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April 5, 1984

To: Members of the Executive Board

From: The Acting Secretary

Subject: Kenya - Staff Report for the 1984 Article IV Consultation and Review Under Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with Kenya and a review under the stand-by arrangement. Draft decisions appear on pages 29 and 30.

This subject will be brought to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Jiménez (ext. 73707) or Mr. Simpson (ext. 75655).

Att: (1)

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INFORMATION

INTERNATIONAL MONETARY FUND

KENYA

Staff Report for the 1984 Article IV Consultation and Review Under Stand-By Arrangement

Prepared by the Staff Representatives for the
1984 Consultation with Kenya

Approved by Oumar B. Makalou and W.A. Beveridge

April 4, 1984

I. Introduction

The 1984 Article IV consultation discussions with Kenya, together with the second review under the current 18-month stand-by program, were held in Nairobi, during January 16-26 and February 22-25, 1984. 1/ The Kenyan representatives included the Minister for Finance and Planning, the Governor of the Central Bank, and other officials from ministries and the Central Bank.

On March 21, 1983 the Executive Board approved Kenya's current stand-by arrangement in an amount equivalent to SDR 175.95 million, representing 119.7 percent of Kenya's quota of SDR 142.0 million (170.0 percent of old quota). Of the total amount, SDR 9.74 million is being provided from ordinary resources; the balance, SDR 166.21 million, is from borrowed resources under the enlarged access policy. So far, Kenya has drawn SDR 129.8 million under the arrangement. As of February 29, 1984 Fund holdings of Kenya shillings subject to repurchase were SDR 385.8 million, or 271.7 percent of quota; excluding special facilities they amounted to SDR 308.2 million, or 217.0 percent of quota (Table 1). Full use of resources available under the stand-by arrangement, taking into account scheduled repurchases, would bring Fund holdings of Kenya shillings subject to repurchase on September 30, 1984 to 282.5 percent of quota or 239.9 percent of quota excluding special facilities.

1/ The first mission comprised Messrs. J.M. Jiménez (head-AFR), J.D. Simpson (AFR), W.R. Mahler (FAD), P.J. Montiel (RES), B.A. Sarr (EP-AFR), Ms. C. Atkinson (EP-ETR), and Miss A. Sookazian (secretary-BUR). The second mission consisted of Messrs. J.M. Jiménez (head-AFR), and J.D. Simpson (AFR).

Table 1. Kenya: Fund Position During Period of Arrangement, March 1983-September 1984

	Outstanding at beginning of arrangement Feb. 28, 1983	1983 Jan.-Mar.	1983 Apr.-June	1983 July-Sept.	1983 Oct.-Dec.	1984 (estimates) Jan.-Mar.	1984 (estimates) Apr.-June	1984 (estimates) July-Sept.
				(In millions of SDRs)				
Transactions under tranche policies (net) 1/	--	45.2	26.0	-2.2	54.3	-4.4	17.5	15.6
Purchases	--	45.2	28.2	--	56.4	--	23.0	23.3
Ordinary resources	--	(9.7)	(--)	(--)	(--)	(--)	(--)	(--)
Enlarged access resources	--	(35.5)	(28.2)	(--)	(56.4)	(--)	(23.0)	(23.3)
Repurchases	--	--	2.2	2.2	2.2	4.4	5.5	7.7
Ordinary resources	--	(--)	(2.2)	(2.2)	(2.2)	(4.4)	(3.3)	(5.6)
Enlarged access resources	--	(--)	(--)	(--)	(--)	(--)	(2.2)	(2.1)
Transactions under special facilities (net) 2/	--	--	-8.8	-8.6	-8.6	-8.6	-8.6	-8.6
Purchases	--	--	--	--	--	--	--	--
Repurchases	--	--	8.8	8.6	8.6	8.6	8.6	8.6
Total Fund credit outstanding (end of period)	300.9	346.1	363.3	352.5	398.2	385.2	394.1	401.1
Under tranche policies 1/	188.6	233.8	259.8	257.6	311.9	307.5	325.0	340.6
Under special facilities 2/	112.3	112.3	103.5	94.9	86.3	77.7	69.1	60.5
				(As percent of quota) 3/				
Total Fund credit outstanding (end of period)	211.9	243.7	255.9	248.2	280.4	271.3	277.5	282.5
Under tranche policies 1/	132.8	164.7	183.0	181.4	219.7	216.6	228.9	239.9
Special facilities	79.1	79.1	72.9	66.8	60.8	54.7	48.7	42.6

Source: IMF, Treasurer's Department.

1/ Ordinary and enlarged access resources.

2/ Compensatory financing facility and oil facility.

3/ New quota, SDR 142 million.

II. Review of Recent Developments and Performance Under Stand-By Arrangement

The mission carried out the second review called for under the present stand-by arrangement, which covered fiscal, monetary, import and exchange and interest rate policies, and negotiated the credit ceilings for the remainder of the program period. The mission found the policies in place adequate to meet the objectives of the program.

1. Background

In contrast to the difficulties encountered in observing the performance criteria established under previous arrangements, in part for reasons beyond its control, the Government of Kenya by the end of 1983 had succeeded in implementing the current program with determination. Indeed, the program's objectives were exceeded in many instances in 1983, through the adoption of a more restrained financial stance when the program targets were perceived to be in jeopardy (Table 2). Consequently, the Government of Kenya has met the performance criteria established for March, June, September, and December 1983, and has completed the first review of the program undertaken by the Executive Board on October 24, 1983 (Table 3).

The current program has relied on a multifaceted adjustment strategy, which included policies aimed at limiting aggregate demand in order to reduce internal and external pressures, and measures to improve the allocation of resources to speed the growth of the economy and assure balance of payments viability in the medium term. Substantial and more rapid than expected progress has been made with respect to stabilization policies, with impressive reductions in the budgetary and balance of payments deficits, domestic credit expansion, and inflationary pressures. The overall balance of payments recorded a surplus in 1983 and is expected to be in equilibrium in 1984.

2. Production and the allocation of resources

The growth rate of real GDP is estimated to have reached 3.7 percent in 1983, compared to 1.8 percent in 1982. However, the improved 1983 growth rate compares unfavorably to the 4.3 percent per year recorded in 1979-81 and particularly to the 8.4 percent annual rate achieved in 1977-78. The annual population growth is estimated at 3.8 percent.

Aided by good weather conditions, the agricultural sector recorded favorable growth rates during 1982-83, with surplus food production in both years, permitting exports of beans and maize. Agriculture accounts for about one third of value added and its performance has been important in maintaining momentum in the economy. The lower growth rate in recent years reflects mainly difficulties in the other sectors, principally manufacturing, construction, and commerce, including tourism. These

Table 2. Kenya: Selected Economic and Financial Indicators, 1981-84

	1981	1982	1983 Revised program	1983 Estimate	1984 Program	1984 Revised program
	(Annual percent changes, unless otherwise specified)					
National income and prices						
GDP at constant prices	4.1	1.8	3.0	3.7	4.0	4.0
GDP deflator	11.0	10.6	12.2	15.8	8.2	10.6
Consumer prices	20.2	14.4	13.0	10.1	8.0	8.0
External sector (on the basis of SDRs)						
Exports, f.o.b.	-6.1	-7.0	-0.1	1.4 1/	9.3	10.1 2/
Imports, c.i.f.	-9.7	-16.2	-7.9	-13.9	9.9	12.4
Non-oil imports, c.i.f.	-16.0	-16.7	-2.3	-11.5	13.6	20.3
Export volume	-5.1	-3.3	-0.1	2.6 1/	2.9	0.5 2/
Import volume	-21.8	-17.8	-8.5	-10.6	5.1	10.0
Terms of trade (deterioration -)	-13.5	-5.9	-0.7	2.5	2.1	7.5
Nominal effective exchange rate (depreciation -) 3/	-15.4	-11.7	...	--	...	...
Real effective exchange rate (depreciation -) 3/	2.1	-7.7	...	5.2	...	...
Government budget 4/						
Revenue and grants	20.3	12.4	17.5	8.8	9.7	12.1
Total expenditure	24.9	8.4	11.0	-3.5	12.2	14.7
Money and credit 4/						
Domestic credit	20.0	26.9	14.8	6.4	14.0	14.2
Government	74.6	55.1	20.3	-0.8	17.6	17.6
Other sectors	7.7	16.7	14.9	9.9	12.0	12.9
Money and quasi-money (M_2)	7.1	8.8	13.3	11.3	9.8	12.8
Velocity (GDP relative to M_2) 5/	3.31	3.47	3.68	3.63	3.98	3.59
Interest rate (annual rate) 5/						
Savings deposit (min.)	10.00	12.50	12.50	12.50	12.50	12.50
Average time deposit	10.75 to 12.50	13.75 to 15.50	13.75 to 15.50	13.75 to 14.50	13.75 to 14.50	13.75 to 14.50
Maximum lending rate	14.00	16.00	16.00	15.00	15.00	15.00
	(In percent of GDP)					
Government budget						
Revenue and grants	26.1	25.7	25.9	24.0	22.4	22.9
Current expenditure	24.7	23.3	21.8	20.5	19.9	20.3
Current account surplus/deficit (-)	1.4	2.4	4.1	3.5	2.5	2.6
Development expenditure and net lending	10.1	9.8	9.1	6.9	6.3	6.4
Overall deficit 6/						
Including grants	9.5	6.6	4.9	3.1	3.7	3.8
Excluding grants	10.3	8.0	6.9	4.9	5.3	5.2
Domestic bank financing	2.8	2.6	1.4	-0.2	1.4	1.4
Foreign financing	4.9	1.7	2.5	1.7	1.2	0.9
Gross domestic investment	28.3	22.3	20.0	20.0	20.0	21.0
Gross domestic savings	19.3	16.9	15.2	15.0	16.2	16.2
External current account deficit 7/						
Including grants	11.1	7.4*	3.4*	2.7	3.6	3.4
Excluding grants	12.3	8.6*	5.1*	4.6	5.1	5.0
External debt						
External debt inclusive of Fund credit (beginning of period)	34	39	38	44	36	43
Debt service ratio 8/	18	24	29	28	29	27
Interest payments 8/	10	13	11	11	10	11
	(In millions of SDRs, unless otherwise specified)					
Overall balance of payments 9/	-198	-149**	-1**	89	-24	--
Gross official reserves (months of imports)	1.6	1.8	2.0	3.0	2.0	2.8
External payments arrears	--	--	--	--	--	--

1/ Non-oil exports are estimated to have risen by 5.7 percent in value and about 5 percent in volume.
2/ Non-oil exports are projected to rise by 13 percent in value and 2.5 percent in volume.
3/ December to December variation.
4/ Fiscal year ending June 30.
5/ Level in percent.
6/ Figures do not add up because of adjustment to cash basis.
7/ Asterisk * reflects severe constraint on foreign exchange availability.
8/ In percent of exports of goods and services.
9/ Double asterisk ** reflects severe constraint on foreign exchange availability.

Table 3. Kenya: Quantitative Performance Criteria (March 83-June 84)

(In millions of Kenya shillings)

	1983				1984	
	March	June	Sept.	Dec.	March	June
					Proposed	
Total domestic bank credit						
Ceiling	25,719	24,995	25,495	26,420	26,365	26,286
Actual	23,637	22,990	24,435	25,374		
Net bank credit to the Government 1/						
Ceiling	8,199	7,032	7,524	7,724	7,154	6,927
Actual	6,999	5,888	6,937	7,156		
New external borrowing contracted or guaranteed by the Government (cumulative) 2/						
1-12 years' maturity						
Ceiling	150	150	150	150	150	150
Actual	--	--	--	--		
1-5 years' maturity						
Ceiling	100	100	100	100	100	100
Actual	--	--	--	--		

Sources: Letter of Intent, January 28, 1983.

1/ The definition of net bank credit to the Government differs from that of the monetary survey in that the former includes the domestic currency counterpart of drawings on Eurocurrency loans and excludes the operations of the Cereals and Sugar Finance Corporation (CSFC). This agency maintains its general account with the Treasury, rather than with a commercial bank; therefore, its operations influence the Government's net position with the banking system, reducing net government credit when the CSFC receives payments, and increasing net government credit when it purchases cereals. Consequently, it is necessary to exclude these operations in order to isolate developments in net government credit due solely to budgetary operations. However, the bank credit utilized by the CSFC is captured in the overall credit ceiling, where this adjustment is not made. For an exact definition of net domestic bank credit and net bank credit to Government see EBS/80/125, pp. 25-27.

2/ In millions of U.S. dollars.

sectors were affected by a weak international economy, domestic uncertainty, a decrease in government outlays, and the other measures implemented to reduce aggregate demand. Manufacturing rose by an average of only 2.4 percent in 1982-83, while in 1983, value added in construction and trade, including tourism, remained below the level attained in 1981.

The growth of the economy for 1984 is now estimated at 4.0 percent. Thus, in terms of growth, the 1983-84 period is now expected to be better than estimated in the program. However, the growth has been unbalanced, mainly reflecting the impact of favorable weather conditions on the agricultural sector.

The GDP deflator is estimated to have increased by almost 16 percent in 1983, as against an average of under 11 percent in the previous three years. The higher rate reflects both the depreciation of the Kenya shilling, which on average was about 18 percent lower (against the SDR) in 1983 than in 1982, and significant adjustments in producer and consumer prices. Producer prices for maize were some 51 percent higher in 1983 than in 1982, while those for wheat and rice were up by 18 percent and 19 percent, respectively. The index of average prices paid to all agricultural producers was about 17 percent higher in 1983, compared with increases of 13 percent and 5 percent in 1982 and 1981, respectively. Excluding major exports, the index increased by about 15 percent in 1983.

Consumer prices moved in line with the GDP deflator in 1983. The average composite consumer price index rose by about 14 percent in 1983 compared to 21 percent in 1982. However, prices have been decelerating throughout the year, aided by a good harvest and the regularization of import flows. Prices in December 1983 were only about 10 percent higher than in December 1982, compared to a 14 percent rise for the previous twelve-month period. To aid the continued amelioration of price pressures, the Government has followed a cautious income and wage policy, allowing wage adjustments in the public sector that only cover part of the rise in the cost of living. There has been no general wage increase for government employees since 1981. The program envisaged that consumer prices could rise by an average of 13 percent in 1983; the actual rise for the year is now estimated at 10 percent. During January-February 1984, prices decelerated further, to about 8.5 percent.

3. Financial developments

The overall budget deficit (cash basis) for 1982/83 had been targeted at K Sh 3.7 billion (4.9 percent of GDP) compared to K Sh 4.3 billion (6.6 percent of GDP) in 1981/82 and K Sh 5.4 billion (9.5 percent of GDP) in 1980/81 (Table 4). The sluggish growth in the nonagricultural sector and the lower than expected flow of imports had an adverse impact on government revenue, leading to a stronger than programmed curtailment of expenditure, particularly development outlays. This had a negative impact on the Government's ability to draw down available grants and

Table 4. Kenya: Central Government Finance, 1979/80-1983/84

(In millions of Kenya shillings)

	1979/80	1980/81	1981/82	1982/83 Program	1982/83 Preliminary	1983/84 Program	1983/84 Revised
Total revenue and grants	12,296	14,789	16,623	19,540	18,085	19,842	20,282
Total revenue	11,984	14,338	15,737	17,970	16,729	18,419	19,091
Foreign grants	312	451	886	1,570	1,356	1,423	1,191
Total expenditure and net lending	15,782	19,717	21,381	23,200	20,630	23,144	23,656
Current expenditure	11,381	13,984	15,031	16,380	15,423	17,575	17,987
Development expenditure and net lending	4,401	5,733	6,350	6,820	5,207	5,569	5,669
Overall deficit (Treasury accounts)	-3,486	-4,928	-4,758	-3,660	-2,545	-3,302	-3,374
Adjustment to financing basis 1/	679	-439	469	--	231	--	--
Overall cash deficit	-2,807	-5,366	-4,289	-3,660	-2,314	-3,302	-3,374
Financing	2,807	5,366	4,289	3,660	2,314	3,302	3,374
Foreign financing (net)	2,010	2,764	1,108	1,850	1,307	1,030	805
Drawings 2/	(2,414)	(3,498)	(2,238)	(3,518)	(2,975)	(2,894)	(2,669)
Repayments	(-404)	(-734)	(-1,130)	(-1,668)	(-1,668)	(-1,864)	(-1,864)
Domestic financing	797	2,602	3,181	1,810	1,007	2,272	2,569
Nonbank	(797)	(1,028)	(1,487)	(785)	(1,127)	(1,072)	(1,369)
Bank and CSFC	(--)	(1,574)	(1,694)	(1,025)	(-120)	(1,200)	(1,200)
Overall cash deficit excluding foreign grants	-3,119	-5,817	-5,175	-5,230	-3,670	-4,725	-4,565
Memorandum items:				(In percent of GDP)			
Total revenue and grants	25.1	26.1	25.7	25.9	24.0	22.4	22.9
Total revenue	24.4	25.3	24.4	23.8	22.2	20.8	21.6
Of which: tax revenue	21.2	21.8	21.3	21.6	18.8	18.3	18.8
Total expenditure and net lending	32.2	34.8	33.1	30.8	27.4	26.2	26.8
Overall cash deficit	5.7	9.5	6.6	4.9	3.1	3.7	3.8
Overall cash deficit (excluding grants)	6.4	10.3	8.0	6.9	4.9	5.3	5.2
Foreign financing	4.1	4.9	1.7	2.5	1.7	1.2	0.9
Domestic financing	1.6	4.6	4.9	2.4	1.3	2.6	2.9
Of which: bank and CSFC	--	2.8	2.6	1.4	-0.2	1.4	1.4

Sources: Economic Survey, 1983, Statistical Abstract, 1982, and data provided by the Kenyan authorities.

1/ The adjustment factor arises because financing data are derived from different sources than revenue and expenditure data. It includes a float element resulting from some checks being issued but not cashed during the fiscal year.

2/ Includes PL 480 and defense appropriations-in-aid loans.

long-term foreign financing, making a further adjustment of expenditures necessary. Since the Government had difficulty in projecting resource availability accurately, a precautionary policy was adopted toward expenditures, which forced even larger reductions in outlays resulting in a reduction of about 23 percent in total real expenditures, with a 37 percent fall in real development outlays. A large grant was received and deposited with the banking system in the closing days of the fiscal year, and the overall cash deficit fell to K Sh 2.3 billion or 3.1 percent of GDP, while there was a net buildup in government deposits. The reduction in the overall deficit has been larger than programmed, and overall credit policy was considerably less expansionary than had been programmed.

The resulting small reduction in the Government's net debtor position in the banking system during 1982/83 was reinforced by a cautious credit policy to the rest of the economy, leading to domestic credit expanding by 6.4 percent compared to a program target of about 15 percent. Credit to the rest of the economy rose by only 10 percent during 1982/83. However, credit to the private sector alone rose by only 6 percent, reflecting the sluggishness of the private sector economy and a delay in investment decisions pending the elections scheduled for September 1983.

In the second half of 1983 the shortfall in total credit had been made up to some extent, but the actual growth of 10.4 percent in the six months still fell short of the target of 14.9 percent. Credit demand by the private sector in the last quarter of 1983, after the elections, rose at an annual rate of over 11 percent (Table 5). Credit to public entities also expanded at a high rate. Consequently, in the second half of 1983 credit to the private sector and public enterprises rose at an annual rate of 16 percent, compared with only 12 percent for the whole of 1983. Nevertheless, there was almost no growth in overall net domestic credit in calendar 1983, compared to an expansion of over 4 percent envisaged in the program. Money and quasi-money rose by 6.5 percent in 1983, compared to a target of 8.0 percent.

Current estimates of the budget outturn for 1983/84 (July-June) indicate a better than expected revenue performance, reflecting the improving economy. Total revenue is now estimated at K Sh 19.1 billion compared to a program total of K Sh 18.4 billion. Almost all of the increase is from income and profit tax revenue which had been conservatively estimated in the original budget. Foreign grant receipts for the current fiscal year are only expected to reach 87 percent of the initial estimates. Despite this shortfall, total revenues and grants are estimated at K Sh 20.3 billion, some 2.2 percent higher than previously projected and 12.1 percent larger than actual collections in the previous fiscal year.

The expenditure program for 1983/84 had included an increase in total outlays and net lending of only 12.2 percent, following a reduction in 1982/83. The authorities have continued to oversee expenditure

Table 5. Kenya: Monetary Survey, 1981-84

(In millions of Kenya shillings)

	1981	1982				1983				1984 (Projections)		
	Dec.	March	June	Sept.	Dec.	March	June	Sept.	Dec.	March	June	Dec.
Net foreign assets	514	-452	-921	-1,945	-1,576	-1,143	-122	-1,200	-534	-350	-500	-534
Total domestic credit	19,888	21,534	21,599	24,441	25,344	23,637	22,990	24,435	25,374	26,365	26,286	28,564
Government (net)	6,178	7,552	7,028	9,585	9,988	8,015	6,973	8,130	8,141	8,400	8,173	9,293
Public entities	465	370	626	585	999	1,047	1,196	1,342	1,854)	17,965	18,113	19,271
Private sector	13,245	13,612	13,945	14,271	14,357	14,575	14,821	14,963	15,379)			
Other items (net)	1,449	2,026	1,972	2,628	2,325	1,078	2,100	1,593	2,002	2,300	2,350	2,300
Advance import deposits	127	115	47	14	--	--	--	--	--	--	--	--
Money and quasi-money	18,826	18,939	18,659	19,856	21,443	21,416	20,768	21,642	22,838	23,715	23,436	25,730
Money	9,997	9,818	9,466	9,492	10,763	10,860	10,611	10,948	11,945	...	...	...
Quasi-money	8,829	9,121	9,193	10,364	10,680	10,556	10,157	10,658	10,893	...	...	...
	(Change as a ratio to the stock of money and quasi-money 12 months earlier)											
Net foreign assets	-9.8	-13.6	-12.7	-11.9	-11.1	-3.6	4.3	3.8	4.9	3.7	-1.8	--
Total domestic credit	25.9	24.0	26.7	28.7	27.5	11.1	7.5	--	--	12.7	15.9	13.9
Government (net)	16.4	14.4	14.6	16.5	20.2	2.4	-0.3	-7.3	-8.6	1.8	5.8	5.0
Public entities	-0.2	-0.5	1.0	1.0	3.5	3.6	3.1	3.8	4.0)	10.9	9.9	8.8
Private sector	9.7	10.1	11.1	11.3	3.8	5.1	4.7	3.5	4.6)			

Sources: Data provided by the Central Bank of Kenya; and staff estimates.

authorizations very carefully but have found it necessary to allow for a further increase. Total expenditures and net lending is now expected to reach K Sh 23.6 billion, representing a rise of about 2.2 percent from the original budget and 14.7 percent from the previous year's outlays. In relation to GDP total expenditure will continue to fall, reaching 26.8 percent compared to 27.4 percent in 1982/83 and 34.8 percent in 1980/81, when the ratio reached its peak. Current expenditure is projected to rise by almost 17 percent in fiscal year 1983/84, with development expenditure increasing by about 9 percent. Most of the increase in expenditure over the budgeted amount in the current fiscal year will be matched by the better performance of tax revenue, with the deficit at K Sh 3.4 billion (3.8 percent of GDP) being almost in line with the program target of K Sh 3.3 billion (3.7 percent of GDP).

In the six months to June 1984, and for 1984 as a whole, economic and financial developments are expected to move closer to the revised targets established in the program. The growth rate for calendar year 1984 is projected at 4 percent, while continued progress is expected in reducing the rise in consumer prices to about 8 percent. The improvement in the economy is also estimated to provide additional revenue, allowing for a slightly more expansionary expenditure stance than previously without adding significantly to the Government's need for bank credit. The demand for bank credit by the private sector and public enterprises is expected to be stronger. For the January-June 1984 period, the program will result in a growth in net credit to government equivalent to 5.8 percent of the initial stock of money and quasi-money over the fiscal year 1983/84, in line with the indicative targets established during the first review of the program. Credit to the rest of the economy is projected to rise faster than the indicative target, so that over the fiscal year it will expand by about 10.1 percent of the initial money stock. This growth rate aims to facilitate the growth of the economy, and takes account of the need for additional financing for grain marketing, arising from the need to transfer maize to eastern Kenya from the Rift Valley as a result of drought conditions. Overall, net domestic credit is projected to rise by 15.9 percent over the fiscal year, somewhat below the estimated expansion in nominal income. Net foreign assets are estimated to remain almost unchanged for the first half of calendar 1984, but to be below the June 1983 level by the equivalent of 1.8 percent of the initial money stock. Consistent with these developments liquidity will rise by about 12.8 percent over the fiscal year (see Table 4). Thus, monetary policy should be considerably less restrictive than in 1983.

Interest rates were increased by about 2.5-3.0 percentage points in December 1982, leading to a cumulative rise of about 6 percentage points since 1981, with lending rates and most time deposit rates attaining positive real levels. At the end of 1983 minimum time deposit rates ranged from about 13.75 percent to 14.50 percent and the minimum savings rate was 12.5 percent. In February 1983 the liquidity requirement of banks was increased by 5 percentage points to 20 percent, to absorb the excess liquidity existing at that time, and to keep commercial bank credit consistent with the program's credit ceilings. The surveillance of nonbanks, which accounted for about 28 percent of total financial system deposits, was also improved. In November 1983 the Central Bank limited the methods that financial institutions may use to calculate interest payments on loans. In the past nonbanks had used irregular interest rate calculations in order to justify higher yields, to the detriment of commercial banks. The maximum rate on loans was lowered by 1 percentage point to 15 percent for banks, but reflecting their higher cost of loanable funds nonbanks were limited to 20 percent. The improvement of the supervision of the financial system has allowed commercial banks to compete better with nonbanks.

4. External sector

The value of import licenses approved by the Central Bank rose rapidly in 1983, as by the end of the year, they were some 56 percent higher (32 percent in SDR terms) than in 1982. The outcome was facilitated by the implementation of the new import system announced in June 1983. Actual utilization of the licenses has remained below expectations. However, there was an apparent speed up in 1983, which is likely to be reflected in import arrivals in 1984, due to a lag between the ordering and the arrival of merchandise. Estimated imports for 1983 were some 6 percent below the target for the year and 14 percent smaller (in SDR terms) than 1982 imports. Export earnings and net invisibles were close to the estimated level (Table 6). Thus, the trend in imports largely explains the reduction of the current account deficit in 1983 to the equivalent of 2.7 percent of GDP, compared with the program target of 3.4 percent, and with a level of 7.4 percent in 1982, and an average of about 12 percent in 1980-81.

Exports are now estimated to have grown by 2.6 percent in volume in 1983 and are projected to expand further by 0.5 percent in 1984, in line with the program estimates for the two years taken together. Non-oil exports are expected to perform better, increasing in volume terms by almost 5 percent in 1983 and by half that amount in 1984. The decline of about 14 percent (in SDR terms) in imports in 1983, following a reduction of 16 percent in 1982, was considerably more than included in the program. However, an important part of the reduction is accounted for by lower government and oil imports, reflecting among other things the Government's conservation policies. Non-oil, nongovernment imports fell by only 5 percent in SDR terms in 1983 and are expected to rebound by 22 percent in 1984. Given the increase in import licensing in 1983, total imports are now projected to increase by over 12 percent in 1984 compared to an earlier estimate of under 10 percent. The balance of payments current account deficit in 1984 is projected at 3.4 percent of GDP compared to the previous estimate of 3.6 percent.

Table 6. Kenya: Balance of Payments, 1978-1984

(In millions of SDRs)

	1978	1979	1980	1981	1982	1983 Prog.	1983 Est.	1984 Prog.	1984 Rev. Prog.
Current account	-527	-400	-681	-633	-420	-205	-153	-246	-218
Trade balance	-736	-620	-1,090	-950	-714	-554	-485	-613	-564
Imports, c.i.f	(-1,501)	(-1,418)	(-2,059)	(-1,860)	(-1,559)	(-1,411)	(-1,343)	(-1,550)	(-1,510)
Exports, f.o.b.	(765)	(798)	(969)	(910)	(845)	(857)	(858)	(937)	(945)
Services, net	135	143	296	237	233	237	214	256	239
Transfers, net	74	77	113	80	61	112	117	111	107
Private	13	19	21	15	-7	...	8	...	8
Government	61	59	92	66	68	...	109	...	99
Capital account, net	367	546	531	428	270	204	242	222	218
Official 1/	228	311	317	208	142	74 2/	139	121 2/	153
Of which: Central government 2/	(159)	(298)	(287)	(166)	(140)	(74)	(117)	(121)	(...)
Private									
Long-term	37	132	84	94	88	102 3/	62	108 3/	65
Short-term 4/	102	103	130	126	40	28	41	-7	--
Allocation of SDRs	--	7	7	7	--	--	--	--	--
Overall balance	-160	153	-143	-198	-150	-1	89	-24	--
Monetary movements	160	-153	143	198	150	1	-89	24	--
Of which:									
Gross official reserves (increase -)	(155)	(-213)	(104)	(176)	(7)	(-58)	(-170)	(-21)	(12)
Use of Fund credit	(5)	(56)	(44)	(23)	(135)	(59) 5/	(88)	(45) 5/	(-12)
Memorandum items:									
Kenya shilling per SDR									
Period average	9.66	9.66	9.66	10.67	12.06	14.23	14.26	14.41	14.44
End-period	9.66	9.66	9.66	11.95	14.04	14.41	14.44	14.41	14.44
Current account balance as percent of GDP									
Including grants	-12.4	-8.5	-12.5	-11.1	-7.4	-3.4	-2.7	-3.6	-3.4
Excluding grants	-13.9	-9.7	-14.2	-12.3	-8.6	-5.1	-4.6	-5.1	-5.0

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

1/ Includes all government and government-guaranteed capital.
2/ Central government and former EAC corporations.
3/ Includes government-guaranteed debt.
4/ Includes errors and omissions, commercial banks' net foreign position, and valuation adjustments.
5/ Assumed a future Fund program.

The net capital inflow in 1983 was also larger than had been foreseen, mainly as a result of larger net drawings of official capital than programmed for the calendar year. Consequently, the balance of payments, which had been targeted to be virtually in balance, is now estimated to have recorded an overall surplus equivalent to SDR 89 million. Given the purchases from the Fund during the year, gross official reserves increased by SDR 170 million during the year, to a more comfortable level equivalent to 13 weeks of projected 1984 imports.

For 1984 a net inflow close to the previous year's level is estimated and the balance of payments should be in overall equilibrium. If short-term capital inflows also return to their more normal levels, they are likely to be tied to import financing and provide for a larger increase in imports.

Developments in the capital account in 1983 and those projected for 1984 indicate that capital inflows may be sustainable at a higher level than previously estimated given an improvement in the budget and a return of confidence in the private sector due to the large amount of undisbursed funds and continued interest by major donors in supporting Kenya's development efforts. The recent Consultative Group confirmed the need of donors to increase their efforts in making available a larger inflow of resources at concessionary terms.

In December 1982 the exchange rate of the Kenya shilling was devalued by 15 percent (in foreign currency terms) and the authorities adopted a flexible exchange rate policy. During 1983, the exchange rate was further depreciated by about 2.8 percent (Chart 1). Despite this action there was a small appreciation in real effective terms. The relative price changes that have taken place in the last two years have tended to alter the import intensity of production and import demand in general. Export profitability has also improved. The available statistics do not yet permit an accurate estimate of the extent of this shift and it is clear that this improvement could be reversed quickly, if policies were to change. In this respect, exchange rate policy plays an important role. The initial progress recorded in the program has suffered some retardation since August 1983 as the exchange rate has been allowed to appreciate in real terms. This appreciation ranged between 2.5-5.0 percent depending on which indicator index is used. The authorities believe the index used by the Fund overestimates the rise by giving too little weight to the U.S. dollar. They stressed that the Government was committed to maintain a flexible exchange rate policy. However, given the importance that has been ascribed to changes in relative prices in bringing about needed changes in the trade balance, a more active policy is necessary in the remainder of the program period and the staff encouraged the authorities to eliminate promptly the real appreciation that had taken place since August 1983.

In addition to the liberalization of imports which has taken place in 1983, the authorities made considerable progress in liberalizing other external payments. Through January 1984, all outstanding transfers of dividends and profits for the period through end-1982 have been released. A restriction in this regard remains only to the extent that some companies have already declared profits for 1983 which have yet not been transferred. Other restrictions, mainly those pertaining to travel abroad, and the payments for consultants continue to be applied in a liberal manner. A further liberalization of the import system, which includes exchange restrictions in the form of foreign exchange quotas for imports, is expected prior to the end of the fiscal year.

III. Report on the Discussions

The consultation discussions took place at a time when the Kenyan authorities were reassessing the outlook of the economy for the medium term, in the context of a newly issued Five-Year Development Plan (1984-88) and in the preparation for the Consultative Group Meeting held early in the year.

The authorities recognized that substantial progress had been made in reducing the internal and external imbalances and that the economy was picking up momentum, while inflationary pressures had been markedly reduced. The authorities faced the dilemma of assuring that the policy package in the plan would promote a more rapid expansion of the economy, while not leading to the reemergence of imbalances. The authorities were concerned that balance of payments pressures could reemerge in the medium term, highlighting the need to persevere with adjustment policies, to move quickly with the structural reform of the economy, and to attract the needed foreign financing. In this regard the authorities also faced the constraint of a rising debt service ratio, which limited their borrowing possibilities in the next few years.

1. Development policies and the allocation of resources

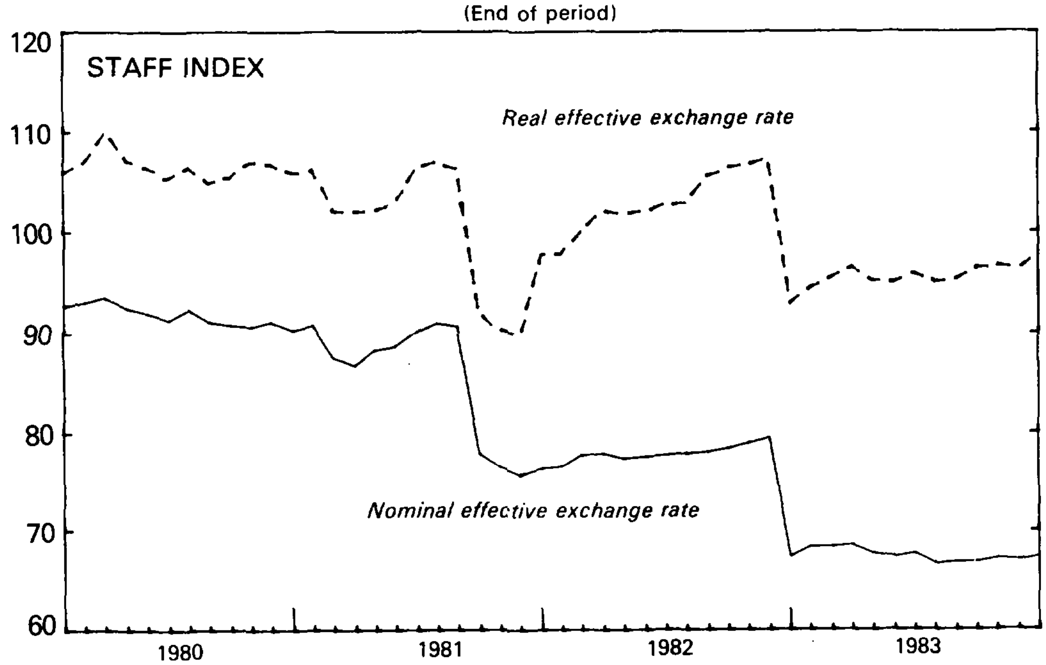
The Kenyan representatives said that on the basis of the continuation of good weather conditions, the growth rate of GDP is expected to pick up gradually to about 6 percent by the end of the plan. Gradual improvement is foreseen in the industrial, construction, and service sectors, including tourism. For the near future the maintenance of food self-sufficiency continues to be a prime objective of the Government. At the same time, a further easing of price pressures is expected, largely as a result of the improvement in domestic supplies. The Kenyan representatives pointed out that in order for this scenario to develop progress needs to be made in furthering the public sector development effort and in increasing domestic savings. It was their view that the resurgence of the economy had been held back by the adjustment of entrepreneurs to a lower availability of domestic credit, high interest rates, and a flexible

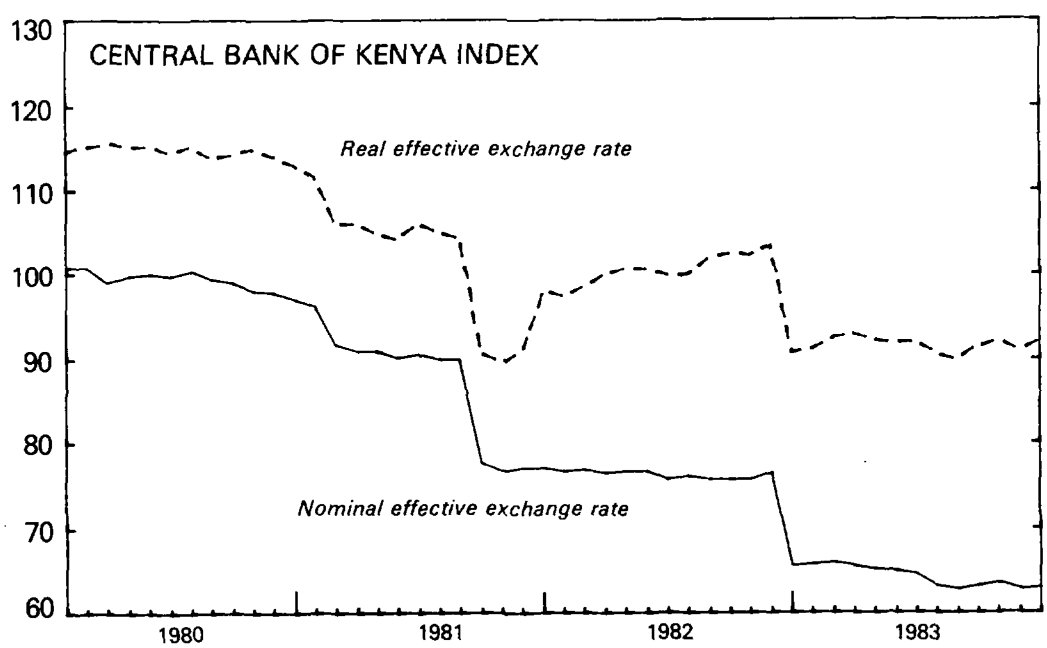
CHART 1

KENYA

TRADE WEIGHTED NOMINAL AND REAL EFFECTIVE EXCHANGE RATE INDICES OF KENYA SHILLING, JAN. 1980 - DEC. 1983

(End of period)





exchange rate policy. For the period ahead, the Kenyan representatives explained, the Government needs to move more forcefully with structural reform of the economy. The high population growth rate, coupled with the need of maintaining Kenya's self-sufficiency in foodstuffs, posed a special problem, especially in view of the country's limited land resources. For the plan period, developments in agriculture are expected to lead to a 1 percent per capita growth in food production. The Government is counting on an expansion of the area under cultivation, particularly in large-scale farms, where land resources are underutilized, the irrigation of arid and semi-arid regions, and on research which would lead to higher productivity, particularly in cereal production. The authorities hoped to implement a population control policy during the next plan period, while at the same time maintaining the incentives for the production of foodstuffs. A program of liberalizing the marketing of basic grains was also going to be implemented during the plan period. Given the sluggish growth in the economy, unemployment has increasingly become a major problem for the Government. Its severity was augmented by the cessation of automatic recruitment of school graduates by the Government and the parastatals.

The Kenyan representatives noted that the immediate outlook for Kenya's traditional exports had improved recently. Coffee production should be higher in the coming season and prices had risen enough to allow for an upward adjustment of Kenya's basic export quota under the International Coffee Agreement. For the immediate future the outlook for tea remained very good, given the shortages which had developed in the world markets. Tea prices had recently reached peak levels and although expected to decline during the year, should remain high on average for 1984. In response to the better prices, tea production has jumped in 1983. The outlook for livestock, particularly exports, had improved given the present availability and the favorable exchange rate. Progress also was being made in horticulture exports, but the lack of adequate transport posed a special problem.

The Kenyan representatives felt that the industrial sector was emerging successfully from a long period of readjustment, which had begun with the breakdown of the East African Community. The large industrial infrastructure, which had been built to meet the needs of the Community, had first to adjust to a smaller market and then to a reduced flow of imported raw materials, caused by the balance of payments difficulties which followed. In the view of the Kenyan representatives the industrial sector was successfully weathering the period of adjustment and it was poised to improve its performance on the basis of a better cost structure, a lower import dependence, and an improved competitive position. In this regard the recent opening of the borders between the ex-members of the East African Community augured well for the future of the sector, provided, of course, that developments in these countries improved.

The Kenyan representatives said that the country had been implementing a successful energy policy. Oil imports for domestic consumption have declined in volume in recent years, to some degree as a result of the sluggishness of the economy, but mainly due to price and conservation measures and to the development of alternative sources of energy. The Kenyan representatives pointed out that increases in prices for imported energy are passed on to the consumer, although there is some cross subsidization on the prices of diesel and kerosene with the profits made on the sale of gasoline.

The Government has given emphasis to the production of hydro and geothermal power in order to replace the more expensive oil-generated electricity. At present only one area, accounting for about 1 percent of total electricity generated, is being served by oil-produced electricity. The use of gasohol has increased and a project has been launched for the development of wood resources in the rural sector. The gasohol program began in August 1983 and at the present time about 40,000 litres a day are being sold. The use of coal by industry is being fostered, as it is abundant in neighboring countries. The implementation of the Kiambere hydroelectric project, which will have a capacity of 140 megawatts, will go a long way in furthering the Government's objectives in this field. Kiambere will be the major project to be implemented in the next few years, at an estimated cost of K Sh 4 billion. It has attracted considerable support from international donors.

The Kenyan representatives pointed out that in 1983 tourism had fared better in Kenya than in the world as a whole. It was estimated that tourism had fallen by about 7 percent worldwide, with the decline in Kenya being slightly over 2 percent. Moreover, this reduction was closely linked to the 1982 August coup attempt. For the future the Kenyan representatives were optimistic about the possible growth of this sector. They felt that the 325,000 arrivals recorded in 1983 could be increased substantially during the plan period. In their view the tourism potential of Kenya still required developing and there was a need for Kenya to be better known in potential markets. In this regard the Government was trying to coordinate its advertising campaigns with those of the major tour operators, as well as trying to encourage more economical transport to Kenya, especially from North America.

2. Financial policies

The Kenyan representatives felt that the large adjustment carried out over the last three fiscal years from the equivalent of 9.5 percent of GDP in 1980/81 to the present target of 3.8 percent in 1983/84 represented a major effort, which had brought the deficit to an almost sustainable level. Domestic and bank financing had been reduced markedly. The former fell from the equivalent of 4.6 percent of GDP to 2.9 percent, while the latter was reduced from 2.8 percent to 1.4 percent. Nevertheless, in an effort to free additional credit resources for the private sector, it was the Government's intention to further reduce the net use of bank credit for budgetary purposes in the 1984/85 fiscal year. This intention has been built into the present development plan, which also projects a larger inflow of foreign grants and loans.

The Kenyan representatives said that although the Government had made substantial progress in its ability to control expenditure over the last three years, it still had considerable difficulty in monitoring expenditure and in accurately forecasting revenue. Moreover, there was also recurring uncertainty regarding the timing of disbursement of foreign loans and grants. It was indicated that in 1982/83 the outlays foregone had inhibited the efficient operation of government offices because of supply shortages, prevented the repair and maintenance of some assets, and forced the temporary delay of development projects which were already substantially completed. Hence, much of the increase in expenditure to be included in a supplementary budget for 1983/84 was considered necessary to make up for what was regarded as an excessive reduction in expenditure in 1982/83. However, the Kenyan representatives expected this increase in expenditure to be offset by a better revenue performance, resulting from the improving economy. The budget for 1983/84 had projected a considerable decline in tax revenue from income and profits, but it was now believed that this estimate was unduly conservative and that revenue from this source should be similar to that in 1982/83. Foreign grants, on the other hand, were now expected to be somewhat lower than was originally envisaged. The Kenyan representatives said that the overall budget deficit for 1983/84 (3.8 percent of GDP), was close to an appropriate level, which could be supported primarily by a prudent level of foreign financing and nonbank financing.

The Kenyan representatives stated that it remains the Government's objective to continue to improve the efficiency of public enterprises. Since the latter part of 1982, there has been a major effort to introduce uniform accounting systems and to improve the monitoring and control of the financial operations of public enterprises, especially of the financial flows between these enterprises and the Government. Substantial progress has been made in reducing the budgetary support to public enterprises, which now appear to be learning to live within the available resources better than in the past. However, there was some concern about the rapid increase in bank credit to public enterprises during the last couple of years and the Government intended to ensure that this sector's credit demands grew more modestly as the private sector demand for credit became more buoyant. The Kenyan representatives pointed out that in an effort to facilitate the divestiture of some public enterprises the Cabinet had approved the State Corporation Bill in June 1983, but that its submission to Parliament had been delayed because it was necessary to take account of the great variation in the legal status of various public enterprises. Particular legal difficulties had arisen in regard to public enterprises owned in conjunction with multinational corporations. It was emphasized that it was the Government's objective to pass the State

Corporation Bill in Parliament as soon as the complex legal issues could be resolved.

The Kenyan representatives said that the Central Bank had been making progress in improving its control over the financial system. They felt that this was a necessary step prior to the implementation of a more active monetary policy. To this end they were looking forward to a joint study of the financial system to be conducted by the Central Bank and the Fund. The Kenyan representatives pointed out that they were committed to the maintenance of positive real interest rates and that the interest rate levels would be kept under continuous review. They noted that following the increase in the liquidity ratio, the liquidity position of commercial banks had remained tight and that this had allowed them to perform well with respect to the credit ceilings. However, for the period ahead, they were concerned that a continuation of such a tight position may undermine the authorities' efforts to improve the availability of credit to the private sector and a reduction in the liquidity ratio may be necessary. Credit availability in their view was an important constraint on the utilization of import licenses.

3. External policies and developments

The Kenyan representatives explained that the rapid progress made in reducing the external imbalances had occurred largely due to imports turning out to be smaller than foreseen. Foreign exchange earnings had been maintained at an adequate level. The import reduction initially reflected restrictive import policies but more recently had resulted from reduced demand caused by the adjustment of relative prices following the exchange rate actions and tariff changes undertaken in the previous two years, together with restrained domestic financial policies and the uncertainty caused by recent political events. They explained that the level of administrative restraint had been sharply reduced in 1983. They felt that a delay in the utilization of licenses had created an overhang of approved licenses that would be used in 1984. Thus, the overall payments surplus recorded in 1983 would disappear in 1984.

The Kenyan representatives were pleased that in 1983 the total net capital inflow, including the private sector and public enterprises, was larger than originally envisaged. In their view it represented an increase toward the traditional levels of capital and aid that Kenya had received in the past. They foresaw that with the improvement in the economy, additional capital would be forthcoming, allowing for an increase in the ratio of the balance of payments current account deficit to GDP from the level attained in 1983. In their view a current account deficit equivalent to 3.5-4.0 percent of GDP was financeable and consistent with an increase in foreign assets.

The Kenyan representatives pointed out that developments in 1983 allowed them to increase gross official reserves by a substantial amount.

At the end of 1983 they were equivalent to 13 weeks of projected 1984 imports. Presently, they regarded this level as satisfactory, but in future years a further increase appeared useful.

The Kenyan representatives noted that in November 1983 the heads of state of the former East African Community agreed on a settlement of the Community's problems. This action had led to the reopening of the borders and the resumption of trade and communications among the three countries. The settlement of outstanding claims was also required, which would mean that Kenya would have to make net payments. Their modality, size, and timing was being negotiated. The payments could become an important charge to the balance of payments, especially if a large proportion was required to be made in foreign exchange, as opposed to goods and services. Consequently, the recent increase in reserves also needed to be viewed in relation to this outstanding and possibly large claim.

The Kenyan representatives explained that the import system announced in June 1983, which aimed at liberalizing the granting of licenses, was now operational. Initial developments to date had indicated that a greater demand existed for the goods in the freer category (Schedule 1A and 1B) than had been foreseen, while there had been less of a demand for the more restrictive categories. In line with the objectives of the program all legitimate licenses requests had been granted. These developments supported the Government's opinion that the system was now more liberal.

The Kenyan representatives said that the progress which had been made in liberalizing other outward payments, mainly dividends and profits would be continued in 1984.

The Kenyan representatives noted that the high debt service ratio was an important constraint in the external sector. The staff estimated it to be 28 percent (including IMF) in 1983 and to rise to 29 percent in 1985 before falling to 21 percent by the end of the plan period (Table 7). The Kenyan representatives explained that the present high level was largely related to repayments on previous Eurocurrency borrowings which had taken place in the late 1970s and early 1980s. Despite these borrowings, only about a third of Kenya's external debt, which totalled SDR 2.7 billion (44 percent of GDP) at the beginning of 1983 is on commercial terms. The Kenyan representatives indicated that careful review was being made of all future borrowing to ensure that the debt service ratio is maintained at a manageable level.

IV. Medium-Term Outlook

The current development plan includes estimates for the outturn of the balance of payments for the plan period (1984-88). These indicate a current account deficit (including grants) averaging about 4.1 percent of

Table 7. Kenya: Debt Service Projection, Summary Table, 1983-89

(In millions of SDRs)

	1983	1984	1985	1986	1987	1988	1989
Debt service 1/							
Non-IMF principal 2/	186	186	223	198	190	201	214
Non-IMF interest 2/	130	133	145	160	177	188	201
Total non-IMF debt service	316	319	368	358	367	389	415
As percent of exports	23	21	23	20	19	18	18
IMF repurchases	43	58	70	90	87	56	47
IMF charges	26	33	34	28	22	16	9
Total IMF debt service	69	91	104	118	109	72	56
As percent of exports	5	6	6	7	5	3	2
Total debt service	385	410	472	476	476	461	471
As percent of exports	28	27	29	27	24	21	20
Memorandum items:							
Exports of goods	858	945	976	1,063	1,177	1,288	1,417
Exports of services and private transfers	547	594	654	719	790	869	956
Total exports	1,405	1,539	1,630	1,782	1,967	2,157	2,373

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

1/ Exchange rates are assumed to be 14.44 K Sh/SDR on average 1984-89.

2/ For fixed-interest loans, interest rates are assumed to decline from 5.5 percent in 1984 to 5.2 percent in 1989. The interest rates applied to flexible-rate loans are consistent with projections made in the Fund's spring World Economic Outlook exercise which shows interest rates declining through the decade so that by 1989 LIBOR is 7 percent. A spread of 1.5 percent above LIBOR is assumed. New disbursements of the former were assumed to carry 30 years maturity and six years grace, which represented the average for these loans during 1973-82. The flexible-interest loans were assumed to carry eight years maturity and three years grace.

GDP, falling from an estimated 4.3 percent in 1984 to 4.0 percent in 1987 and 1988 (Table 8 and Chart 2). It also projects net capital inflows in excess of the current account deficit leading to small annual increases in the level of reserves. Exports are expected to rise from 15.2 percent of GDP in 1984 to 16.3 percent in 1988, with nontraditional exports increasing their share sharply. Imports are projected to remain about the same in relation to nominal GDP, while net service earnings are estimated to fall in relation to GDP from the equivalent of 3.8 percent of GDP in 1984 to 2.9 percent in 1988. Net transfers are estimated to average about 1.7 percent of GDP, while long-term capital is expected to average 3.7 percent of GDP, with official capital accounting for about 70-73 percent of the total. Together, official capital and net official transfers are expected to average about 4.3 percent of GDP in the plan period. The plan also projects an inflow of short-term capital, which with the need to finance repurchases to the Fund, averages 1.5 percent of GDP during the plan period. However, this item has been estimated largely as a residual and thus includes in part, additional borrowing to be arranged. The plan projections were prepared early in 1983 and did not incorporate the most recent estimates of the 1983 balance of payments, which now include a lower level of imports and a smaller current account deficit. The Kenyan authorities felt confident that the amount of additional required capital could be generated, particularly following the Consultative Group meeting. If the assumption for a reserve buildup is dropped, the short-term capital required in the plan would be reduced by about 20 percent, bringing it to less than 5.0 percent of the expected imports during the plan period.

By and large the scenario developed by the staff, which benefited from using more recent 1983 data, does not differ in substance from the Kenya data, although in detail important differences emerge. Most importantly, the staff's projection confirms the Kenyan view that with a small increase in capital flows the balance of payments during the plan period is sustainable, allowing a modest buildup of reserves, without worsening Kenya's debt service ratio. The staff estimates a smaller increase in exports. The difference arises from optimistic assumptions in the plan with regard to coffee exports and nontraditional exports. Coffee exports are likely to continue to be constrained by Kenya's export quota, while the assumed growth of nontraditional exports appears to the staff to be too large, particularly in relation to the policies now in place. A higher growth rate in nontraditional exports could be possible, if the world economy had a sharper outturn than is now projected and/or if a more active and successful export promotion policy package was implemented.

The review by the staff indicated that net invisible earnings, particularly tourism and other transportation, are likely to increase somewhat faster than included in the plan. The staff projects that net transfers will average 1.4 percent of GDP during the plan period, somewhat less than shown in the Kenyan estimates. The staff estimated net

Table 8. Kenya: Medium-Term Balance of Payments, 1984-88

(In millions of SDRs)

	1984	1985	1986	1987	1988
Staff projections					
Current account 1/	-218	-286	-307	-326	-355
Trade balance	-564	-644	-703	-762	-838
Imports, c.i.f.	(-1,510)	(-1,620)	(-1,766)	(-1,939)	(-2,126)
Exports, f.o.b.	(945)	(976)	(1,063)	(1,177)	(1,288)
Services, net	239	258	284	312	343
Transfers, net	107	100	112	124	141
Of which: official	99	90	101	112	127
Capital account, net	218	388	436	457	456
Long-term capital, net 2/	218	247	305	355	398
Of which: official	(153)	(177)	(211)	(242)	(262)
Borrowing to be arranged, net 3/	--	141	131	102	58
Overall balance 4/	--	102	129	131	101
Reserves (increase -)	(12)	(-32)	(-39)	(-44)	(-45)
Kenya Development Plan estimates					
Current account 5/	-274	-291	-326	-345	-390
Trade balance	-630	-671	-731	-777	-853
Imports, c.i.f.	(-1,594)	(-1,752)	(-1,953)	(-2,169)	(-2,433)
Exports, f.o.b.	(965)	(1,081)	(1,222)	(1,392)	(1,580)
Services, net	248	260	270	282	291
Transfers, net	107	121	135	150	177
Capital account, net	312	391	445	471	451
Long-term capital, net	234	266	294	317	348
Of which: official	(165)	(195)	(217)	(232)	(256)
Borrowing to be arranged, net 6/	78	125	151	154	103
Overall balance	38	100	119	126	61
Reserves (increase -) 7/	(-26)	(-30)	(-29)	(-39)	(-6)

Sources: Staff estimates and Kenya Development Plan.

Table 8. (concluded). Kenya: Medium-Term Balance of Payments, 1984-88

1/ Assumes the terms of trade rise by 7.5 percent in 1984, decline 2.9 percent in 1985, and 1.4 percent in 1986, and are broadly unchanged thereafter; the import system is liberalized and the value of non-oil imports grows by more than the rate of real economic growth; nontraditional exports increase their market share somewhat between 1983 and 1988; official transfers decline to 1.3 percent of GDP in 1985 and remain at that ratio thereafter. The resulting current account deficit as a percent of GDP:

	1984	1985	1986	1987	1988
Including grants	3.4	4.1	3.9	3.7	3.7
Excluding grants	5.0	5.3	5.2	5.0	5.0

2/ Assumes normal net long-term capital inflows of 3.4 percent of GDP in 1984, rising to about 4 percent of GDP 1987 and 1988, compared to an average of about 6 percent of GDP 1978-1983, including two Eurocurrency loans, and 5.3 percent excluding Eurocurrency loans. Within this total, normal flows of concessional and semiconcessional public and publicly guaranteed debt are assumed to rise from 2.4 percent of GDP in 1984 to about 2.8 percent of GDP by 1987-88. They averaged 3.7 percent in 1978-83 excluding Eurocurrency loans; 4.4 percent including.

3/ Assumes net new borrowing on commercial terms to maintain reserves at their end-1984 level in relation to imports (about 12 weeks) and to repay the Fund.

4/ Fund repurchases, net, due 1984-1988 are 1984--SDR 11.7 million; 1985--SDR 69.7 million; 1986--SDR 89.8 million; 1987--SDR 86.8 million; 1988--SDR 56 million.

5/ Assumes the terms of trade are broadly unchanged in 1984-88; total imports rise in line with nominal GDP; other exports increase their market share sharply; transfers average about 1.7 percent of GDP in 1985-88 (official transfers implicitly average about 1.6 percent); the resulting current account deficit in relation to IMF estimates of GDP is:

	1984	1985	1986	1987	1988
Including grants	4.3	4.1	4.2	4.0	4.0
Excluding grants	5.9	5.7	5.8	5.6	5.6

6/ Assumes additional borrowing, labeled short-term in the plan, to buildup reserves. The Plan does not allow for IMF repurchases in 1984-87, so the plan figures have been adjusted here to include borrowing needed to meet Fund repurchases in 1984-88.

7/ Reserves decline in relation to imports, from 12 weeks at end-1984 to 9.7 weeks at end-1988, despite a buildup in their absolute level.

transfers and long-term capital together to average 3.9 percent of GDP, a lower value than included in the plan. However, although the Kenyan estimates of official flows may be optimistic, the staff projects a somewhat higher inflow of private capital, with the result that both estimates of the capital account are close. It is possible that a more rapid revival of the economy would increase revenues allowing for a larger utilization of foreign grants and loans. Given the staff's lower base for 1984 imports, the staff projects imports to be somewhat lower than in the plan. Accordingly, the current account deficit estimated by the staff averages 3.8 percent during the plan period. Assuming the scheduled repurchases due to the Fund and a reserve buildup which would keep the level of gross official reserves at its 1983 equivalent in relation to imports, the staff estimates that there will be a need for additional borrowing equivalent to about 1.0 percent of GDP per year during the plan period or about 4.8 percent of projected imports. Importantly, the level of this additional borrowing falls throughout the plan period from about SDR 141 million in 1985 to SDR 58 million in 1988. By 1988, the amount of capital to be arranged is almost equivalent to the assumed increase in reserves for that year. Without the assumed buildup in reserves, the needed financing over the period would fall by over one third.

The financing gap projected by the staff is somewhat smaller than that included in the plan. It could be in actual fact even smaller, if net short-term capital inflows become larger. It should be noted that the level of capital inflows assumed by the staff is somewhat smaller in relation to GDP than was recorded in the period 1978-83 when they averaged 4.4 percent of GDP. From this perspective the staff projections could be considered somewhat conservative. However, a large inflow of capital is likely also to be accompanied by larger imports, without much effect on the overall balance and the need for additional borrowing. Although the development plan does not make specific suggestions as to where the additional capital could be generated, it is understood from the Government that they are hoping to negotiate a third structural adjustment loan with the World Bank and to receive additional bilateral loans to meet the borrowing requirement for the plan; to have a continued financial relationship with the Fund is also assumed. The staff assumes that all of the additional borrowing is provided on commercial terms; therefore, the projections of the debt service is on the basis of the worst case.

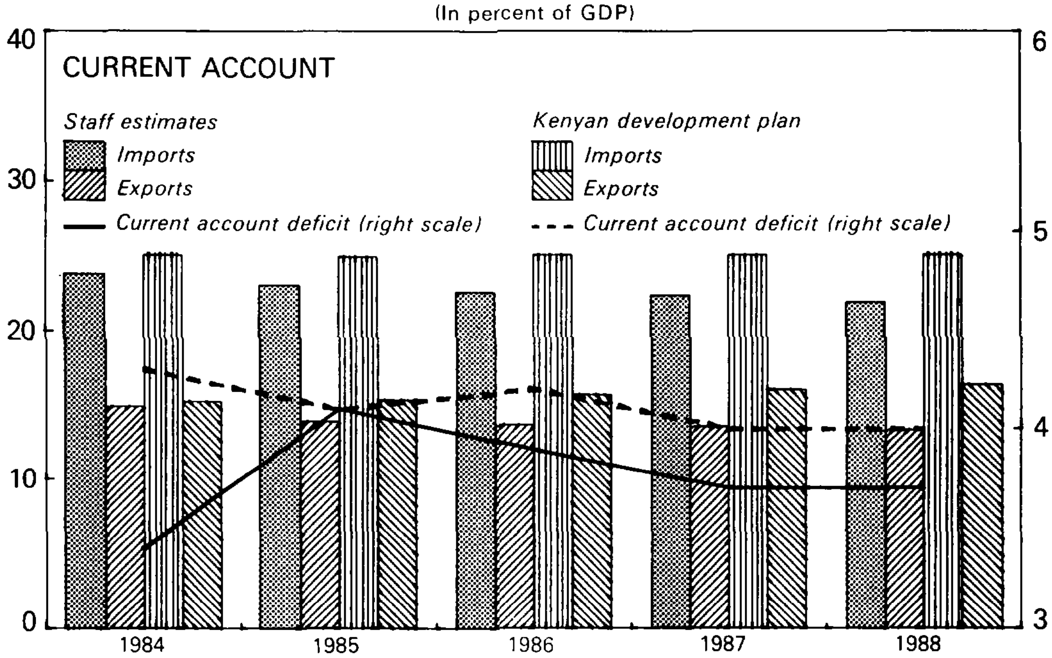
On this basis, the debt service ratio is projected to remain close to its present level of 28 percent through 1985 and fall sharply thereafter to less than 20 percent by 1990. If a more active export policy is implemented then much of the needed borrowing could be foregone, although some additional imports would also be required to support the export drive. Even though the staff's projections and the plan's projections differ somewhat with respect to specific balance of payments items, it is noteworthy that the overall balance and the ratio of the current account deficit are quite similar. Most importantly, the Kenyan projections show a larger borrowing need than those of the staff. In view of the

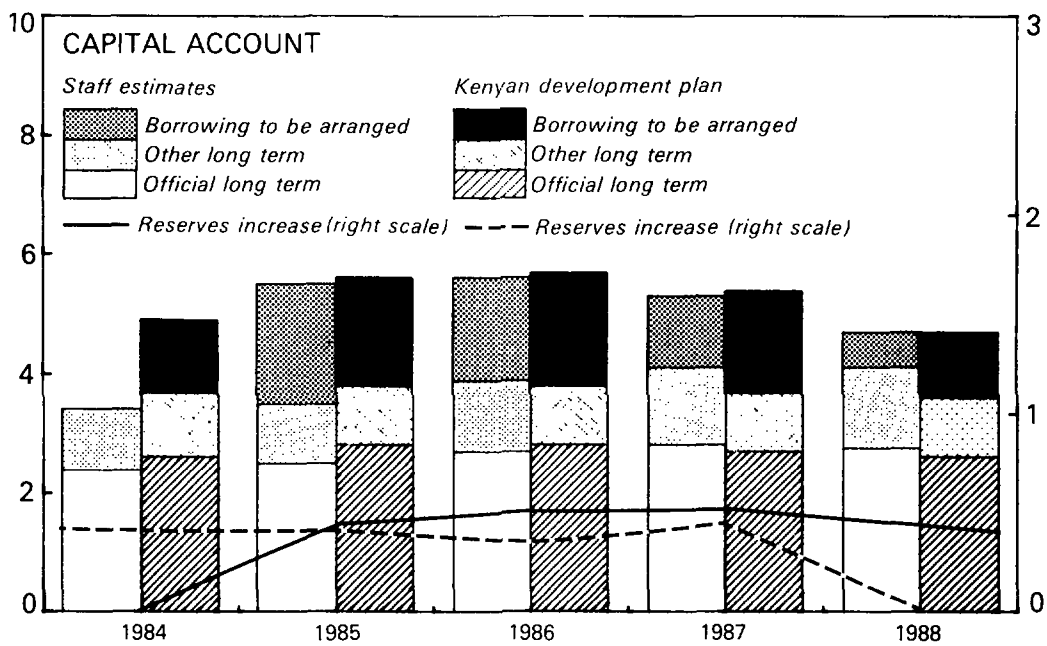
CHART 2

KENYA

MEDIUM TERM BALANCE OF PAYMENTS PROJECTIONS, 1984-88

(In percent of GDP)





projections and the reduction in the debt service ratio in the plan period, the staff feels that the balance of payments is sustainable in the medium term given the availability of the required capital flows.

Neither the Kenyan nor the staff's projections take account of the possible payments arising from the settlement of claims of the former East African Community, because the amounts and method of payment is still being negotiated. To the extent that payment in foreign exchange may be required a burden on the balance of payments will be generated which will largely be met by adjusting the assumption on reserves and by additional borrowing. In this regard the fall in the projected debt service ratio after 1986 provides the necessary margin for this borrowing.

V. Staff Appraisal

The determination with which the Government of Kenya has implemented the current stand-by arrangement is shown not only by the fact that the performance criteria for March, June, September, and December 1983 were observed, but also by the large margins with which the ceilings and objectives were met. This commitment brought about a larger than programmed compression of domestic demand, largely because of difficulties in estimating some of the key variables. Fortunately, the good weather conditions which existed during the period have allowed for a higher growth rate, than would have been possible under the financial policies followed. The upturn in tea prices at the end of 1983 also helped in generating an overall payments surplus.

The successful economic adjustment has been strengthened by the continuation of a realistic policy with respect to producer prices, energy conservation, and efforts in the tourist sector. At the same time progress has been made in liberalizing external payments, not only by increasing the approval of import licenses, but also by the clearing of unremitted dividends and profits. Nonagricultural activity has shown signs of picking up in the last quarter of 1983, following the Presidential and Parliamentary elections held in September 1983. The flexible exchange rate policy has been important in maintaining the competitive position of the export sector achieved at the end of 1982. However, since August 1983 the danger has existed that incentives are being reduced as the exchange rate has been allowed to appreciate in real terms. This will also have a negative impact on maintaining import demand at a sustainable level and in moving swiftly with the further liberalization of the import regime.

Although the improved agricultural production has helped in reducing inflationary pressures, the wage and incomes' policy followed by the Government and its tight financial policies have also played key roles. The Government's policies have reduced internal and external imbalances and set the stage for an improvement in the growth rate, which should be facilitated by the implementation of the recently published Five-Year Development Plan (1984-88).

Fiscal policy for 1983/84 includes an overall deficit which still appears to be too large, given that there is a need to reduce further the level of bank financing used by the budget in order to provide more credit to the rest of the economy. Increased emphasis should be given to drawing down available foreign financing, particularly grants, in order to strengthen the development effort. The Governement's ability to bring about a rapid adjustment of the economy has also encouraged foreign donors to increase their support. Thus, the increase in program assistance that became available in 1983 as a result of the donors' conference does not now appear to have been temporary and Kenya is likely to receive foreign financing at a higher level in relation to GDP than previously estimated.

However, in order to strengthen the development effort, and to provide resources to meet the recurrent cost needs of development projects as they are completed, additional local funding will be necessary and measures will need to be taken to reverse the deterioration in the revenue to GDP ratio which took place in the last few years.

For the remainder of the stand-by arrangement, the credit policy implied in the performance criteria provides for a relaxation and an increased availability of credit to the rest of the economy. Such an increase will provide the reinforcement needed to spur the economy to the targeted growth rate. The authorties are to be commended on their efforts to bring the financial system under more rigorous control. The maintenance of positive real interest rates will be important in promoting financial savings and in maintaining an adequate allocation of financial resources.

The balance of payments has registered substantial adjustment over the last two years achieving a level which is broadly sustainable on the basis of likely available capital flows. The outlook for the medium term indicates that the current account deficit of the balance of payments is likely to remain sustainable, provided that capital inflows are somewhat larger in the next few years than in the recent past. It seems likely that such additional capital inflows can be generated, perhaps partly from commercial sources and that they would not lead to an undue burden of debt service. The projections indicate that the authorities should move quickly to arrange for such an increased flow of capital. The authorities expect to generate the needed resources through a combination of new borrowings which would include a third structural adjustment loan from the World Bank, continuing financial relationship with the Fund, and increased aid from bilateral donors. The discussions that took place at the recent Consultative Group Meeting point to the feasibility of obtaining the additional flows. What is important for the medium term is perseverance by the authorities in continuing prudent and realistic financial policies, while moving quickly in implementing the structural reforms which will remove the bottlenecks presently visible, so that the growth rate can increase more quickly. In this context, care must be taken that price incentives are maintained in the export sector and that a more vigorous program of export promotion is implemented. Success in this area could provide a larger growth of exports than presently envisaged, which could be translated into further improvement in the growth rate of the economy. Continued emphasis needs to be put on the integration of external policies so as to allow the continued liberalization of the exchange and trade regime in the context of a flexible exchange rate policy which will maintain the competitive position achieved in the export sector. Additional liberalization of the tariff and import system is expected under the present program by the end of the fiscal year. It is important that the authorities should continue the move away from quantitative restrictions on imports and toward a free allocation of foreign exchange.

In the past two years, the Government has been very restrained in acquiring additional external debt. This policy has meant that the peak of the debt service ratio will be reached in the period 1984-85, with a substantial reduction taking place in the following years, even after taking into account the additional borrowing required during this period to finance the current account, repay the Fund, and increase reserves somewhat. The present level of the debt service ratio points to the need to continue a cautious borrowing policy in the next two years. In the latter part of the plan period the Government will have room to engage in additional borrowings, without unduly affecting the debt service ratio. The maintenance of this margin is important given the possible payments which Kenya may be required to make in settling the outstanding claims of the former East African Community.

Kenya maintains restrictions on the availability of foreign exchange for certain categories of imports, and on dividend and rental income remittances that are subject to Fund approval under Article VIII. The staff welcomes the progress made so far in liberalizing invisible payments--specifically the payments of outstanding dividends and profit remittances for the period through 1982. The staff notes the authorities intention to remove these restrictions as soon as the balance of payments position permits and encourages the authorities to make early progress in eliminating the restrictions. In the meantime, the staff recommends that the Executive Board grant approval for the retention of the exchange restrictions.

The staff believes the measures incorporated into the program are appropriate to Kenya's prevailing circumstances and expects to remain in close contact with the Kenyan authorities regarding the implementation of the program. The staff takes note of the authorities' wish to negotiate a subsequent program with the Fund at the termination of the current one.

VI. Proposed Decision

The following draft decisions are proposed for adoption by the Executive Board:

1984 Consultation

1. The Fund takes this decision relating to Kenya's exchange measures subject to Article VIII, Section 2, and in concluding the 1984 Article IV consultation with Kenya, in the light of the 1984 consultation with Kenya, conducted under Decision no. 5329-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Kenya maintains restrictions on payments and transfers for current international transactions subject to approval under Article VIII, Section 2, arising from limitations on foreign exchange for certain imports, and for dividend and rental income remittances. In the circumstances of Kenya, the Fund grants approval for their retention until March 31, 1985, or the next Article IV consultation with Kenya, whichever is the earliest.

Review Under Stand-By Arrangement

1. Kenya has consulted with the Fund in accordance with paragraph 4 (b) of the stand-by arrangement for Kenya (EBS/83/41, Supplement 1, 3/23/83) and paragraph 16 of the letter of the Minister of Finance and the Governor of the Central Bank of Kenya dated January 28, 1983 annexed thereto in order to review policies and to establish performance criteria subject to which purchases may be made by Kenya.

2. The letter dated March 27, 1984 from the Minister of Finance and the Governor of the Central Bank of Kenya setting forth certain

policies and measures which the authorities will pursue shall be annexed to the stand-by arrangement of Kenya, and the letter of January 28. 1983, supplemented by the letter of September 13, 1983, shall be read as supplemented by the letter of March 27, 1984.

3. Accordingly, Kenya will not make purchases under the stand-by arrangement that would increase the Fund's holdings of Kenya's currency in the credit tranches beyond 25 percent of quota, or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 percent of quota during any period in which the data at the end of the preceding period indicate that the limit on total domestic credit of the banking system described in paragraph 6 of the letter of March 27, 1984 or the limit on net credit from the banking system to the Government described in paragraph 5 of the letter of March 27, 1984, are not observed.

4. *With respect to the fiscal, monetary, import, and exchange and* interest rate policies, the Fund finds that no additional understandings are necessary.

KENYA - Basic Data

Area, population, and GDP per capita

Area	580,000 square kilometers
Population: Total (1983)	17.8 million
Growth rate	3.7 per cent
GDP per capita (1983)	SDR 319

	1979	1980	1981	1982	1983 Prel.
GDP (at 1976 market prices)					
Total (in billions of Kenya shillings)	35.4	37.1	38.6	39.3	40.7
Agriculture (per cent of total)	31	29	30	31	31
Manufacturing (per cent of total)	11	12	12	12	12
Government (per cent of total)	12	13	13	13	13
Annual real rate of growth (per cent)	3.9	4.8	4.1	1.8	3.7
Investment as per cent of GDP (at current market prices)	23	30	28	22	22
Prices (per cent change)					
GDP deflator	7	11	11	11	16
Cost of living index	9	13	20	14	10

Central government finance 1/	1979/80	1980/81	1981/82	1982/83 Prelim. actual	1983/84 Revised
	(In billions of Kenya shillings)				
Total revenue	12.0	14.3	15.7	16.7	19.1
Foreign grants	0.3	0.5	0.9	1.4	1.2
Total expenditure	15.8	19.8	21.4	20.6	23.7
Recurrent	11.4	14.0	15.0	15.4	18.0
Development	4.4	5.7	6.4	5.2	5.7
Adjustment	0.7	-0.4	0.5	0.2	--
Overall deficit (-)	-2.8	-5.4	-4.3	-2.3	-3.4
Foreign financing (net)	2.0	2.8	1.1	1.3	0.8
Domestic borrowing (net)	0.8	2.6	3.2	1.0	2.6
Of which: from banking system	--	1.6	1.7	-0.1	1.2

1/ Fiscal year July 1-June 30.

KENYA - Basic Data (concluded)

	1979	1980	1981	1982	1983
Money and credit		(Per cent change)			
Domestic credit	3	14	28	26	0
Government	7	10	79	62	-18
Private sector	-3	22	14	5	7
Money and quasi-money	14	3	13	14	6
	1979	1980	1981	1982 Prel.	1983 Est.
Balance of payments		(In millions of SDRs)			
Exports, f.o.b.	798	969	910	845	858
Imports, c.i.f.	-1,418	-2,059	-1,860	-1,559	1,343
Trade balance	-620	-1,090	-950	-714	-485
Services and private transfers (net)	162	317	252	226	222
Official transfers (net)	59	92	66	68	109
Current account balance	-400	-681	-633	-420	-153
Capital account (net)	546	531	428	270	242
Official	311	317	208	142	139
Private	235	214	220	128	103
Of which: long-term	132	84	94	88	62
Allocation of SDRs	7	7	7	--	--
Overall surplus or deficit (-)	153	-143	-198	-150	89
Current account deficit as percent of GDP					
Including grants	-8.5	-12.5	-11.1	-7.4	-2.7
Excluding grants	-9.7	-14.2	-12.3	-8.6	-4.6
Gross official foreign reserves (end of period)	496	392	215	209	379
In weeks of imports	13	10	7	8	...
External public debt					
Disbursed and outstanding (end of period)	1,588	1,964	2,221	2,510	
Debt service as per cent of exports of goods and non-factor services					
Excluding the Fund	10	12	17	22	
Including the Fund	13	13	18	24	

Kenya: Relations with the Fund

(As of February 29, 1984)

I. Membership status:

(a)	Date of membership	February 3, 1964
(b)	Status	Article XIV

A. Financial Relations

II. General Department

(a)	Quota	SDR 142.0 million
(b)	Total Fund holdings of Kenya's currency	SDR 517.57 million (364.48 percent of quota)
(c)	Fund holdings of Kenya's currency subject to repurchase	SDR 385.80 million (271.69 percent of quota)
	Of which: Credit tranche	SDR 93.30 million (65.70 percent of quota)
	SFF	SDR 94.83 million (66.78 percent of quota)
	E.A.R.	SDR 120.06 million (84.55 percent of quota)
	C.F.F.-R.	SDR 17.25 million (12.15 percent of quota)
	C.F.F.-C.	SDR 60.38 million (42.52 percent of quota)

III. Current Stand-By or previous arrangements and special facilities

(a) Current stand-by:

(i) Duration from 21 March 1983 to 20th September 1984
(ii) Amount - SDR 175.95 million
(iii) Utilization - SDR 129.8 million
(iv) Undrawn balance - SDR 46.15 million

Kenya: Relations with the Fund (continued)

(b) Previous arrangements:

1 extended arrangement approved in July 1975, and
4 stand-by arrangements approved respectively in November 1978, August 1979, October 1980, and January 1982. Amounts range from SDR 17.25 million to SDR 241.50 million.

(c) Special facilities approved included oil facility, Trust Fund loans, SFF subsidy account and compensatory financing facilities for export shortfalls and cereal imports.

IV. SDR Department

(a) Net cumulative allocation - SDR 36.99 million
(b) Holdings: amount to 2.17 million or 5.88 percent of net cumulative allocations.

V. Administered Accounts

(a) Trust Fund loans:

(i) Disbursed - SDR 46.91 million
(ii) Outstanding - SDR 43.32 million

(b) SFF Subsidy Account:

(i) Payments by Fund - US$5,966,829.29

VI. Overdue Obligations to the Fund - none

B. Nonfinancial Relations

VII. Exchange system: Pegged to the SDR at K Sh 14.42 = 1 SDR (since July 18, 1983).

Intervention currency and rate - U.S. dollar (January 1984) K Sh 13.91 = US$1.

VIII. Last Article IV Consultation and Stand-By Review.

Article IV, December-January 1982-83 (SM/83/24) discussed by the Executive Board on March 21, 1983 - (EBM/83/50). The following Decision was adopted:

Kenya: Relations with the Fund (continued)

1. The Fund takes this decision relating to Kenya's exchange measures subject to Article VIII, Section 2, and in concluding the 1982 Article XIV consultation with Kenya, in the light of the 1982 consultation with Kenya conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Kenya continues to retain restrictions on payments and transfers for current international transactions subject to approval under Article VIII, Section 2, as described in SM/83/26. In view of the budgetary, monetary, and exchange rate measures recently taken, and Kenya's declaration that these measures are temporary, the Fund extends approval for their retention until December 31, 1983.

Last Stand-By Review, July-August 1983 (EBS/83/219) discussed by the Executive Board on October 24, 1983 (EBM/13/150). The following Decision was adopted:

1. Kenya has consulted with the Fund in accordance with paragraph 4(b) of the stand-by arrangement for Kenya (EBS/83/41, Supplement 1, 3/23/83) and paragraph 16 of the letter of the Minister of Finance and the Governor of the Central Bank of Kenya dated January 28, 1983 annexed thereto in order to review policies and to establish performance criteria subject to which purchases may be made by Kenya.

2. The letter dated September 13, 1983 from the Minister of Finance and the Governor of the Central Bank of Kenya setting forth certain policies and measures which the authorities will pursue shall be annexed to the stand-by arrangement for Kenya, and the letter of January 28, 1983 shall be read as supplemented by the letter of September 13, 1983.

3. Accordingly, Kenya will not make purchases under the stand-by arrangement that would increase the Fund's holdings of Kenya's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 percent of quota during any period in which the data at the end of the preceding period indicate that the limit on total domestic credit of the banking system or the limit on net credit from the banking system to the Government, both described in paragraph 7 of the letter of September 13, 1983, is not observed, provided that the purchase of the equivalent of SDR 28.2 million can proceed on the basis of the observance of the credit ceilings for June 1983 and the conclusion of this review.

4. With respect to the fiscal, monetary, import, and exchange and interest rate policies, the Fund finds that no additional understandings are necessary.

Kenya: Relations with the Fund (concluded)

Kenya is on a 12-month cycle for Article IV consultations.

IX. Technical Assistance

CBD experts: Three experts assigned to Central Bank of Kenya. Technical assistance mission on Kenya Financial System.

Fiscal: Technical assistance in fiscal area (1981).

Financial Relations of the World Bank Group with Kenya

(As of December 31, 1983)

Date of membership: February 3, 1964
Capital subscription: SDR 40.0 million

	World Bank loans			IDA and Third Window loans			Total	
	Net committed	Disbursed	Disbursement ratio	Net committed	Disbursed	Disbursement ratio	Committed	Disbursed
Agriculture, livestock, and rural development	119.5	32.8	27.4	181.5	22.2	12.2	301.0	55.0
Population	--	--	--	23.0	0.5	2.2	23.0	0.5
Education	10.0	3.4	34.0	63.0	6.8	10.8	73.0	10.2
Tourism	17.0	9.5	55.9	--	--	--	17.0	9.5
Energy and petroleum exploration	56.0	28.4	50.7	--	--	--	56.0	28.4
Industries and development finance institutions	48.2	19.5	40.4	10.0	7.1	71.0	58.2	26.6
Utilities	90.0	22.4	24.9	47.0	6.5	13.8	137.0	28.9
Transport	152.0	43.9	28.9	--	--	--	152.0	43.9
Telecommunications	64.7	20.6	31.8	--	--	--	64.7	20.6
Structural adjustment loans	60.9	10.9	17.9	70.0	67.6	96.6	130.9	78.5
Technical assistance	--	--	--	4.5	0.1	2.2	4.5	0.1
Total	618.3	191.4	30.9	399.0	110.8	27.7	1,017.3	302.2

Repayments	Bank:	74.6	IDA:	4.2	W.B. Group:	78.8
Debt outstanding	Bank:	543.7	IDA:	394.8	W.B. Group:	938.5
Total undisbursed	Bank:	426.9	IDA:	288.2	W.B. Group:	715.1

IFC operations

Promotion of tourism facilities, capital markets, industrial development (pulp and paper, textiles, cement) and development financing. Total net commitments on loans and equity held by IFC amount to US$43.1 million, of which US$36.6 million have been disbursed.

Source: World Bank.

Nairobi, Kenya
March 27, 1984

Mr. J. de Larosière
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. de Larosière:

1. In our letter of September 13, 1983 we detailed the difficulties faced by the Government of Kenya in meeting the credit ceilings established for June 1983, because of a worsening economic and financial environment. On the basis of the additional measures taken by the Government, the performance criteria were met, but it required a tighter fiscal and monetary restraint than assumed in the program, which affected economic activity negatively. This outturn reflects the continuing difficulties faced by the Government of Kenya in fine tuning economic and financial policies, given the very uncertain present environment, which contains many elements beyond the direct control of the Government.

2. While the world economic situation has recorded some improvement, this has not yet had much impact on the developing countries. The timing of aid and other capital flows has been difficult to predict and the prices of many of our export commodities fluctuate often unpredictably, frequently requiring compensatory domestic policy actions.

3. Despite these and other difficulties, the Government of Kenya has strived with dedication to implement the current adjustment program, which is being supported by a stand-by arrangement. Substantial progress has been attained and the performance criteria included in the stand-by arrangement for March, June, September, and December have been observed. Supported by the continuation of good weather conditions the growth of GDP is beginning to show an improvement. Private sector confidence has solidified, the availability of imports has increased, and the financial position of the public sector has improved. For 1984 real GDP growth is estimated at 4 percent compared to an average of under 3 percent in the previous 2 years. The better supply conditions have also allowed a major containment of price pressures, with the cost of living rising by 10 percent in 1983 compared to over 14 percent in 1982 and a target of 13 percent for 1983. A further reduction is projected for 1984, indicating much faster progress in this area than previously estimated.

4. Balance of payments developments have also been much better than previously estimated, with a large overall surplus recorded in 1983. The price for tea unexpectedly improved in the closing months of 1983, at a time when weather conditions had a very beneficial impact on production leading to an important rise in volume. Sales of nontraditional exports have also continued strong. The coffee sector is also performing somewhat

better. Total export earnings excluding petroleum are estimated to attain a level of K Sh 10.4 billion, better than previously projected. The Government has endeavored throughout the year to facilitate import approvals by a more liberal import licensing policy. This objective has been furthered by the new import system introduced in 1983 and explained in our letter of September 13, 1983. Import licenses approved by the Central Bank have risen by 56 percent during 1983. However, this liberalization was initially affected by a low level of demand for imports that led to a low utilization of approved licenses. This has now begun to be reversed. Thus, the actual inflow of imports through customs has been somewhat lower than would have been predicted by the level of approved licenses. Imports have been lower than targeted in 1983, but are expected to rise significantly faster than previously programed in 1984. In 1983, the current account deficit fell to the equivalent of 2.7 percent of GDP compared to 7.4 percent in 1982. In addition, capital inflows were somewhat higher than earlier estimated, and the balance of payments recorded an overall surplus equivalent to SDR 89 million. The favorable balance of payments outturn for 1983 should be interpreted with caution, mainly because of the large value of outstanding import licenses and the expected fall in tea prices to more normal levels in 1984. These factors will affect the 1984 balance of payments outturn.

5. The ceilings on net credit to the Government have so far been observed. A margin emerged at the end of December 1983, as a result of improved revenue collections in the first half of the fiscal year and larger domestic nonbank financing. On the basis of the performance to date, the Government of Kenya now projects the 1983/84 budget to result in revenues of K Sh 19.1 billion, or 4 percent higher than earlier projected and 14 percent larger than in 1982/83. Even though foreign grants are now estimated to fall short of projected levels, the total of revenue and grants will be some 2 percent higher than earlier estimated. Total expenditure and net lending is also now projected to be 2 percent higher than budgeted, reflecting a need for maintenance expenditure and an increase in other goods and services. Development outlays are projected to rise by an equal proportion to other expenditures. On this basis, the overall budgetary deficit is now estimated at K Sh 3.4 billion (3.8 percent of GDP), compared to a target of K Sh 3.3 billion (3.7 percent of GDP). However, an increase in net bank financing will not be required over the indicative level included in the program. In this regard the Government intends to limit its recourse to net bank credit, as defined in our Government's letter dated January 28, 1983, to K Sh 7,154 million at the end of March 1984 and K Sh 6,927 million at the end of June 1984, compared to K Sh 7,156 million at the end of December 1983.

6. Credit to the private sector and public entities has evolved as specified in the program through 1983 and the shortfall in overall net domestic credit from the ceiling at the end of December is largely the result of lower net bank credit to the Central Government. Credit to the private sector and public entities rose by about 12 percent in 1983,

while overall net domestic credit was almost unchanged. In line with the ceiling on net government credit specified above, the Government intends to limit the net domestic credit of the banking system, as defined in our Government's letter dated January 28, 1983, to K Sh 26,365 million at the end of March 1984 and K Sh 26,286 million at the end of June 1984, compared to K Sh 25,374 million at the end of December 1983. The target for June 1984 will permit an annual increase in credit to the private sector and public entities equivalent to 9.9 percent of the stock of money and quasi-money at the start of the fiscal year.

7. In line with the expectations of the new Development Plan the Government expects to reduce its recourse to net bank credit in the 1984/85 fiscal year in order to permit a larger proportion of the credit increase to be allocated to the private sector.

8. For 1984 the balance of payments current account deficit is now estimated at K Sh 3.2 billion compared to K Sh 3.5 billion previously estimated. The revised figure includes a slightly smaller figure for imports because of lower import prices and the lower base for imports estimated for 1983. Export performance is in line with the program's targets with non oil exports performing better than programed. The overall balance is now projected to be in equilibrium compared to a previously projected overall deficit of K Sh 347 million. The balance of payments is adjusting more rapidly than projected and there has been a major improvement in the level of official foreign reserves. Over the two years 1983-84 the ratio of current account deficit to GDP is expected to average 3.1 percent compared to a previous target of 3.5 percent, with an overall surplus for the period of K Sh 1,246 million compared to a deficit of K Sh 240 million previously projected. At the end of 1984 gross reserves are projected to equal 12 weeks of imports compared to a previous target of 9 weeks.

9. Arrangements are now being put into place to reopen the borders between the members of the former East African Community. This should bring forth a period of trade expansion which should be beneficial to all countries concerned. However, as part of this process, substantial payments will have to be made by Kenya for the final settlement of the common assets of the Community. The procedures for Kenya's payments to former members of the East African Community are now being negotiated and the amounts are likely to have a significant impact on the balance of payments and budgetary projections for 1984 and beyond.

10. The Government of Kenya is viewing 1984 as a year of consolidation as the outlook for the 1984-88 period points to the reemergence of balance of payments pressures given the present projections on commodity prices. The Government expects the strategy contained in the 1984-88 Development Plan announced in December 1983 and other policy initiatives to provide the basis for dealing with this problem. The objectives of the Government will be to improve the rate of economic growth while moving toward internal

and external equilibrium. In this regard the Government is counting on a favorable response from donors as a result of the Consultative Group Meeting for Kenya held in Paris in early 1984, and additional support from the World Bank and the Fund.

11. Since the present program was launched, the Government has kept the exchange rate of the Kenya shilling under continuous review. The Government's intentions in this regard are stated in our letter of September 13, 1983. This letter also spelled out the Government's intention to further the relaxation of the import system prior to the end of the current fiscal year.

12. The Government of Kenya believes that the policies set forth in this letter are adequate to meet the objectives of its program, but it will take any further measures that may become appropriate for this purpose. Kenya will consult with the Fund on the adoption of any measures that may be appropriate, in accordance with the policies of the Fund.

Yours sincerely,

/s/

Philip Ndegwa
Governor of the Central
Bank of Kenya

/s/

Professor George Saitoti
Minister for Finance and
Planning