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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/78

10:00 a.m., May 16, 1984

W. B. Dale, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	
	G. Ercel, Temporary
	X. Blandin
	M. Teijeiro
	M. K. Bush
	S. R. Abiad, Temporary
	T. Yamashita
J. E. Ismael	Jaafar A.
	L. Leonard
	H. A. Arias, Temporary
	G. Grosche
	G. Gomel, Temporary
R. N. Malhotra	
Y. A. Nimatallah	
J. J. Polak	
	H.-S. Lee, Temporary
	O. Kabbaj
	E. I. M. Mtei
M. A. Senior	
	I. Fridriksson, Temporary
	T. A. Clark
Zhang Z.	Wang E.

L. Van Houtven, Secretary
R. S. Laurent, Assistant

Also Present

African Department: L. M. Goreux, Deputy Director; N. Calika, F. d'A. Collings, T. T. Gibson, J. M. Jimenez, J. Kakoza, P. D. Mortimer-Lee, D. J. Scheuer, J. D. Simpson. Central Banking Department: P. Duvaux, J. Kinyua. European Department: T. R. Boote, P. C. Hole. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; S. J. Anjaria, S. Kanesa-Thasan, N. Kirmani. Fiscal Affairs Department: W. R. Mahler, B. A. Sarr. Legal Department: J. G. Evans, Jr., Deputy General Counsel; Ph. Lachman. Middle Eastern Department: K. Nashashibi. Research Department: P. J. Montiel. Secretary's Department: A. P. Bhagwat. Advisors to Executive Directors: S. El-Khouri, S. M. Hassan, L. Ionescu, W. Moerke, Y. Okubo. Assistants to Executive Directors: J. Bulloch, M. Eran, V. Govindarajan, D. Hammann, J. M. Jones, H. Kobayashi, A. Koné, M. J. Kooymans, G. W. K. Pickering, E. Portas, Shao Z., J.-O. Tedesco, M. A. Weitz, J. C. Williams.

1. KENYA - 1984 ARTICLE IV CONSULTATION, AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1984 Article IV consultation with Kenya and a review under an 18-month stand-by arrangement in an amount equivalent to SDR 175.95 million or 119.7 percent of quota, together with a proposed decision concluding the 1984 Article XIV consultation (EBS/84/79, 4/5/84; and Sup. 1, 5/8/84). They also had before them a report on recent economic developments in Kenya (SM/84/79, 4/16/84).

The staff representative from the African Department noted that, in line with Kenya's flexible exchange rate policy, the exchange rate for the shilling had been depreciated in several steps by a total of 2.5 percent during the previous 30 days. The action was aimed at conserving the competitive position attained by Kenya at the start of the current program with the Fund.

Mr. Mtei made the following statement:

> It was clear at the time of the last review of the stand-by arrangement with Kenya in October 1983 that the authorities were making serious efforts to implement the stabilization program agreed with the Fund in March 1983. The staff report that is before the Board today confirms that the program remains on track. This was possible because the authorities had acted promptly and with determination to strengthen the adjustment process after it became apparent that some of the initial assumptions underlying the program were not likely to materialize.
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> The authorities believe that continued cooperation with the Fund is essential. However, it is their view that the Fund would have a greater impact if its resources were made available to Kenya under an extended arrangement after the present stand-by arrangement comes to an end. Although the amount of resources that could be made available under the extended Fund facility would be modest relative to the needs of the Kenyan economy, a medium-term commitment by the Fund would be instrumental in attracting longer-term assistance for the Government's development plan, announced last November, from other multilateral agencies as well as donor countries. This is one of the principal advantages of having an extended arrangement as opposed to a series of one-year stand-by arrangements. Moreover, an extended arrangement will be compatible with the priority that is being placed on tackling the structural problems of the economy with a view to establishing the basis for sustained economic growth. It is to be noted that economic activity has fallen short of historical standards in recent years, a serious problem given the high rate of population growth in Kenya.

The annual growth rate of real GDP is expected to approximate 6 percent by the end of the plan period, reflecting a more balanced development across the various sectors of the economy than in the recent past, when agriculture was the main source of growth. For the immediate future, the outlook for 1984 is for a 4 percent increase in real GDP, slightly more than in 1983.

Self-sufficiency in food remains a priority of the Kenyan Government. To this end, policies are being geared toward improving marketing and credit facilities as well as land use in order to boost production. There is also a commitment to maintaining producer prices at remunerative levels, which, along with an improvement in weather, has been an important factor behind the recent growth in the agricultural sector. Coffee production should be higher in the coming season, and efforts are being made to increase tea production to take advantage of shortages that have developed in the world market. In all, agricultural production is expected to increase at an average annual rate of 4.5 percent over the plan period.

The growth rate of the manufacturing sector is expected to more than double by the last year of the plan, progressing from 3 percent in 1984 to 7.5 percent. This is to be facilitated by channeling a greater amount of resources to productive purposes in the private sector. The manufacturing sector is also expected to benefit from the revival of domestic demand as well as from improved marketing conditions resulting from the opening of borders in the East African area.

The energy policy of the Kenyan Government has led to a reduction in the use of petroleum products which are being replaced by other sources of energy, particularly hydroelectrics, geothermal, charcoal, and gasohol. Meanwhile, domestic energy prices are being maintained at levels that cover costs. Between 1976 and 1982, retail prices of petroleum products increased by over 27 percent, and they were further adjusted by 7 percent in 1983.

The 1983 budget shows a marked improvement in the financial position of the Government, with a decline in the deficit relative to GDP by more than 3 percentage points compared with the previous year. This was achieved even though the growth in revenue was less than half of what was projected earlier in the year. This meant that fiscal policy had to become more restrictive, although it was clear that such a move would have adverse consequences for the Government's development program. The improvement in the budget enabled the authorities to stay well within the credit ceiling and to contain the rate of increase in the money supply, which contributed to the decline in inflation.

Fiscal policy will remain cautious in 1984. However, expenditure is likely to be slightly higher than planned in order to facilitate the smooth operation of the Government. It is to be noted that this increase is expected to be matched by a better revenue performance in view of the anticipated improvement in the economy. The deficit for 1984 is projected to be the equivalent of 3.8 percent of GDP, a figure consistent with a further decline in inflation, and will be financed mainly by external inflows and nonbank borrowing.

Reflecting the Government's intention to rationalize all public expenditure, there is concern in Kenya that a rather large portion of the budget was being absorbed by public enterprises, some of which were being operated inefficiently and unprofitably. Consequently, steps are being taken to improve the monitoring and control of the financial operations of these enterprises, especially financial flows between them and the Government. The Investment Division of the Ministry of Finance and Planning is attempting to introduce more uniform accounting procedures, and it now reviews the financial accounts of all of the large public enterprises. This Division is also making an effort to project the financial investment requirements of the major public enterprises so as to facilitate better planning in the future.

Interest rate policy has been flexible in recent years, and the authorities intend to continue with this approach. Most interest rates are now positive in real terms, reflecting the Government's intention to improve the mobilization and allocation of domestic resources. Minimum time deposit rates range from 13.75 percent to 14.5 percent, and the minimum savings rate is 12.5 percent. The liquidity ratio, which was raised in February 1983, might be reduced during the course of 1984 to enable commercial banks to meet the credit needs of the private sector as the economy recovers.

The current account deficit has narrowed considerably, from the equivalent of 12.5 percent of GDP in 1980 to 2.7 percent in 1983. However, the situation reflects by and large the compression of imports, which declined by about 43 percent between 1980 and 1983. The declining trend in imports is expected to be reversed in 1984, reflecting the progress made thus far toward liberalizing the import system. The balance of payments recorded a surplus of SDR 89 million in 1983 and is expected to be in approximate equilibrium in 1984.

The authorities have continued to manage the exchange rate in a flexible manner. With the recent depreciations, the Kenya shilling will be at about the same real effective level as in early 1983, when the program was launched.

Kenya's debt service ratio is projected to rise to 29 percent in 1985 before falling to 21 percent by the end of 1988. The authorities intend to monitor the situation closely to ensure that future borrowing does not lead to an unsustainable position.

The medium-term outlook for the Kenyan economy is encouraging. Economic growth is expected to be more balanced, as the recovery beginning in the manufacturing sector becomes firm, and real GDP is projected to continue its upward trend. Moreover, with the continuation of prudent policies, the budget deficit should be held at a manageable level, obviating the need for substantial borrowing from the banking system. Another good omen is that given a small increase in capital inflows, Kenya's balance of payments during the plan period is likely to be sustainable, allowing an increase in reserves without increasing the debt service burden. In this connection, the Government hopes to be able to negotiate a third structural loan with the World Bank, as well as receive additional assistance from friendly countries.

Mr. Clark recalled that six months previously, when the Executive Board had first reviewed progress made by Kenya under the present stand-by arrangement, his chair had commended the authorities for successfully implementing the program. That endorsement remained appropriate. At present, all the performance criteria had been met, some by a large margin. Financial imbalances had been significantly reduced, as both the fiscal and current account deficits had declined to 3.5-4 percent of GDP, and the annual rate of inflation had fallen below 10 percent. Nonetheless, progress had not been achieved without cost, especially in terms of per capita income. For the remainder of the stand-by arrangement, as the staff had said, a principal goal of the authorities should be to improve the supply side further so that more rapid growth could resume.

On fiscal policy, Mr. Clark continued, the authorities should press ahead with reforming public sector enterprises. He welcomed their intention to ensure that the demand for credit from public sector enterprises would grow more modestly in future.

With regard to monetary policy, one of the authorities' main concerns must be to establish conditions favorable to private sector investment, Mr. Clark remarked. He hoped that they would make further progress in reducing the amount of domestic credit pre-empted by the public sector. He praised their commitment to maintaining positive real interest rates, which should make a contribution to boosting domestic savings, and welcomed the progress made in improving control over the financial system. In that connection, he looked forward to the results of the joint study by the Central Bank of Kenya and the Fund staff. To the extent that the system of financial intermediation could be strengthened, there should be greater scope for mobilizing domestic savings.

On supply-side measures, Mr. Clark commented that there were four areas in which reform could make a great contribution to expanding exports and thus reviving economic growth. First, in the agricultural sector, maintenance of adequate price incentives could be reinforced by a liberalization of market procedures, as recommended by the World Bank. Second, measures to promote further diversification of nontraditional exports would be helpful. Third, he welcomed the recent moves within East Africa toward lifting trade barriers and the progress toward settling the outstanding claims of the former East African Community composed of Kenya, Uganda, and Tanzania; both those developments should encourage trade with neighboring countries. Fourth, the restraint shown by the authorities in wage policy had contributed not only to reducing inflation but also to maintaining Kenya's international competitiveness. As there had been no general increase in wages since 1981, it would not be surprising if considerable pressure for a general wage rise, at least in the public sector, had built up. Could the staff or Mr. Mtei supply further information on the authorities' stance?

The staff was correct that continued flexibility in exchange rate policy would be needed to maintain the good competitive position of the export sector achieved at the end of 1982, Mr. Clark said; he therefore welcomed the information on the recent series of devaluations of the shilling.

Balance of payments developments in 1983 seemed to have been encouraging, although the position had been distorted by lower than projected imports, Mr. Clark continued. A revival of imports would be needed to sustain economic growth. The World Bank had estimated that an annual real increase in imports of 3 percent would be necessary to underpin annual GDP growth of 4-5 percent, suggesting that the authorities would have little scope to reduce the current account deficit by further compressing imports.

At first sight, especially compared with the prospects for some other African countries, the figures in Table 8 of EBS/84/79 looked reasonably encouraging, Mr. Clark went on. They should be viewed with a degree of caution, as disruptions like bad weather, fluctuating commodity prices, and uneven financial flows could not be ruled out. For example, there were continuing uncertainties about the final terms of the financial settlement among members of the former East African Community. Such uncertainties reinforced the need for the authorities to consolidate the progress made in adjustment by placing additional emphasis on structural aspects.

On many occasions, his chair had stressed the importance of close collaboration between the Fund and the Bank, Mr. Clark said. Kenya had made both drawings under the second structural adjustment loan from the World Bank, and would have the opportunity for a third loan if satisfactory understandings on policy could be reached. He would greatly encourage the Kenyan authorities to try to achieve such understandings. From the Fund's point of view, there were arguments for continuing support. At the present stage, he would not rule out the possibility of an extended arrangement, but much would depend on the determination of the authorities to pursue the structural measures that seemed to be called for.

Mr. Ismael commented that Kenya had made substantial progress under the present stand-by arrangement; he would urge the authorities to persevere with present policies until they attained success. Kenya had a good track record with the Fund: except for 1981, it had been using Fund resources continuously since 1975, and the authorities hoped to conclude another arrangement at the end of the current program. The possibility of a medium-term arrangement under the extended Fund facility should be explored, in view of the adjustment efforts that remained to be accomplished and the need to lend support to the medium-term plan. Why was no such arrangement being contemplated for Kenya?

Economic performance had recently improved, but the medium-term prospects were less than bright, being too dependent on factors beyond the authorities' control, Mr. Ismael continued. First, sustainability could be assured only if capital--from both private and official sources--flowed in as projected. In view of the difficulties faced by Kenya in securing external financing, he would hope that such flows could be assured as planned in the medium term. Second, the country's debt service payments as a proportion of exports seemed to be somewhat too large for comfort. The 7 percent rate of return on capital assumed by the staff appeared overoptimistic. The sensitivity of existing debt servicing would, of course, depend on the proportion of debt currently tied to such rates, but if--as the staff had projected--Kenya needed to arrange for higher inflows of private capital, during the rest of the 1980s the debt service ratio might turn out to be higher than currently foreseen. He invited the staff to comment on the point, as interest rates might not decline as rapidly as forecast in the years ahead. Third, the estimates for export growth might be on the high side, because the world economy might grow more slowly than predicted. Moreover, greater allowance should be made for fluctuations in proceeds from Kenya's exports of coffee.

All those factors called for prudence in framing policy during the medium-term development plan, Mr. Ismael went on. Nonetheless, he might be more confident if there were more positive developments in domestic savings. After all, the savings ratio had been only 19 percent of GDP in 1981 and had deteriorated to 15 percent in 1983; under the revised program for 1984, it was expected to improve only slightly, to 16 percent. More should be done to raise the ratio in the years ahead.

In 1983/84, the overall deficit of central government finance could prove to be on the high side, Mr. Ismael continued. Nonetheless, he sympathized with the authorities' concern about rising unemployment and rapid population growth, which called for a more vigorous recovery in domestic activity. On the other hand, the external constraint precluded a more active demand management policy, which would jeopardize the gains already made. The emphasis on domestic financing in the current program--equal to 2.9 percent of GDP from domestic sources and only 0.9 percent of GDP from external sources--would have to be monitored more closely and with more caution. Even though the figure was less than in 1980/81 and 1981/82, there was a danger that the private sector might be squeezed out from the credit market if the economy were to rebound more sharply. He therefore welcomed the authorities' intention to reduce deficit spending in 1984/85.

The authorities would need to ensure better control of the rapid increase in bank credit to public enterprises, which seemed to have been growing rapidly in recent years, Mr. Ismael noted. Although there had been progress in controlling public finances, was it still true, as mentioned in paragraph 2 on page 17 of EBS/84/79, that the authorities were experiencing difficulty in monitoring expenditures as well as uncertainty in forecasting revenues? He was particularly concerned about expenditures, as the success of the investment effort would depend on the authorities' ability to monitor and control that variable, taking corrective measures if necessary should expenditures get out of hand. The authorities' ability to control spending would be impaired if weakness existed in monitoring public sector spending, especially of parastatal enterprises, which would be essential for the success of the program. If the staff believed that the situation could be remedied in Kenya's interest, provided that the Fund sent technical assistance, then it should do so. In addition, doubts about forecasting revenue raised questions about the firmness of the revenue estimates for 1983/84 and the medium-term plan. In conclusion, he was impressed with the substantial progress achieved under the stand-by arrangement and had no difficulty in supporting the proposed decisions.

Ms. Bush said that she was in general agreement with the staff appraisal. The staff report confirmed the continued progress achieved by the authorities in pursuing adjustment during the current stand-by arrangement, specifically in reducing the fiscal deficit from 9.5 percent of GDP in 1980/81 to 3.8 percent in 1983/84. She did however tend to agree with the staff that even the current figure was slightly in excess of sustainable levels. Furthermore, the current account deficit had fallen substantially from 12 percent of GDP in 1980 to 2.7 percent of GDP in 1983. If, as the staff suggested on page 21 of EBS/84/79, Kenya's balance of payments position would be sustainable in the medium term, given the assumed availability of capital flows, the question of the appropriate role of the Fund in Kenya over the medium term arose. At the time of the Board discussion of prolonged use of Fund resources in June, her chair would address the issue in a more comprehensive and detailed fashion.

On page 17 of EBS/84/79, Ms. Bush noted, the staff said that the Kenyan authorities had indicated some difficulty in monitoring expenditure and forecasting revenue. They had already achieved substantial progress in the fiscal area; like Mr. Ismael, she would like to see the momentum of progress maintained. Was additional technical assistance from the Fund in that area being considered? Finally, her authorities had found the medium-term analysis helpful in forecasting Kenya's medium-term prospects.

Mr. Leonard expressed support for the proposed decisions. Like previous speakers, he commended the Kenyan authorities for their pursuit of adjustment policies under the current program. Compared with the mixed experience of a few years previously, a significant turnaround had taken place in relations between Kenya and the Fund.

In the past 12 months, output had expanded, inflation had eased, and internal and external imbalances had been notably reduced, Mr. Leonard said. Progress under the current stand-by arrangement provided an encouraging example of the benefits to be gained by tackling economic difficulties through sound adjustment policies.

There was continued reason for optimism in 1984, Mr. Leonard remarked. First, financial policies would continue the adjustment effort undertaken during the past three fiscal years. Most real interest rates were being kept positive, and the authorities were committed to keeping them under constant review. Nonetheless, he agreed with the staff that the increase in domestic financing of the fiscal deficit could unduly limit access by the private sector to the total amount of credit available under the program. Second, the external current account deficit seemed capable of being financed in 1984, given the extent of development assistance currently available to Kenya. In that connection, the increase in gross official reserves in 1983 was most encouraging, as was the authorities' intention to maintain reserves at about the present level.

Two areas still called for attention, Mr. Leonard observed. The first was medium-term structural reform, particularly of the exchange rate. The staff had noted that the exchange rate for the shilling had appreciated in real terms since August 1983 and that the competitive position of Kenya's exports might be in danger of being eroded. The recent further depreciations of the shilling announced by the staff at the present meeting therefore represented moves in the right direction but did not appear to have been large enough to offset the real appreciation that had occurred previously. Closely related to the exchange rate issue was the liberalization of the import system. Present restrictions could give rise to undesirable distortions in resource allocation, and it seemed important to do away with the restrictions as soon as possible. So far, progress in that direction had been fairly modest; although the authorities intended to open up the system in 1984, he would prefer to see a more ambitious schedule adopted. Liberalization of the import system should not damage the economy, provided that the exchange rate was set at the right level and other supply-side policies affecting the external account were carried through successfully.

His second area of concern was Kenya's external account, Mr. Leonard commented. Although the current account gap projected over the medium term could be financed, enough financing would be obtainable only if Kenya could depend on a continuation of the recent higher inflows of development assistance. Whether such inflows would continue was largely in the authorities' hands, depending on how willing they appeared to adhere to sound economic policies in the years ahead. The staff's medium-term projection suggested that, over the plan period, Kenya would need borrowing beyond development assistance equal to roughly 1 percent of GDP each year. The projected borrowing further underscored the need for the Kenyan authorities to maintain and strengthen international confidence in their management of the economy.

Mr. Nimatallah expressed agreement with the staff analysis and conclusions, and could therefore support the proposed decisions. The authorities deserved commendation for having successfully implemented the program under the stand-by arrangement. The quantitative performance criteria for 1983 had been observed, and the program's targets had been exceeded in many instances. He could support the program for the remaining period under the stand-by arrangement. In particular, he welcomed the continued emphasis on fiscal restraint, the increase in the availability of credit to the private sector, the further liberalization of the import regime, and the continued pursuit of a flexible exchange rate policy. All those measures should help to reduce further the domestic and external imbalances in the economy.

Policies would have to be reinforced in a number of areas for Kenya's economy to achieve balance of payments sustainability in a growth-oriented context, Mr. Nimatallah continued. In particular, the authorities needed to strengthen the development effort within an environment of financial stability. That would require an enhancement of revenue performance, which had deteriorated in recent years. It would also require that the authorities institute mechanisms to allow for a more rapid use of the external development financing available to them. Robust export performance would be necessary to strengthen the current account over the medium term, requiring clear policies to enhance the development of the export sector. Furthermore, a gradual liberalization of the import regime might be desirable to increase economic efficiency and improve resource allocation.

Given the importance of structural adjustment, he would have liked to see greater coverage in the staff papers of the World Bank's activities in Kenya, Mr. Nimatallah remarked. A discussion of the implementation of policies during two programs under structural adjustment loans with the Bank would have been helpful; the authorities were after all seeking a third such loan. He would also have liked to see a more complete discussion in the staff papers of the economic and financial aspects of the new Five-Year Development Plan.

In conclusion, Mr. Nimatallah said, the authorities had made commendable efforts at adjustment during the previous two years, with encouraging results. They would have to continue to make structural and financial adjustments in order to achieve balance of payments sustainability over the medium term in a growth-oriented context. He welcomed the authorities' intention to seek a new arrangement with the Fund when the present program ended; because of Kenya's need for structural adjustment and the other reasons given by Mr. Mtei in his statement, an extended arrangement might be more suitable for Kenya, and he hoped that Kenya and the Fund would be able to reach agreement on a suitable arrangement.

Mr. Senior expressed support for the proposed decision, noting that the stabilization program under the current stand-by arrangement had been highly successful. By implementing a combination of restrictive demand policies and significant measures to expand supply, the authorities had placed the economy in a better position to attain balance of payments viability with rapid rates of growth in the coming years. The authorities should be commended for their effort.

In 1983, fiscal and monetary adjustment had contributed to reducing the inflation rate even further than projected, while significantly improving Kenya's balance of payments position, Mr. Senior recalled. However, the rapid, successful adjustment of the economy had not occurred without serious difficulties entailing lower economic activity and reduced employment, as seen in the fiscal adjustment. Furthermore, the depressed state of activity in nonagricultural sectors, coupled with uncertain conditions in the external environment, particularly with respect to the timing of disbursements of foreign loans and grants, had had an unfavorable effect on the Government's revenues and expenditures. As the staff pointed out, despite the substantial measures taken to liberalize the import regime, the smaller than programmed flow of imports together with sluggish economic activity had produced a shortfall in revenue that had led the authorities to curtail expenditure drastically, affecting development projects, employment, and economic activity. He hoped that the difficulties that had given rise to such a painful and costly adjustment could be lessened in the future; a country like Kenya, with one of the highest rates of population growth in the world, needed to maintain high rates of economic growth as well.

For the remainder of the program, Mr. Senior said, he welcomed the pursuit of a more relaxed credit policy that would contribute to accelerating activity in the private sector in combination with more active spending on development projects. He also noted with satisfaction that the rate of economic growth had been more favorable than previously expected, entailing better prospects for the inflation rate and the balance of payments position, as long as the flow of foreign financing turned out to be larger than previously foreseen in relation to GDP. Indeed, medium-term projections by the staff and the authorities, under the next Five-Year Development Plan, showed that the balance of payments position could remain sustainable if Kenya obtained adequate flows of financing. Given the authorities' determination so far in implementing the stabilization effort and their intention to maintain sound adjustment policies in the future, those projections did not seem unrealistic. It was encouraging that the recent meeting of the consultative group had indicated favorable prospects for obtaining the additional financing needed. He had no doubt that such high-quality adjustment would continue to receive the Fund's support.

Mr. Grosche said that Kenya had made substantial progress in overcoming its internal and external imbalances; the country had a good chance of embarking on a growth path with inflation remaining subdued. The authorities should stick to their cautious macroeconomic policies combined with prudent structural measures; positive results were already visible. First, the agricultural sector in Kenya contrasted favorably to that of many countries in the region and served as a strong backbone for the economy. Second, the industrial sector was beginning to emerge from a long period of readjustment. Third, revenues and expenditures were being brought better into line, with expenditures being subjected to an improved monitoring system, even though further progress was needed with regard to public enterprises. Fourth, international reserves had reached a reassuring figure.

He concurred with the staff view that the fiscal deficit could be further reduced, Mr. Grosche went on; the reduction should also be helpful in making more credit available to the private sector and in promoting development. The 30 percent fall in real development outlays should not be a cause for great concern, provided that only projects with a low rate of return had been affected; he invited the staff to comment on the point. In order to finance development projects, Kenya could resume its larger recourse to foreign sources. With the debt service ratio still within manageable limits and expected to fall in the future, the authorities had some room for maneuver. He had noted with interest the remarks made by the staff on page 13 of EBS/84/79 that capital inflows might be sustainable at a higher level given an improvement in the budget, a return of confidence in the private sector, and continued interest by major donors in supporting Kenya's development efforts.

As to structural reform, he shared the view expressed by previous speakers that the authorities should move more forcefully, Mr. Grosche went on. They should also take more steps to reform education. Social unrest among those who had left the universities indicated a need to better tailor the educational system to Kenya's economic requirements.

The projected growth of exports in 1984 of 0.5 percent in volume terms, with non-oil exports expected to perform slightly better, contrasted with the projected growth in the volume of world trade of some 5.5 percent, Mr. Grosche noted. Recalling Kenya's commitment to a flexible exchange rate policy, he welcomed the staff's statement on the recent devaluations of the shilling, steps in the right direction to maintain competitiveness for Kenya's exports. On the other hand, he recognized that exports of some commodities, such as coffee, remained artificially restrained by international trade agreements.

The report on recent economic developments provided useful details on the improvement in the external accounts, due principally to a drastic reduction in imports, Mr. Grosche continued. It was nonetheless reassuring that only a small part of the reduction in imports had affected goods, any shortage of which might crucially hamper future productive capacity.

Two balance of payments projections had been included in the paper, one by the staff and one by the Kenyan authorities, Mr. Grosche went on. There were only slight differences between the two projections: the authorities expected a stronger foreign trade position and also a larger need for foreign financing. In that connection, the amount of outstanding claims on Kenya from the former East African Community represented a source of uncertainty; a figure of $148 million had been mentioned in press reports. Had the Kenyan authorities already considered some precautionary measures to offset the expected outflow? In conclusion, the economy had performed satisfactorily so far. The determination shown by the authorities in implementing the current stand-by arrangement was commendable, and he supported the proposed decisions.

Mr. Ercel said that, like other Directors, he was pleased to note that substantial progress, more rapid than expected, had been made under the most recent stand-by arrangement. Not only had Kenya joined the countries that were correcting their imbalances by implementing programs supported by the Fund, but Kenya would also be able to move forward in carrying out a structural reform of the economy, since the problems confronting the authorities were largely structural. As the Kenyan Government hoped to negotiate a third structural adjustment loan with the World Bank, the structural adjustment lending program of the World Bank, together with close coordination between the programs of the Fund and those of the Bank, would help to ensure the achievements of the Government's medium-term objectives. He invited the staff to provide more information on progress to date with respect to a third structural adjustment loan.

He was pleased to note the improvement in the surveillance of nonbank financial institutions, about which he had expressed concern in earlier Board discussions about Kenya, Mr. Ercel remarked. To expand control over the operations of such institutions, the authorities had extended coverage of various regulations, previously applicable only to commercial banks to other financial institutions as well. The staff was correct that better supervision of the financial system as a whole would allow commercial banks to compete more effectively with nonbank institutions. In addition, the flexible interest rate policies followed since 1980 had been an important means of promoting financial savings and improving the financial structure. In Kenya, the structure of interest rates for deposits and loans had been different from that in similar countries: interest rates on deposits had generally been pegged at minimum levels, while rates for loans had generally been pegged at maximum levels. He would appreciate knowing the staff's view on the positive or negative effects, in the context of monetary policy, of using either the minimum or the maximum interest rates for both loans and deposits.

Despite the divergences between the projections of the staff and those of the authorities set forth in the development plan, Mr. Ercel went on, the balance of payments seemed sustainable, given the availability of the necessary capital flows. Thus, the authorities had some room for maneuver in taking a more forceful approach to structural problems. As additional investments would also be required, what projections had the staff been able to make concerning investments and the domestic savings ratio as percentages of GDP for the next five years?

Although Kenya remained dependent on two major export commodities, coffee and tea, the share of nontraditional exports had reached 45 percent of export earnings by the end of 1983, Mr. Ercel concluded. It was difficult to expand nontraditional exports rapidly, but, with special efforts and the implementation of a successful export promotion policy, such an expansion represented one of the more promising avenues toward viable medium-term and long-term balance of payments positions. Finally, he supported the proposed decisions.

Mr. Malhotra noted that the staff papers indicated that the Kenyan authorities had shown remarkable determination in implementing the current stand-by arrangement, having made substantial progress in reducing internal and external imbalances. Therefore, he fully supported the proposed decisions. However, the economy had yet to overcome many of its difficulties; per capita income in 1983 had remained stuck at the 1979 figure. In 1983, the major contribution to growth had been satisfactory agricultural production due partly to good weather. Growth in nonagricultural sectors had been slow; balanced growth would begin only when nonagricultural sectors registered a healthy growth trend, although there had been signs of improvement in production in those sectors as well. He was however concerned that developmental outlays for 1982/83 had been reduced by as much as 37 percent in real terms, and that the program for 1983/84 provided for only a 9 percent increase in such outlays. Although it was not clear in which areas those reductions had been made or what the impact of the reductions would be on medium-term growth in the economy, a drastic reduction in development expenditure did appear to have adversely affected the absorption of external capital.

The authorities had had further success in bringing down the rate of inflation, Mr. Malhotra remarked; the rate of consumer price increases had been falling. Under the prudent policies being followed, he hoped that inflation would be brought down further to a still more satisfactory pace from the annual figure of 10 percent at end-December 1983.

On the expenditure side, the Kenyan authorities had reduced the budget deficit from 9.5 percent of GDP in 1980/81 to 3.1 percent in 1982/83, Mr. Malhotra observed. However, in 1983/84 the deficit was expected to widen to some 3.7 percent of GDP owing to a 17 percent rise in current expenditure and a 9 percent rise in development expenditure. On the monetary side, the authorities had followed a restrictive policy in 1982/83: domestic credit expansion had been limited to 6.4 percent, even though the program target had been 15 percent, and that cautious policy had continued in 1983/84, although in a less rigorous manner. Under the current stand-by arrangement, the target for domestic credit expansion had been set at 15.9 percent, below the projected expansion in nominal income, indicating that the authorities planned to persevere with their cautious approach. Furthermore, they had raised interest rates to positive real levels.

The narrowing of Kenya's current account deficit from 12.5 percent of GDP in 1980 to an estimated 2.7 percent in 1983 had been achieved mainly through heavy import compression, Mr. Malhotra noted. Reflecting the moderate expansion required, the target figure for 1984 would be 3.4 percent of GDP. In view of the need for absorption of external savings in Kenya, a reasonable current account deficit was necessary.

As the staff had said in Part III of EBS/84/79, the Kenyan authorities intended to follow a balanced and cautious course designed to expand the economy in order to achieve a sustained momentum of growth, Mr. Malhotra went on. They recognized that the most important step would be to implement identified structural reforms, notably expanding agricultural production; further developing agricultural infrastructure, such as marketing, improving performance in the export sector; heightening efficiency in the industrial sector, including energy; and expanding capacity in all those areas. He welcomed the authorities' intention to study possible improvements in the existing system of monitoring and controlling expenditures, with assistance from the Fund.

In the external sector, the medium-term projections indicated that Kenya's current account deficit would continue at about 3.7 percent of GDP until 1988, part of it being covered by long-term capital, Mr. Malhotra stated. The debt service ratio was expected to peak at 29 percent of export receipts in 1985 and then gradually decrease to about 20 percent by 1989. Kenya would require continued support in the form of official assistance to maintain the medium-term sustainability of the balance of payments. In the light of the already high debt service ratio, the authorities had rightly followed a cautious policy in incurring additional debt on commercial terms.

It would be important for the Fund to continue to support Kenya in the future, Mr. Malhotra concluded. He saw great merit in Mr. Mtei's suggestion for an extended arrangement following the current stand-by arrangement. The authorities had to pursue structural adjustment, in the framework of the recently adopted development plan.

Mr. Gomel noted that Kenya's performance under the current 18-month stand-by arrangement had been successful in a number of domains. He appreciated the authorities' resolve and their ability to steer the economy along a more favorable trajectory. The policy targets for 1984 appeared reasonable; balance of payments adjustment would continue, aiming roughly at balance in 1984 and growing surpluses in subsequent years, and an expansion of domestic activity would be engineered through more relaxed financial policies.

On the external front, after a marked declining trend, imports were expected to pick up considerably as output growth recovered and the import licensing system was progressively relaxed, Mr. Gomel commented. It was thus imperative for the authorities to put in place policies conducive to brisker growth in exports. Therefore, he agreed with the staff's prescriptions both on the necessity of export-promoting schemes and also on the importance of maintaining Kenya's competitive position internationally. Within a supply-oriented development strategy, some degree of import substitution could be attained, provided that the configuration of relative prices was appropriate.

Domestically, he supported the authorities' desire to give renewed impetus to the economy and appreciated their particular interest in energy conservation and agricultural reform, Mr. Gomel continued. In improving domestic resource mobilization and decreasing dependence on external financing, domestic savings would play a pivotal role. Could the staff explain how domestic savings could be increased through monetary policy and financial instruments and institutions?

The staff's medium-term scenarios were of great expositive and analytical clarity, Mr. Gomel concluded. In particular, the staff was informative and clear in setting forth the way in which assumptions were laid out and the inferences drawn from them, as well as the balance of payments outlook beyond the program period. The staff had also done well to juxtapose two alternative scenarios, one devised by the staff and the other by the authorities. A similar presentation of different scenarios should be pursued, whenever possible, in staff reports for consultations with other countries.

Mr. Alfidja expressed broad agreement with the staff evaluation of developments in and prospects for Kenya's economy. Performance under the present stand-by arrangement continued to be impressive, and the authorities were to be commended for their determination to implement strong measures to meet the objectives of the program. All the performance criteria set for 1983 had been met, with many having been exceeded: economic activity had recovered, and real GDP was estimated to have risen by 3.7 percent in 1983, mainly as a result of an expansion in agricultural production, reflecting not only good weather but also substantial producer price incentives for maize, wheat, and rice. Partly as a result of the expansion in domestic supplies, pressures on prices had diminished considerably.

The adjustment made by the authorities in the fiscal area was also praiseworthy, Mr. Alfidja went on. They had sharply reduced the overall budget deficit as a proportion of GDP, more than halving it from 1981/82 to 1982/83. Both current and development expenditures, especially the latter, had been severely curtailed, and had in fact been lower than foreseen under the program, in view of the uncertainties concerning total revenue and the disbursement of foreign grants. Although it was prudent financial management to ensure that the expenditure commitments were matched by an inflow of resources, his chair continued to be concerned, as on previous occasions, about the unfavorable effect on overall economic activity of prolonged, relatively large cutbacks in development expenditure. He therefore hoped that the authorities would follow the suggestion made by the staff and would give greater emphasis to drawing down available foreign grants in order to strengthen their development efforts.

On the external side, the commendable progress made in reducing imbalances had been largely attributable to a further decline in imports arising mainly from the devaluation of the shilling, the effects of tariff reforms, and the curtailment of development expenditure, Mr. Alfidja noted. The authorities had also brought about an improvement in the overall balance of payments position and had narrowed the current account deficit, while substantial net inflows of capital had enabled them to build up official reserves. To consolidate the gains already made, the authorities needed to continue to maintain producer incentives in the export sector in order to take advantage of the apparent recovery in foreign demand for Kenyan exports. He welcomed the authorities' flexible approach to exchange rate policy for maintaining Kenya's competitiveness.

He agreed with the Kenyan authorities that Fund involvement in their country would have a greater effect if Fund resources were made available under an extended arrangement after the expiration of the present stand-by arrangement, Mr. Alfidja concluded. Such an approach would be more appropriate for many African countries, like Kenya, that were faced with deep-seated structural maladjustments. He supported the proposed decisions.

Mr. Blandin remarked that the Kenyan authorities had achieved encouraging results in implementing the Fund program, significantly reducing two major financial imbalances in particular. First, the overall budget deficit had been reduced by two thirds from 1981 to 1983, owing mainly to higher than projected revenues, reflecting the recovery of the economy. Second, the current account deficit had been reduced beyond the targeted figure as a proportion of GNP. That outstanding result--due mainly to a fall in imports by 12 percent under the 1982 figure--was a positive element, even though the staff expected non-oil imports to rise by 22 percent in 1984. A restrictive monetary policy had allowed the authorities' progress toward those two basic equilibria. Thus, they seemed to have succeeded in meeting the annual targets, which were elementary conditions for a recovery in future growth. Furthermore, some structural adjustments had already been made, and the results achieved in agriculture were worth noting in an African country.

Nevertheless, Mr. Blandin continued, he wondered whether the medium-term position of Kenya would turn out to be as good as those results seemed to indicate. Additional structural adjustments were required for Kenya to reach balance of payments sustainability over the medium term in a satisfactory context of growth. First, the economic growth rate had again been lower than the 3.8 percent annual rate of population growth. He hoped that the projected growth of 6 percent could be attained, but, until family planning could be improved, the high rate of population growth would continue to diminish the chances for Kenya's economy to take off. Second, even though the terms of trade had risen by 2.5 percent in 1983 and were expected to rise by 7.5 percent in 1984, strong pressure on domestic consumption would probably be necessary to reach the 10 percent rise in exports projected for 1984. Third, he agreed with Mr. Grosche's analysis of Kenya's educational problems. Fourth, to what extent might the ease in monetary policy needed to accelerate growth risk a reacceleration of the rate of inflation?

The Kenyan program was a test of a developing country's ability to carry out structural adjustment and to stimulate growth through investments financed by national savings, Mr. Blandin considered. The first stage had been successful, and the authorities' further efforts deserved encouragement from the Fund. He agreed with Mr. Clark that there were strong arguments for continuing support from the Fund when the program under the stand-by arrangement ended. Clearly, an extended arrangement would be the most suitable instrument to help a country put in place supply-side measures. Finally, he had no difficulty in supporting the proposed decisions.

Mr. Kabbaj recalled that, in the previous review under the stand-by arrangement with Kenya, Executive Directors had been impressed by the country's good performance, which contrasted with three successive programs concluded previously. The authorities had been particularly commended for planning to implement all the measures called for, including additional emergency measures, and for meeting all the performance criteria. Since that time, the economic situation had continued to improve, and the program had remained well on track, with substantial progress in stabilizing the economy, curtailing budgetary and external account deficits, and containing credit expansion and inflationary pressures. The overall balance of payments position had turned around to a sizable surplus in 1983--enabling Kenya to strengthen its international reserves appreciably--and was projected to be in equilibrium in 1984. Three important elements had played a major role: good weather had boosted agricultural output in 1982 and 1983; the international prices of Kenya's major exports had recovered; and imports had continued at a depressed level, resulting in large declines in the current account deficit but also contributing to the sluggishness of economic activity. The commendable progress achieved so far should, however, be credited mainly to the authorities' more decisive implementation of the program's financial policies and the bold measures enacted in the past two years, including a substantial curtailment of both current and development expenditures, the adoption of high producer prices for major agricultural exports, and the improvement of resource allocation through a more flexible exchange rate policy and incentives to saving.

Although the growth rate of real GDP had more than doubled in 1983, Kenya's financial performance under Fund programs had been obtained at a relatively high cost in terms of growth, Mr. Kabbaj recalled. Unfortunately, employment did not seem to have kept pace with the rising population. At the earlier discussion, many Executive Directors had suggested that, at the present stage of adjustment, the authorities might consider the use of more growth-oriented policies to consolidate the progress achieved under the program. It was therefore encouraging to note that both the 1984 financial program and the newly issued Five-Year Development Plan were emphasizing the need to resume a suitable level of real growth gradually and to embark on more rapid economic expansion while persevering with prudent adjustment policies. He particularly welcomed the primacy given in the Development Plan to maintaining the country's self-sufficiency in food by promoting greater production of foodstuffs. In addition, he welcomed the attention paid in the Plan to the problem of population growth, and to the need for accelerating the implementation of structural economic reform.

For the Plan to succeed, the authorities would have to maintain prudent financial policies, preserve Kenya's competitive position, and attract inflows of foreign assistance, Mr. Kabbaj remarked. On the one hand, the authorities had expressed an intention to continue with their cautious development efforts; on the other hand, the success of the consultative group meeting for Kenya held in Paris in early 1984 seemed to indicate that foreign donors and creditors would provide sufficient capital inflows. He had also noted with interest Mr. Mtei's comments about the desirability of an extended arrangement to put Kenya's cooperation with the Fund into a medium-term perspective and to help the country to attract longer-term assistance.

The program for 1984 appeared consistent with the original targets under the stand-by arrangement and with the objectives of the Development Plan, Mr. Kabbaj concluded. He largely shared the staff assessment. Nonetheless, there seemed to be a need for greater effort to avoid earlier experiences with forgone outlays and also delays in the disbursement of foreign loans and grants, which had resulted in a larger reduction in development expenditure than foreseen under the program. Like the staff, he believed that maintaining Kenya's competitive position would be crucial to consolidating the 1983 performance. Although the external debt position was not alarming, the authorities should exercise caution in contracting new foreign borrowing needed for financing the Development Plan and also in assessing new projects. He endorsed the proposed decisions.

Mr. Zhang said that he supported the proposed decisions. During the first year of the program, when adverse developments had occurred, the Kenyan authorities had been able to act promptly and with determination, thus carrying out adjustment. They had placed high priority on redressing structural and sectoral imbalances and on establishing a more solid basis for sustained development and growth, which was expected to rise to 6 percent annually by the end of the current Development Plan. Moreover, as the staff report showed, the overall medium-term outlook was encouraging, and the authorities intended to continue their present prudent internal and external policies. They expected to hold down the budget deficit at a manageable figure, and the prospects for obtaining the necessary capital from multilateral agencies and donor countries for domestic investment were good. Unlike many other developing countries, Kenya faced no external debt problem; indeed, the debt service ratio was expected to fall substantially by 1988.

The staff had said that the Fund had played and would play a catalytic role in Kenya's borrowing efforts, Mr. Zhang continued. What did the term "catalytic" mean? Was the Fund's role in Kenya different from its role in Latin American countries? Differences in definition and resulting differences in labeling countries would not be important except that the staff displayed a tendency to pigeonhole countries into different categories and to put limits on borrowing for each category.

Should Kenya apply for an extended arrangement in the future, Mr. Zhang asked, would the staff consider the request within the framework of the Kenyan Development Plan? Would the staff thus take into account the targets and policies contained in the Plan? In conclusion, he was sympathetic to Mr. Mtei's suggestion that the Fund might consider an extended arrangement in responding to any future requests from Kenya for the use of Fund resources.

Mr. Teijeiro noted with satisfaction that the Kenyan authorities had observed all the performance criteria for 1983, reflecting their strong commitment to adjustment. They had brought about impressive reductions in the budget and balance of payments deficits, in domestic credit expansion, and in inflationary pressures. The large adjustment carried out during the past three years in the current account and in the fiscal position was impressive, as was the management of interest rates and wage policy. He welcomed the authorities' decision to carry out a study of the financial system with assistance from the Fund. In addition, in the light of developments during the past few years, the decision to improve control over public enterprises seemed appropriate.

There was still much room for improvement on the supply side, so as to enhance the growth prospects of the economy, Mr. Teijeiro continued. In particular, export promotion, combined with continued liberalization of the exchange and trade regime, seemed to be the first priority. Like Mr. Mtei, he believed that Fund assistance under an extended arrangement would be much more appropriate for the present needs of the Kenyan economy. He hoped that the authorities could implement structural measures and could reach agreement with the Fund on such an arrangement in the near future. In conclusion, he supported the proposed decisions.

The staff representative from the African Department, responding to questions, recalled that Mr. Clark and other Executive Directors had commented on the distribution of credit between the private sector and the public sector. In the past few years, public enterprises had acquired a considerable amount of available credit. However, a substantial part of the credit granted to the banking system had gone to government nonbank financial institutions, which had then re-lent the credit to enterprises in the private sector. The staff had found it difficult to net those figures out, but certainly all of the crop financing and the purchases of grain for the strategic stock had been done by government nonbank financial institutions.

Referring to the prudent wage policies followed by Kenya, the staff representative continued, Mr. Clark and others had concluded that, after several years of cautious policies, wage pressures had recently built up. In April, for instance, there had been increased union activity for higher wages. Certainly, the market-oriented policies followed with respect to various consumable items that had recently been rising in price--together with higher costs for goods from abroad owing to the devaluations of the shilling--had added to the pressure. In fact, the delay in the adjustment of the exchange rate had in part been influenced by the difficult pressures being faced on the wage front. The authorities felt that a continuation of a very active exchange rate policy at a time when such pressures were being exerted would undermine their wage policy.

Several observations had been made by Mr. Ismael on the staff's assumptions used in the debt service projections in the staff papers, the staff representative recalled. The assumptions were in line with those used in the World Economic Outlook. In addition, in relation to many countries to which Kenya's economy was similar, Kenya had a small proportion of its debt on commercial terms set according to the London interbank offered rate (LIBOR), and Kenya would repay a substantial portion of the debt by 1989. The staff had calculated that a 1 percent increase in LIBOR would increase Kenya's debt service ratio in 1989 by 0.7 percent.

The authorities' problem with forecasting expenditure and revenue had been noted by Mr. Ismael and Ms. Bush, the staff representative observed. Despite continuing difficulties, the authorities had carried out substantial improvements during the program period, as reflected in their ability to shift fiscal policy during the course of the program, and to tighten it when necessary. The Government of Kenya was highly complex, with a substantial number of agencies allowed to expend resources, yet the country had only a limited staff of accountants. As the fiscal policy followed during the past few years had allowed only a small margin of increase, it had resulted in a decline in expenditure in some categories. It was more difficult to estimate revenue and spending at a time when the authorities were planning only small increases or, indeed, were trying to decrease the amounts involved. The authorities had also been concerned with observations that they had not implemented various arrangements successfully, and they had tried hard to err on the conservative side in order to improve their record. As several Directors had correctly pointed out, many of the remaining difficulties existed in the public enterprise sector, in which the results had been somewhat mixed. The number of public enterprises still suffering financial problems had fallen substantially during the past two years, and difficulties remained in only a small number of them, particularly those dealing with agriculture. The authorities had tried to manage those enterprises under their control tightly and were moving rapidly to try to improve the others. Many developing countries had found that public enterprises dealing with agriculture, which were spread throughout the country, were somewhat difficult to bring under control. In Kenya, the authorities had placed emphasis on securing improvements in agriculture, and they had not wanted to delay implementing their policies in that sector by taking stringent disciplinary actions.

Several Executive Directors had spoken on the recent changes in the exchange rate, the staff representative noted. In particular, Mr. Leonard had said that the devaluation adjustment might not have been large enough. It was sometimes difficult to pinpoint exactly where the correct exchange rate for currency should lie, particularly when many of the elements entering into such a judgment had to be estimates of how prices had moved in the previous month, in the country involved and also in its trading partners. Substantial differences could emerge among knowledgeable persons about what sort of basket should be used for the exchange rate. In the staff's view, the current exchange rate for the Kenya shilling was pitched in an area that was correct, if it were maintained. According to one of the baskets used, even without the devaluations recently carried out by the authorities, there would have been a small real depreciation in the exchange rate for the shilling.

Many Executive Directors had spoken about the progress that had or had not been made in the import system, the staff representative recalled. In examining the progress made so far, observers had to make a judgment about exactly how liberally the present system was being implemented. The Kenyan authorities believed that their generosity in issuing licenses had made the application of the present system considerably more liberal than it would appear from the institutional description; indeed, measured by the number of licenses granted, there had been a substantial increase. Under the licensing system, the greatest demand had not been for items that were highly restricted, a feature leading the staff to conclude that the pricing actions undertaken by the authorities, including the flexible exchange rate and tariff changes, had gone a long way toward reducing the excess demand that had previously existed for restricted items.

The authorities had been cautious in carrying out additional changes in the legal framework of the system, the staff representative explained. In 1982, owing to balance of payments pressures, they had had to reverse certain actions previously taken to liberalize the system; they had subsequently concluded that the reversal had had a negative impact on public confidence. Their present view was that the more forward-moving a system could become, the better public confidence in it would be served. It was however important to point out that the Fund staff expected the authorities to take major actions in the new budget, which would be introduced to Parliament in June, to liberalize the system further.

Having reviewed the fall in development expenditures, the staff representative went on, Mr. Grosche and others had wondered where cuts had been made and what their possible impact might be. Unfortunately, in practice, it was sometimes difficult to follow economic principles. The authorities would have done well to cut those expenditures that had the least return on development expenditure for the future. The legal contracts concluded by the authorities with various companies implementing projects did not give them the freedom to carry out cuts in that way. Indeed, had many of the projects been stopped, the financial outlays that those legal contracts would have necessitated would have turned out to be greater than any savings that might have been realized on the projects. Consequently, most of the cuts had affected projects in which there would be a saving in expenditure, irrespective of what the outlay might be. It was difficult to state exactly what the effects of those reductions would be on Kenya's prospects for growth. The effect was certainly negative, but the most important result had been to increase the authorities' inability to begin new projects: they had to deal with a one-year or two-year lag in beginning new major projects. In that respect, the small increase being projected in government development expenditure was in line with the authorities' ability to bring new projects on stream.

With respect to the balance of payments, the staff representative observed, Mr. Grosche had asked about the small increase projected in exports for 1984 and beyond. It was important to keep in mind that coffee and tea, which comprised a substantial portion of Kenya's exports, were tied to quotas and to markets that were not buoyant. Moreover, as Kenya sought to expand nontraditional exports, many of the markets to which those products were normally geared were undergoing perhaps a worse period than the Kenyan economy. However, according to the projections, a small increase in total exports would be made possible by a substantial rise in nontraditional exports.

Several Executive Directors had mentioned recent developments in the defunct East African Community, the staff representative continued. It was still too early to be definite about the outcome of the negotiations under way. Certainly, the Kenyan authorities would not be required to make the transfer of resources over a very short period; the agreement permitted them several years in which to do so. There was also the possibility that part of the transfers could be made in goods rather than in currency, a matter still under negotiation. As a precautionary measure, however, the authorities wished to maintain the present level of international reserves, which represented a cushion against whatever negative repercussions might derive from having to make such payments.

With regard to Mr. Blandin's comments on medium-term projections, the staff representative observed, both the authorities and the staff were aware that the future projected for Kenya would not arrive automatically. The authorities were certainly aware that they could not loosen the reins on aggregate demand and must continue to follow their policies astutely in the political arena. After all, Kenya did have a parliamentary system, and the authorities were the first to recognize that a substantial improvement in the process of structural reform was required. In that respect, at the consultative group meeting in Paris, the World Bank had endorsed the Kenyan Development Plan as being an adequate vehicle to deal with those structural reforms. Also, Mr. Nimatallah had said that he would prefer the staff reports to include more information on the economic and financial prospects of the Five-Year Development Plan; a detailed exposition of the Plan would be presented in a subsequent paper. In the present papers, the staff had been concerned mainly with reviewing the feasibility of the external aspects of the Plan in view of the required medium-term projections. The staff would also keep in mind Mr. Nimatallah's request for a more extensive review of Kenya's relations with the World Bank.

A question had also been raised on how much progress was being made with respect to the third structural adjustment loan from the World Bank, the staff representative noted. Candidly, relations between the Bank and the Kenyan authorities were not as good as they might have been, although the World Bank had released all the resources tied to the most recent structural adjustment loan. The World Bank staff felt that the Kenyan authorities had delayed taking necessary action in some areas of economic policy and would be sending a mission to Nairobi in July to discuss those questions as well as the framework of future economic assistance. The Kenyan authorities had pointed out that they had given priority to reducing the external and internal pressures on the economy, as they had felt that structural measures undertaken while those pressures still existed would be less successful.

A question about the Fund staff's import projections had been raised, the staff representative continued. Although imports had declined overall since 1980, a substantial part of the decline had been taken up by the reduced need to import food. In contrast, the 1980 figure had reflected a prolonged drought during which the country had had to import large amounts of grain. In addition, the budget adjustment that had taken place had been helpful in reducing the level of imports by the Government. Consequently, non-oil, nongovernment imports had declined less than the global figures would show, indicating that the private sector was fairly well supplied. On the basis of licensing authorized in 1983, the staff was projecting a large increase in non-oil, nongovernment imports during 1984.

Illustrations of the types of savings and monetary policy required had been requested by Mr. Gomel, the staff representative recalled. In comparison with what its per capita income would seem to indicate, the Kenyan financial system was highly developed, and the resources of that system had grown at a substantial rate in the past. Only in the past few years had the growth rate decelerated, owing largely to the difficult political situation--coup attempts followed by parliamentary elections--and to a lack of buoyancy in the growth of income. At present, income was projected to rise, and the staff thought that Kenya would again record the rapid growth to which it had once been accustomed. Moreover, maintenance of an adequate interest rate policy would be an important element. Once a study in preparation by the Fund in conjunction with the Kenyan authorities had been completed, the staff would be in a better position to describe what additional policies were needed.

A question had also been asked whether setting a maximum on lending rates and a minimum on deposit rates represented an adequate instrument for financial management, the staff representative observed. Ideally, the staff would feel that a market-oriented interest rate structure would be the best tool for the authorities. However, despite the depth of their financial system, the authorities felt that there was a large degree of oligopoly involved, and they also felt that a maximum rate on lending was a necessary tool to prevent undue profits in the financial system. To a certain degree they were correct in that view, because many of the banks were indeed involved in nonbank financial institutions, over which they exercised considerable control. The staff would be in a better position to discuss the matter further once the study previously mentioned was completed.

In the medium term, the authorities believed that the Fund would need to act as a catalyst in attracting foreign assistance and also as a guardian in maintaining the type of financial discipline that Kenya had enjoyed during the past two years, the staff representative from the African Department concluded. During the consultative group meeting, donors had indicated that they were more comfortable when they saw that the country was in close contact with the Fund. The Kenyan authorities had also expressed the belief that, in a further arrangement with the Fund, it would be much more beneficial for them to have a growth-oriented program aimed at removing structural deficiencies than one that could be classified as attempting merely to control aggregate demand.

The staff representative from the Exchange and Trade Relations Department recalled that several Directors had questioned the nature of any further Fund support that might be made available to Kenya. Specifically, Mr. Mtei had expressed a desire for support to be provided in the form of an extended arrangement. In the decision establishing the extended Fund facility (Decision No. 4377-(74/114), adopted September 13, 1974), the Executive Board had stated, in Section II, paragraph 2(b)(i), that a member country requesting an extended arrangement should present a program setting forth the objectives and policies for the whole period of the extended arrangement, and adequate for the solution of the member's problem. Furthermore, in Section II, paragraph 1, the Executive Board had said that such assistance would be given in support of comprehensive programs that included policies of the scope and character required to correct structural imbalances in production, trade, and prices.

Thus, four aspects at least needed to be borne in mind, the staff representative explained. One was that the program had to be adequate for the solution of the member's problem. In Kenya, on the basis of the projections given in the staff report, the objective of attaining balance of payments viability by the end of the program period did appear realizable. Second, in view of the Development Plan elaborated by the authorities, which had received the sponsorship of the World Bank, there would seem to exist a reasonable foundation for putting together a program of the type required under Decision No. 4377-(74/114). Third, the prospect of how well any program might be implemented would have to be borne in mind. For example, the program would have to be realistic, because the staff had had experience with programs that had soon proved unimplementable because they had been put together on assumptions that had turned out to be overoptimistic. In addition, the track record of the authorities, which in Kenya appeared to be good, would have to be taken into consideration. Fourth, the staff would review the collaboration of the member concerned with the World Bank in carrying out structural adjustment policies and implementing previously agreed policies. Apparently, some differences had emerged between the World Bank and the Kenyan authorities on the nature of the country's performance under previous structural adjustment loans.

As pointed out by Mr. Mtei, the amount of Fund support provided under an extended arrangement might be limited because of the ceiling on cumulative use under an extended arrangement of ordinary resources at 165 percent of a country's quota, the staff representative remarked. At the end of February 1984, Kenya's use of ordinary Fund resources had equaled 65.7 percent of quota, leaving a margin for further use under any possible extended arrangement.

Kenya was one of the countries that had used Fund resources for a long period, as Ms. Bush had pointed out, the representative from the Exchange and Trade Relations Department concluded. The matter of prolonged use of Fund resources was going to be discussed by the Board in June, and the staff would take Executive Directors' conclusions into account in arriving at any decision on a possible extended arrangement.

On the basis of the criteria referred to, he believed that there might well be a reason to reach a positive conclusion, but it would be useful to wait for the forthcoming discussion on prolonged use of Fund resources.

The Acting Chairman observed that Table 1 on page 2 of EBS/84/79 showed that total Fund credit outstanding in Kenya was estimated at 282.5 percent of quota, with almost 240 percent being outstanding under tranche policies by the end of the July-September 1984 quarter, when the present stand-by arrangement would expire. Of necessity, there would be a fairly stringent limitation on the amount of Fund resources to be provided under any new arrangement, extended or otherwise. Furthermore, before entering into negotiations for an extended arrangement, the Fund would wish to see a strong performance by the authorities under the present arrangement. The Fund would also wish to follow the further development of Kenya's relations with the World Bank, which ought to be in a position to endorse not only the general architecture of the Development Program but also the specific implementation of structural measures.

The staff representative from the African Department, in response to a question by the Acting Chairman, explained that the Fund and the Bank staffs had similar views on Kenya. There had been differences in the timing of certain actions under the different programs. Under the World Bank program, the Bank staff had expected the authorities to take some action to change the import system officially around January 1984. The other area in which difficulties existed between the World Bank and the Kenyan authorities concerned the freeing of the grain marketing system.

Mr. Zhang, referring to the remark made by the staff representative from the African Department that the Fund was again going to play a catalytic role in Kenya, asked whether there was a general definition of a catalytic role. Moreover, should Kenya request an extended arrangement, would the Fund staff take into account the economic targets and policies that were implied in the authorities' Development Plan?

The Acting Chairman commented that the guidelines on access as they stood would be applied at the time of the negotiations.

The staff representative from the Exchange and Trade Relations Department noted that questions of investment and supply-oriented policies would be at the center of discussions on the delineation of a program, and that the Development Plan of the Kenyan authorities would certainly be taken into account. However, the Plan had been based on excessively optimistic assumptions regarding the availability of foreign resources. For that reason, the Fund depended on the World Bank not merely to provide an assessment of the broad feasibility of the macroeconomic scope of the Plan but also to analyze the individual components of expenditure. Although the staff would take the Plan into account, it would not necessarily accept the assumptions and contents of the Plan as they were presented. The staff would review them and arrive at an agreement with the Kenyan authorities.

Mr. Mtei said that he was glad that Executive Directors agreed that the authorities had acquitted themselves well in their endeavors to fulfill the performance criteria under the stand-by arrangement with the Fund. As several Executive Directors had observed, in some respects the authorities had actually overperformed. Indeed, the attainment of the performance criteria had entailed unpopular social measures, not only wage restraint and high taxes, but also increased unemployment resulting from the stagnation in growth in industry and other sectors of the economy. Owing principally to good weather, only in the agricultural sector had growth been fairly satisfactory during the previous year. The unemployment problem had been compounded by mushrooming population growth; as mentioned by the staff representative from the African Department, trade union dissatisfaction and pressure had been growing in recent months. Therefore, the resolve of the authorities in pursuing the austerity measures under the program had to be appreciated, especially against the background of the aftermath of the attempted coup in August 1982 and the general elections of September 1983. They believed that the package of measures agreed with the Fund represented the correct cure for the country's economic and financial problems in the long run, so that they had demonstrated their commitment to the objectives of the program.

Under the stand-by arrangement, Kenya had achieved a substantial measure of the needed stability in its external and internal financial position, Mr. Mtei observed. As stabilization had also meant that growth in most sectors had been stagnant or minimal and was only beginning to pick up slowly, the authorities were eager at the earliest opportunity to resume growth at a satisfactory pace and on a sustainable basis. They believed that sustainable growth could best be engendered under conditions of financial stability, both internally and externally, which were facilitated by Fund-supported programs. They therefore hoped that at the conclusion of the stand-by arrangement, the Fund would be able to continue to give them support. Considering that greater attention should be given to structural problems, they hoped that the stand-by arrangement would be followed by an extended arrangement geared more to the supply side and to economic growth.

Some Executive Directors had expressed misgivings about the request, Mr. Mtei continued. First, some Directors had been concerned whether the country had a medium-term to long-term plan that was well conceived and designed to enable an extended arrangement to be implemented with success. Second, at the present meeting and on previous occasions, some Executive Directors had expressed the fear, which the recent improvement in Fund liquidity had made less justified, that the Fund should probably not be making long-term commitments to a single country. Third, some had argued that, for practical purposes, a one-year stand-by arrangement--to be followed by perhaps one or two similar ones--could be designed in the same manner as an extended arrangement to achieve medium-term structural adjustment. Regarding the first misgiving, Kenya had already worked out a Five-Year Development Plan to begin on July 1, 1984, and it was within the framework of such a Plan that a program under an extended arrangement would be drawn up. In addition, the World Bank had concluded two structural adjustment loans with Kenya and was negotiating a third one with the authorities. The differences of opinion between Kenyan officials and IBRD staff on the design of the loan demonstrated that the Kenyan authorities understood what was involved; thus, there were hardly any insurmountable problems on that score. Continued support for Kenya by a number of multilateral and bilateral donors for the Plan, especially for the structural adjustment designed within the Plan, would depend greatly on their being assured that the Fund would be present during that period to facilitate an environment of financial stability both internally and externally. In that connection, he was happier than Mr. Zhang about the catalytic influence of the Fund under the circumstances.

As to the second reservation, about committing Fund resources for a long time to a single country, Mr. Mtei went on, Kenya had already reached a high percentage of the maximum of multiples of quota that it could draw under enlarged access. As of September 30, 1984, repurchase obligations in the credit tranche for Kenya would be 240 percent of quota. Therefore, no large amounts in SDR terms would be involved, even if the Board were to approve an extended arrangement. In other words, the Fund would indeed be active as a catalyst for other donors to come to Kenya's assistance by providing, under an extended arrangement, an atmosphere of stability for other donors to participate fully.

The third argument was that a succession of two or more stand-by arrangements would serve the same purpose as an extended arrangement, Mr. Mtei said. In fact, other donors would be more assured and make the necessary medium-term to long-term commitments if they noticed that the Fund's presence from the inception of a medium-term structural adjustment program would also extend through the medium term.

Turning to Kenya's settlement of the liabilities connected with the winding up of the former East African Community, Mr. Mtei predicted that there would be greater regional trade, with Kenya benefiting by exporting, now that agreement had been reached between the three countries that had once made up the Community. Some of the amounts could be settled by transfers of Kenyan goods that otherwise would not have been easily exported. Indeed, the major creditor country in the settlement arrangement to be receiving payments was Uganda, which might be paid by using Kenyan infrastructure. Final negotiations on the modalities of payment had yet to take place; he assumed that Kenya would be given time by the former partners in the Community to settle its liabilities.

On the exchange rate, the Kenyan authorities had acted faithfully, Mr. Mtei continued. As recently as the beginning of the present week, they had made a small adjustment of about 1.5 percent in order to regain the effective exchange rate at the beginning of 1983. The present exchange rate for the Kenya shilling accorded with the calculations made by the Fund staff, and Kenya was current in its exchange rate in accordance with the letter of the agreement in the stand-by arrangement. Kenya was maintaining its competitiveness, although Mr. Grosche was correct that Kenya, as an exporter of primary commodities, especially coffee and tea, was greatly constrained by other factors than just its competitiveness through the mechanism of its exchange rate.

Speaking personally, Mr. Mtei added that, in designing and monitoring the implementation of adjustment programs, the Fund staff should be flexible and allow for a reasonable band of deviations when examining questions like an appreciation or depreciation of the real effective exchange rate for a currency. Even in the stand-by arrangement with Kenya, such an interpretation might have been possible because the wording had not been specific about the deviation from the effective exchange rate at the beginning of 1983. The staff and Executive Directors acknowledged that the manner in which so-called effective exchange rates were computed was not always empirically correct or without dispute. In the case of Kenya, there should not have been so much concern about deviations that had amounted to less than 2 percent. Especially in a developing country like Kenya, in which data entering into the computation of the real effective exchange rate were not always reliable, it was important for the Fund to allow for a margin of error on either side.

In fact, he knew from recent personal experience that the Kenya shilling was one of the rare currencies for which the official exchange rate was correct, Mr. Mtei concluded. At any rate, anyone who had worked in commercial banking could confirm that an adjustment of 1.5 percentage points could easily be absorbed, or its effect watered down, by the discounts or premiums applicable to customers in commercial banking transactions. Indeed, when the Executive Board had recently discussed a stand-by arrangement for Yugoslavia, he had complimented the staff for being pragmatic and flexible by not objecting to the authorities' depreciation of the dinar by some 25 percent, when the staff's calculations had indicated an adjustment of about 30 percent. The staff had acknowledged that the Fund should not be dogmatic about such figures and that the important thing was to track a country's competitiveness under such circumstances. As the Executive Board would have an opportunity soon to review exchange rate questions, he looked forward to the occasion when the Board could provide the staff with more workable guidance.

The Acting Chairman made the following summing up:

> Directors warmly commended the Kenyan authorities for their determined implementation of the current stand-by arrangement. All performance criteria had been met or exceeded, and the financial and balance of payments objectives had been achieved. Directors noted that the successful implementation of the adjustment program had relied on austere financial policies pursued by the Kenyan authorities and on realistic wage and incomes policies. The rate of inflation had slowed by more than had been programmed and was still declining. The dampening effect on the economy of demand management measures had been largely offset by weather-induced growth in agriculture. Agricultural production had also been positively affected by the maintenance of incentives to production, including adequate producer price levels made possible by a flexible exchange rate policy.

Directors broadly endorsed the Kenyan authorities' policy stance for 1984. They noted the significant fiscal adjustment that had taken place in the last few years, which had substantially reduced the overall deficit. However, Directors indicated that there remained a need to strengthen public sector savings in order to reduce further the level of bank financing of the budget and to shift credit to the private sector. Thus, Directors saw a need to increase government revenue and to narrow the domestic financing of the budget deficit and thereby to avoid unduly limiting access to credit by the private sector. In this respect, Directors observed that the buoyancy of budgetary revenue had been declining in recent years and that drawings on already committed foreign assistance could be speeded up.

Directors encouraged the Kenyan authorities to make further progress in reforming the public sector enterprises with a view to limiting their credit demands.

With regard to monetary policy, Directors stressed the importance of encouraging private investment and of strengthening the savings performance of the economy by maintaining positive interest rates in real terms. They commended the authorities on their effective control of the financial system.

Directors welcomed the increase in authorizations for imports and invisible payments. They noted that further structural change in the external sector should be pursued by the liberalization of the exchange and trade regime and the rationalization of the tariff system. Such action would be facilitated by the continued pursuit of a flexible exchange rate policy. Directors welcomed the recent exchange rate adjustments and urged the authorities to maintain the necessary flexibility in order to strengthen competitiveness, although acknowledging that Kenya's major exports were also constrained by factors other than an inappropriate exchange rate.

Directors underscored the importance of pursuing successfully the 1984-88 Development Plan in order to further structural reform and invigorate the economy. Noting Kenya's very high population growth rate, Directors advised that greater effort was required in implementing the Plan not only to avoid the re-emergence of external pressures but also to accelerate growth in the real sector. Directors observed that the adjustment implemented under the current program had improved the medium-term outlook for the economy. The balance of payments was projected to be broadly in balance and the debt service ratio to be appreciably reduced once heavy repayments of commercial medium-term debt had taken place. At the same time, Directors advocated caution in new borrowings on commercial terms. They urged the authorities to strengthen Kenya's export performance in order to improve the sustainability of the external position. This, Directors noted, underscored the need to strengthen supply-side policies, to maintain appropriate price incentives to producers, and to pursue policies of wage restraint.

A number of Directors were supportive of the Kenyan authorities' desire to negotiate an additional program with the Fund that would emphasize supply policies, perhaps in the form of an extended arrangement.

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

The Executive Board then took the following decisions:

Decision Concluding 1984 Article XIV 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 XIV consultation with Kenya, in light of the 1984 Article IV consultation with Kenya conducted under Decision No. 5392-(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 earlier. (EBS/84/79, Sup. 2, Cor. 1, 6/26/84)

Decision No. 7701-(84/78), adopted
May 16, 1984

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.

5. Paragraph 4(c) of the stand-by arrangement for Kenya in EBS/83/41, Supplement 1, March 22, 1983, shall be amended to read as follows:

> (c) during the entire period of this stand-by arrangement, while Kenya has any overdue financial obligation to the Fund or if Kenya....

Decision No. 7702-(84/78), adopted
May 16, 1984

2. RELATIONS WITH GATT - CONSULTATION WITH CONTRACTING PARTIES - FUND GUIDANCE

The Executive Directors considered the recommendation of the Committee on Liaison with the CONTRACTING PARTIES to the GATT, relating to the guidance statement for the Fund representative at the GATT balance of payments consultation with Israel (EBD/84/122, Sup. 1, 5/16/84; EB/CGATT/84/3, 5/14/84).

The Acting Chairman explained that the guidance statement for the Fund representative in connection with the GATT's balance of payments consultation with Israel had been approved, on a lapse of time basis, by the Committee on Liaison with the CONTRACTING PARTIES to the GATT. In general, the timing of GATT consultations was fixed, taking into account the schedule for Fund missions and consultation discussions in the Executive Board, a practice that, in most cases, had allowed the Fund representative to the GATT consultations to have the benefit of a recent Executive Board discussion on the country concerned. Unusually, in the present instance, the GATT consultation with Israel was scheduled to be held from May 21 to May 25, ahead of the Board's discussion of the staff report for the 1984 Article IV consultation with that country, tentatively scheduled for June 15. Under the circumstances, the guidance statement attached to EB/CGATT/84/3 was being brought before the Executive Board for its approval.

Mr. Polak commented that the procedure seemed somewhat unusual, but, as the staff recommended that the Board approve it for the convenience of the GATT, he had no particular objection.

Mr. Clark remarked that the covering note to EB/CGATT/84/3 suggested that the attached guidance statement would go forward as if it reflected the Board's views on the Article IV consultation with Israel, which had not yet been held. As Executive Directors were in no position to anticipate those views, was it possible to make that point clear to the GATT? Moreover, if management had wished to incorporate the Board's views in the guidance statement, it would have done well to circulate the Committee's recommendation (EB/CGATT/84/3) more than a day and a half in advance of the Board meeting.

The staff representative from the Exchange and Trade Relations Department, who would be the Fund representative to the GATT consultation with Israel, recalled that the normal procedure for approving Fund statements to the GATT was for the staff to present them to the Executive Board Committee on Liaison with the CONTRACTING PARTIES to the GATT, which subsequently submitted them to the full Executive Board, in both instances for approval on a lapse of time basis. On a number of occasions, the most recent Article IV consultation discussion in the Executive Board had taken place a fairly long time prior to the GATT consultation. For example, both in 1980 and 1982 there had been a lag of about one year between the previous Article IV consultation discussion in the Board on Israel and the approval of the Fund statement on Israel to the GATT.

A judgment had to be made whether the staff had enough of the elements that would make it possible to present a reasonable statement on a particular country when one was requested by the GATT, the staff representative from the Exchange and Trade Relations Department continued. In some instances, the statement might be formulated on the basis of information obtained by the staff from national authorities during an informal staff visit, or a mission related to the use of Fund resources; or perhaps an Article IV consultation had been held six or nine months before the statement destined for the GATT was presented to the Board. Of course, if an Article IV consultation had recently taken place, the conclusions drawn would provide a sound basis for the statement to the GATT, but the link was not rigid. The suggestion made by Mr. Clark that the Executive Board should say to the GATT that the Fund statement did not reflect the results of the Article IV consultation discussion would not be desirable; the statement would not be serving its purpose if it did not reflect the views of the Fund.

Mr. Leonard said that his position was close to that of Mr. Clark. The CONTRACTING PARTIES to the GATT should have the benefit of whatever information the Fund could provide. Nonetheless, he was reluctant to accept the commitment from the Fund that was involved in the last paragraph on page 3 of EB/CGATT/84/3. For the most part, the paper was factual, and he had no problems with it. However, on page 3, the statement reading "the current policy strategy aims appropriately at improving the balance of payments," included a value judgment in the word appropriately, and he was not certain whether the ultimate judgment of the Board would be identical with it. In the next sentence, the phrase "the Fund hopes that the authorities" contained a recommendation that might not turn out to be the recommendation made by the Board. Therefore, the final paragraph should be neutralized to some extent, or a covering statement should be included saying exactly what the status of the paper was at the present stage.

Mr. Blandin noted that he shared Mr. Clark's and Mr. Leonard's concerns. The procedure seemed to be quite unusual, in that it prejudged the conclusions of the Executive Board on an Article IV consultation that had not yet taken place. He would have preferred to make it clear that the paper did not represent the Fund's judgment on Israel, as Mr. Clark had suggested, but, if that were impossible, he could go along with Mr. Leonard's suggestion to delete the statements containing prejudgments. If the Executive Board had to deal with such a case again, like Mr. Clark, he would much prefer to have the relevant paper circulated further in advance of the Board discussion.

Ms. Bush commented that it was desirable to try to facilitate the timetable for discussions set forth by the GATT. Nonetheless, listening to the staff representative's explanation of what had happened previously when there had been a significant lapse of time between the GATT discussion and the Article IV consultation discussion of a country in the Executive Board, she would have assumed that the transmittals by the Fund to the GATT would have reflected the Board discussion that had previously taken place. She would thus be inclined to propose that there might be some way to indicate that the present papers had not yet gone before the Board.

The staff representative from the Exchange and Trade Relations Department, in response to a question by the Acting Chairman, explained that the main provision of the GATT relating to quantitative import restrictions was that GATT members should refrain from imposing such restrictions. Exceptions were provided for under Articles XII and XVIII of the GATT, which allowed countries to impose restrictions for balance of payments purposes. Under the GATT Articles, balance of payments justifications for restrictions imposed by countries belonging to both the Fund and the GATT should be sought from the International Monetary Fund. Article XV provided that the CONTRACTING PARTIES to the GATT should undertake to collaborate with the Fund so that the two organizations could pursue a coordinated approach with respect to exchange rate questions within the jurisdiction of the Fund as well as questions of quantitative restrictions and other trade measures within the jurisdiction of the GATT. When a CONTRACTING PARTY that was also a member of the Fund invoked either Article XII or Article XVIII--permitting restrictions to be imposed for balance of payments purposes--it was required to undertake consultations in the GATT Balance of Payments Committee. Israel had invoked Article XII, an action that required it to consult in the Balance of Payments Committee each year.

At meetings of the GATT Balance of Payments Committee, the staff representative continued, after an introductory statement by the representative of the consulting country, the Fund representative was called upon to make a statement assessing the country's balance of payments position. The GATT consultation focused mainly on trade restrictions for balance of payments purposes. The statement by the Fund was supposed to conclude with a judgment whether there was indeed a balance of payments justification for the restrictions in question. The final part of the statement contained in EB/CGATT/84/3 was thus a usual feature of Fund statements to the GATT. The background information of a factual nature contained in the Fund statement was, in any case, available to the GATT from the recent economic developments report provided to it.

While in recent years there had been no case in which the Fund had concluded flatly that there was no balance of payments justification for such restrictions, the staff representative noted, several years previously, there had been one case in which the country concerned had found itself in a very comfortable balance of payments position; in that case, the Fund had concluded that a balance of payments justification for the restrictions did not exist. The conclusions in the Fund statements had tended to encourage the country concerned to pursue policies enabling it to reduce reliance on restrictions, and the proposed concluding portion of the statement on Israel was along the same lines.

The GATT held some 10 or 12 consultations every calendar year for balance of payments reasons under Articles XII and XVIII, the staff representative remarked. For both substantive and administrative reasons, the practice had developed of grouping those consultations into two or sometimes three meetings of the Balance of Payments Committee, held usually in the spring and autumn of each year. From the GATT's point of view, there were certain advantages in grouping the countries in such a way. For example, it avoided the necessity of holding frequent meetings of the Balance of Payments Committee, which involved officials from national capitals who frequently had to travel to Geneva for such consultations. In addition, experts were often sent over from the national treasuries of countries participating in the consultations.

For Israel, the staff representative stated, in accordance with the understanding that GATT Article XII consultations should take place once every year, arrangements had initially been made to hold the consultation in October 1983. At the request of the Israeli authorities, the consultation had been postponed to March 1984 and subsequently to May 1984. In the remainder of the year, the only meetings of the GATT Balance of Payments Committee currently foreseen would take place at the end of October. Thus, the question was whether the Fund would be willing to accommodate the GATT in its May meeting of the Balance of Payments Committee or whether it should encourage the consultation to be delayed until October.

Mr. Grosche noted that, in order to meet Mr. Leonard's concerns, the word "appropriately" could be deleted from the first sentence of the last paragraph in EB/CGATT/84/3. As for the last sentence in the paragraph, the hope expressed there was a general one often included in Fund statements and not specifically applying to Israel. The sentence should thus be kept as it stood.

The staff representative from the Exchange and Trade Relations Department, in response to a question by Mr. Polak, explained that, if the question had been pursued of scheduling a consultation in the GATT Balance of Payments Committee in March 1984, the Fund staff might have requested that it be postponed, because the Fund staff members involved in drafting the statement would have been on mission in Israel. In the past, there had been a situation in which the most recent GATT consultation with Israel had taken place in November 1982 while the previous Article IV consultation in the Executive Board had taken place in May 1981. On that occasion, the staff had presented to the GATT a statement approved according to the normal procedures some 18 months after the most recent Board discussion on Israel.

The staff representative from the European Department added that, had the GATT discussed Israel in March, the Fund staff would probably have still said that the current policy strategy in Israel aimed appropriately at improving the balance of payments, but the staff would have been less sure, ahead of consultation discussions, of the thrust of Israeli policy. In any event, the tone of the last paragraph would not have been greatly different at that time.

The Acting Chairman noted that Article IV consultations were being held more and more frequently on the standard 12-month cycle, rather than an 18-month or a 24-month cycle; such difficulties in coordinating timing with GATT consultations might well arise in the future.

Mr. Leonard commented that, if Executive Directors were to be faced with such a situation in the future, they ought to have adequate opportunity to consider the relevant paper. The Board might well have to make a snap decision at present, but there should be no doubt that the Board was approving a paper if it were transmitted to the GATT.

The Acting Chairman agreed that, under the terms of the GATT Articles, the statement to be introduced at a balance of payments consultation was considered a statement of the Fund, which, in the present context, meant the Executive Board. Nonetheless, having become aware of the timing difficulties involved in the case of Israel, management in the future would try to avoid such situations, while continuing to collaborate fully with the GATT. In that sense, the present case would not represent a precedent if it could possibly be avoided. In any event, Executive Directors would certainly be given enough time in future to look at guidance statements.

Mr. Gomel commented that the proposed text should be sent as it stood.

The Acting Chairman drew the conclusion that the Board was willing to go along with the guidance statement as it stood. He took full note of the disquiet of Executive Directors on the matter.

The Executive Board then took the following decision:

The Executive Board approves the guidance statement for the forthcoming consultation with the CONTRACTING PARTIES to the GATT on their consultation with Israel included in EB/CGATT/84/3 (5/14/84).

Decision No. 7703-(84/78), adopted
May 16, 1984

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/77 (5/14/84) and EBM/84/78 (5/16/84).

3. RESERVE TRANCHE - ATTRIBUTION OF REDUCTION IN FUND HOLDINGS OF CURRENCIES - REVIEW

The Executive Board has reviewed Decisions Nos. 6830-(81/65), adopted April 22, 1981, effective from May 1, 1981 and 6831-(81/65), adopted April 22, 1981, effective from May 1, 1981, as amended by Decision No. 7059-(82/23), adopted February 22, 1982. It has concluded that the decisions shall remain in effect without any change. (SM/84/84, 4/23/84; and Sup. 1, 4/30/84)

Decision No. 7704-(84/78), adopted
May 14, 1984

4. HUNGARY - STAND-BY ARRANGEMENT - WAIVER OF PERFORMANCE CRITERION

1. Hungary has consulted with the Fund in accordance with paragraph 4 of the stand-by arrangement for Hungary (EBS/83/268, Supplement 2 (1/16/84)) and paragraph III.3 of the letter dated December 2, 1983 from the Deputy Chairman of the Council of Ministers of the Hungarian People's Republic and the Governor for the Fund of the Hungarian People's Republic attached thereto.

2. The attached letter from the First Deputy President of the National Bank of Hungary shall be attached to the stand-by arrangement for Hungary, and the letter dated December 2, 1983, attached to the stand-by arrangement, shall be read as supplemented and modified by the attached letter.

3. The Fund finds, in light of the attached letter, that no additional understandings are necessary concerning the non-observance of the performance criterion relating to the limit on

outstanding short-term foreign debt in convertible currencies for March 31, 1984 and that Hungary may proceed to make purchases under the stand-by arrangement. (EBS/84/109, 5/9/84)

Decision No. 7705-(84/78), adopted
May 14, 1984

5. EXECUTIVE BOARD - REPRESENTATION EXPENSES

The Executive Board approves the recommendation to extend the rules governing the reimbursement of representation expenses in order to cover Assistants to Executive Directors when they travel outside Washington, D.C. on official business of the Fund, as set forth in EBAP/84/99 (5/10/84) and Correction 1 (5/11/84).

Adopted May 15, 1984

6. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 83/184 are approved. (EBD/84/137, 5/9/84)

Adopted May 15, 1984

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/101 (5/11/84) and EBAP/84/102 (5/14/84) is approved.

8. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/84/103 (5/14/84) is approved.

APPROVED: November 15, 1984

LEO VAN HOUTVEN
Secretary