986	Kenya	Sixth Education		37.50	43.90
1675	1986	Kenya	Petroleum Exploration Technical Assistance		6.00	5.27
1718	1986	Kenya	Agricultural Sector Management		11.50	8.85
1738	1987	Kenya	KIE 2nd Small Scale Industry		6.00	6.67
1758	1987	Kenya	Animal Health Services		15.00	14.96
1820	1987	Kenya	Second Railway		28.00	26.07
1849	1988	Kenya	Agriculture Research		19.60	19.91
A0360	1988	Kenya	Industrial Sector Operation		10.00	—
1904	1988	Kenya	Population III		12.20	11.63
1927-0	1988	Kenya	Industrial Sector Operation		102.00	46.63
1927-1	1989	Kenya	Industrial Sector Operation		53.70	53.48
1973	1989	Kenya	Geothermal Development		40.70	40.82
1974	1989	Kenya	Rural Services		20.80	20.02
			Total	977.92	1,023.45	462.64
			Of which: has been repaid	282.44	14.99	
			Total now outstanding	695.48	1,008.46	
			Amount sold			
			Of which: has been repaid	11.74		
			Total now held by Bank and IDA	683.74	1,008.46	
			Total undisbursed	62.53	400.12	462.64

1/ In addition, Kenya was one of the beneficiaries of 10 loans totalling US$244.8 million, which were extended for the development of common services (railways, ports, telecommunications, and finance for industry) operated regionally for the three partner states of the former East African Community (EAC).

Kenya - Relations with the World Bank Group (continued)

Table 1. The Status of Bank Group Operations in Kenya (concluded)

B. Statement of IFC Investments in Kenya as of March 31, 1989

Fiscal year	Obligor	Type of business	Amount in millions of U.S. dollars Loan	Equity	Total
1967, 1968, and 1973	Kenya Hotel Properties	Hotels	5.2	0.7	5.9
1970, 1974, 1977, 1979, 1981, and 1988	Pan African Paper Mills	Pulp and Paper	25.7	6.3	32.0
1972	Tourism Promotion Services	Hotels	2.4	— 1/	2.4
1976	Rift Valley Textiles Ltd.	Textiles	6.3	2.8	9.1
1977	Kenya Commercial Bank Ltd.	Capital Market	2.0	—	2.0
1980, 1983, and 1987	Development Finance Company of Kenya Ltd.	Development Finance	8.1	1.3	9.4
1981	Kenya Commercial Finance	Money and Capital Market	5.0	—	5.0
1982	Bamburi Portland Cement Co., Ltd.	Cement and Construction Material	4.4	—	4.4
1982	Diamond Trust of Kenya Ltd.	Money and Capital Market	—	0.8	0.8
1982, 1986	Industrial Promotion Services (Kenya) Ltd.	Money and Capital Market	—	2.0	2.0
1983	Tetra Pak Converters Ltd.	Pulp and Paper Products	2.2	0.4	2.6
1984	Leather Industries of Kenya Ltd.	Tanning	2.1	0.6	2.7
1985	Madhu Paper International Ltd.	Pulp and Paper Products	37.1	2.0	39.1
1986	Equatorial Beach Properties	Tourism	5.6	—	5.6
1986	Oil Crop Development Ltd.		9.7	1.4	11.1
1987	Agro Development Limited	Agri-Business	1.3	—	1.3
	Total Gross Commitments		117.1	18.3	135.4
	Less cancellations, terminations, repayments and sales		90.9	6.0	96.9
	Total Commitments now held by IFC		26.2	12.3	38.5
	Total Undisbursed		1.5	1.2	2.7

1/ US$44,937.

Kenya - Relations with the World Bank Group (continued)

US$112 million was approved. In order to stimulate investment, promote export production, and make industries more efficient, the reform program covers areas such as trade liberalization, tariffs, price controls, export promotion, corporate taxation, financial sector policies, and industrial public enterprises. A complementary financial sector adjustment operation was approved in June 1989. It addresses *inter alia* interest rate reforms, rationalization of the banking regulatory framework, restructuring of depository institutions, and the development of capital and money markets.

4. Infrastructure

Highway projects and the promotion of railways have accounted for most of the lending to date. A major water supply project for Nairobi was approved in July 1989. In addition, the Bank is preparing an urban development project whose main feature will be to enhance the financing and management capacity of municipal authorities.

5. Population

The third IDA-financed project to help the Government promote fertility was approved in 1988 and is now being implemented.

6. Education and health

The Bank's attention is currently directed at developing viable financing and management capacity in both sectors. Lending operations designed to promote more efficient utilization of resources and to implement appropriate mechanisms to increase cost sharing are being prepared.

7. Adjustment lending

The World Bank negotiated and fully disbursed two structural adjustment loans (SAL) to Kenya. The first, negotiated in March 1980, was for US$70 million and was fully disbursed by September 1980. The second, negotiated in July 1982 for SDR 130 million, was disbursed in two tranches: in September 1982 and January 1984. The SAL programs were implemented under adverse external circumstances which negatively affected Kenya's performance. The protracted balance of payments crises of 1981 and 1982, as well as the coup attempt in August 1982, forced adjustments in the Government's policies and led to delays and reversals in policy initiatives included in the SAL programs. The speed of implementation was also affected by a shortage of technical personnel and the preoccupation of the authorities with short-term stabilization efforts.

Kenya - Relations with the World Bank Group (concluded)

It has been agreed between the Bank and the Government that, for the near future, Bank financial support for the Government's structural adjustment efforts will take the form of sector adjustment loans rather than the comprehensive SAL. As noted above, an agricultural sector adjustment loan was approved by the Bank's Board in June 1986, an industrial sector adjustment loan was approved in June 1988, and a financial sector adjustment loan was approved in June 1989. Further sector adjustment operations are scheduled in agriculture, education, and health.