FOR AGENDA

EBS/83/41

CONFIDENTIAL

February 23, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Kenya - Request for Stand-By Arrangement

Attached for consideration by the Executive Directors is a paper on a request from Kenya for a stand-by arrangement equivalent to SDR 175.95 million. A draft decision appears on page 25.

This subject, together with the staff report for the 1982 Article IV consultation (SM/83/24, 2/2/83) will be brought to the agenda for discussion on a date to be announced.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

KENYA

Request for Stand-By Arrangement

Prepared by the African and the Exchange
and Trade Relations Departments

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

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

February 22, 1983

I. Introduction

In the attached letter dated January 28, 1983, the Government of Kenya requests a stand-by arrangement for a period of eighteen months in an amount equivalent to SDR 175.95 million, representing 170.0 per cent of Kenya's quota. Of this amount SDR 9.74 million would be from the Fund's ordinary resources and SDR 166.21 million from borrowed resources under the enlarged access policy. 1/

As of January 31, 1983 the Fund's holdings of Kenya shillings amounted to SDR 411.1 million (397.2 per cent of quota) including SDR 94.8 million under the supplementary financing facility, SDR 93.8 million in the credit tranches, and SDR 120.8 million under the special facilities. The proposed stand-by arrangement, if fully utilized, would increase the Fund holdings of Kenya shillings to SDR 510.5 million (or 493.2 per cent of quota) and SDR 441.4 million (or 426.5 per cent of quota) excluding holdings under the special facilities (Table 1). Purchases under the arrangement will be phased in six installments: an installment of SDR 45.2 million on approval, three quarterly installments of SDR 28.2 million each, a quarterly installment of SDR 23.0 million, and a final installment of SDR 23.3 million. This phasing is related to the expected cash flow requirements for balance of payments financing.

The background to recent economic developments in Kenya is described in section II. The targets, assumptions, and the principal elements of

1/ A staff team comprising Messrs. J. Jiménez (head-AFR), J.D. Simpson (AFR), D. Lipton (ETR), and L. Doe (FAD), and Miss A. Greasley (secretary-SEC), visited Kenya during the period November 28-December 10, 1982 for the discussions which provided the basis for the proposed stand-by arrangement. Mr. Makalou participated in some of the discussions.

Table 1. Kenya: Estimated of Purchases and Repurchases and Fund Holdings of Kenya shillings, 1983-84

	Phasing of purchases	Actual or scheduled repurchases		Fund holdings			
				Total		Per cent of quota	
		Including special facilities	Excluding special facilities	Including special facilities	Excluding special facilities	Including special facilities	Excluding special facilities
	(In millions of SDRs)						
1983							
January	--	1.0	1.0	411.1	290.0	397.2	280.2
February	--	8.8	--	402.3	290.0	388.7	280.2
March	45.2	--	--	447.5	335.2	432.4	323.9
April	28.2	2.2	2.2	473.5	361.2	457.5	349.0
May	--	8.8	--	464.7	361.2	449.0	349.0
June	--	--	--	464.7	361.2	449.0	349.0
July	--	2.8	2.8	461.9	358.4	446.3	346.3
August	--	8.6	--	453.3	358.4	438.0	346.3
September	28.2	--	--	481.5	386.6	465.2	373.5
October	--	2.2	2.2	479.3	384.4	463.1	371.4
November	28.2	8.6	--	498.9	412.6	482.0	398.7
December	--	--	--	498.9	412.6	482.0	398.7
1984							
January	--	4.4	4.4	494.5	408.2	477.8	394.4
February	--	8.6	--	485.9	408.2	469.5	394.4
March	--	1.7	1.7	484.2	406.5	467.8	392.8
April	23.0	3.7	3.7	503.5	425.8	486.5	411.4
May	--	8.6	--	494.9	425.8	478.2	411.4
June	--	5.5	5.5	489.4	420.3	472.9	406.1
July	23.3	2.2	2.2	510.5	441.4	493.2	426.5
August	--	8.6	--	501.9	441.4	484.9	426.5
September	--	5.5	5.5	496.4	435.9	479.6	421.2
October	--	3.7	3.7	492.7	432.2	476.0	417.6
November	--	--	--	492.7	432.2	476.0	417.6
December	--	5.5	5.5	487.2	426.7	470.7	412.3

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

the stabilization program for 1983/84 are described in section III. The staff appraisal and the proposed decision are contained in section IV.

II. Background

Recent economic and financial developments have been reviewed in the Staff Report for the 1982 Article IV consultation (SM/83/24) and in the Recent Economic Development Report (SM/83/26). During the last four years, economic growth in Kenya was hindered by declining terms of trade, poor weather, weak foreign demand resulting from the world recession, and inappropriate domestic policies. As a result, economic activity has weakened and strong balance of payments pressures emerged. The deteriorating economic and financial situation also highlighted certain deficiencies of the economy such as the fall in competitiveness of the export sector, the increased reliance of domestic industries on import protection, and the slowing down of agricultural growth. Real GDP rose by 4 per cent on average during the period 1979-82, a rate which barely kept up with the rapid population growth, estimated at 3.8 per cent per annum.

In 1980-81 aggregate domestic demand rose strongly, fueled by an expansionary fiscal policy; the overall budgetary deficit rose from 5.7 per cent of GDP in fiscal year 1979/80 (July/June) to 9.5 per cent in fiscal year 1980/81. Credit policy was accommodating and the balance of payments current account deficit registered a large deficit (11 per cent of GDP on average) in 1980-81. Domestically, excess demand conditions were reflected in a sharp acceleration in the inflation rate from 9 per cent in 1979 to 20 per cent in 1981.

The Government's attempts to deal with the deteriorating situation through a one-year stabilization program in 1979 and a two-year arrangement in 1980 were not successful; some of the performance criteria were not observed nor were all of the contemplated purchases carried out. A new program was approved by the Executive Board in January 1982. Although the credit ceilings were exceeded in June 1982 and it did not prove possible to reinstate the program following a coup attempt in early August, the Kenyan authorities made significant progress in implementing the elements of the program. The overall budgetary deficit in fiscal year 1981/82 was reduced from the equivalent of 9.5 per cent of GDP in 1980/81 (10.3 per cent excluding grants) to 6.5 per cent (7.8 per cent excluding grants), compared to a target of 6.4 per cent (7.3 per cent excluding grants) (Table 2). However, Kenya did not receive the level of net foreign financing expected in the program. Faced with the difficulties of stopping ongoing projects and in the expectation that the delayed foreign resources would be received shortly, the Kenyan authorities did not curtail expenditures, but instead sought to make up for the shortfall in foreign resources through increased nonbank financing and made a special effort to keep expenditures to the budgeted level. In addition, the growth of credit to the private sector, at 16 per cent, exceeded the implicit ceiling of 15.3 per cent due to a larger harvest than originally forecast.

Table 2. Kenya: Selected Economic and Financial Indicators, 1981-83

	1981		1982		1983
	Program	Estimate	Revised program	Projection	Projection
	(Annual per cent changes, unless otherwise specified)				
National income and prices					
GDP at constant prices	4.2	4.1	4.2	4.5	3.0
GDP deflator	12.0	9.7	15.4	14.4	12.2
Consumer prices	10.0	20.0	14.0	14.4	13.0
External sector (on the basis of SDRs)					
Exports, f.o.b.	-11.0	-3.2	11.3	-0.8	7.5
Imports, c.i.f.	-6.5	-8.2	0.4	-13.1	0.8
Non-oil imports, c.i.f.	3.7	-17.1	2.1	-15.1	0.7
Export volume	-1.1	--	6.0	-1.2	3.0
Import volume	-14.2	-21.5	-3.0	-13.5	-4.0
Terms of trade (deterioration -)	-7.5	-18.5	1.0	1.4	-1.0
Nominal effective exchange rate (depreciation -)	--	-14.5	...	3.0	...
Real effective exchange rate (depreciation -)	--	- 6.7	...	--	...
Government budget 1/					
Revenue and grants	18.2 2/	21.3	10.1 3/	12.2	17.5
Total expenditure	8.0 2/	29.7	4.9 3/	3.5	11.0
Money and credit 1/					
Domestic credit	20.3 2/	24.2	25.2 3/	33.0	15.7
Government	37.5 2/	83.4	50.3 3/	65.5	20.3
Private sector	15.2 2/	9.5	15.3 3/	16.0	15.6
Money and quasi-money (M_2)	7.0 2/	7.1	7.5 3/	9.1	13.3
Velocity (GDP relative to M_2) 4/	3.20 2/	3.23	3.68 3/	3.55	3.68
Interest rate (annual rate) 4/					
Savings deposit	... 5/	10.00 6/	...	12.50	12.50
Average time deposit	... 5/	10.75 to 12.50	...	13.75 to 15.50	13.75 to 15.50
Maximum lending rate	... 5/	14.00	...	16.00	16.00
	(In per cent of GDP)				
Central government current account surplus/deficit (-)	3.8 2/	-0.2	2.5 3/	1.1	2.1
Central government overall budget deficit					
Including grants	4.3 2/	9.5	6.4 3/	6.5	4.7
Excluding grants	5.4	10.3	7.3	7.8	6.7
Domestic bank financing	1.8 2/	2.8	1.6 3/	2.6	1.3
Foreign financing	2.3 2/	4.9	2.6 3/	1.7	2.4
Gross domestic investment	23.0	23.0	22.0	22.0	20.1
Gross domestic savings	12.5	16.2	16.4	16.4	15.2
External current account deficit 7/					
Including grants	10.3*	10.2*	8.0*	7.1*	5.9*
Excluding grants	11.7*	11.4*	8.9*	8.0*	7.1*
External debt	34.9	34.4	37.6	34.1	37.3
inclusive of use of Fund credit:					
External debt	36.7	38.3	39.4	39.0	43.6
Debt service ratio 8/	13.0	20.6	14.9	22.1	22.4
Interest payments 8/	5.5	8.4	7.9	10.7	12.7
	(In millions of SDRs, unless otherwise specified)				
Overall balance of payments 9/	-149.0**	-198.0**	-169.0**	-146.0**	-42.0**
Gross official reserves (months of imports)	1.2	1.4	1.5	1.7	1.4
External payments arrears	--	--		--	--

1/ Fiscal year ending June 30.
2/ Refers to stand-by program approved on October 15, 1980 and canceled on January 8, 1982.
3/ Refers to stand-by program approved on January 8, 1982.
4/ Level in per cent.
5/ The program did not specifically indicate level, only upward direction.
6/ Rate introduced in September 1981.
7/ Asterisk * reflects severe constraint on foreign exchange availability.
8/ In per cent of exports of goods and services.
9/ Double asterisk ** reflects severe constraint on foreign exchange availability.

During 1982 the current account deficit of the balance of payments was reduced by over 3 percentage points to about 7 per cent of GDP, below the program's target of 8 per cent, largely on the basis of a more restrictive import policy made necessary by low foreign exchange reserves. This tightening of the import policy reversed the progress made earlier in liberalizing the trade system, with the introduction of a new import tariff scheme in late 1981. A complete and detailed review of developments under this stand-by arrangement is available in SM/83/24.

III. The 1983/84 Financial Program

1. Introduction

The objective of the 1983/84 financial program is to continue the medium-term balance of payments adjustment began under the previous stand-by arrangement, while creating the conditions for raising the growth rate to a more adequate level. In 1983 the domestic economy is projected to grow by about 3 per cent, but to resume higher rates thereafter. The growth of domestic prices is expected to be limited to 13 per cent. Growth impetus will stem from the agricultural and the agroindustrial sectors, which are partly export-oriented, and thus important beneficiaries of the recent exchange rate action. Most of the devaluation gain will be passed on to producers.

The fiscal adjustment initiated in 1981/82 will continue in 1982/83, with a further narrowing of the deficit to 4.7 per cent of GDP (6.7 per cent excluding grants). As in previous years, the brunt of the adjustment in this fiscal year will fall on budgetary expenditures, which in real terms are expected to decline by 2 per cent; partly as a result of revenue measures taken last December, revenue will grow by 3 per cent in real terms.

Credit policy will be geared to provide financing for private sector activity, while budgetary recourse to net bank credit will be substantially reduced, with overall credit expanding in line with income. Money and quasi-money is projected to grow less rapidly than nominal GDP in order to contain the rise of domestic prices. To that end, overall domestic credit will be allowed to increase by 17 per cent, while growth in money and quasi-money is set at 13 per cent. The increase in net bank credit to the government in terms of the stock of monetary aggregates at the beginning of the period will decline from 14.6 per cent in FY 1981/82 to 5.5 per cent in FY 1982/83. The moderation in the growth of net bank credit to the government will free available resources and permit the financing of the private sector.

As a result of the expected domestic and external developments and the financial policies announced by the authorities, the current account deficit of the balance of payments is expected to decline from 7.1 per cent of GDP (8.0 per cent excluding grants) in 1982 to 5.9 per cent (7.1 per cent excluding grants) in 1983 and to a lower level in subsequent years. This adjustment will be generated in part by the realignment in the level of prices of internationally traded goods, resulting from the 15 per cent depreciation of the Kenya shilling in terms of the SDR effected between December 3, 1982 and early January 1983. As a result, there will be a restrained import demand and a higher level of export incentives, which will make unnecessary the continuation of the export compensation scheme in the near future.

The proposed stand-by arrangement contains the following performance criteria:

1. Quarterly ceilings on total domestic credit of the banking system;

2. Quarterly subceilings on net credit to the Central Government;

3. A ceiling on external loans contracted or guaranteed by the Government on commercial terms in a maturity range of 1-12 years, with a subceiling on such loans in the maturity range of 1-5 years;

4. Two reviews of fiscal, monetary, exchange rate, and import policies before September 1, 1983 and January 15, 1984, respectively.

5. The standard provisions relating to multiple currency practices, and restrictions on payments and transfers for current international transactions and on imports for balance of payments reasons. The quantitative performance criteria are summarized in Table 3 and a summary of the program is provided in Table 4. Credit ceilings have been fixed only for end-March and end-June 1983, the second half of the current fiscal year. Ceilings for September and December 1983 will be determined during the first review, when the policies embodied in the 1983/84 budget will also be discussed. Ceilings for March and June 1984 will be set during the second review.

In 1982 the Government of Kenya requested exceptional assistance from its main donors. In two meetings (London, November 1982 and Nairobi, January 1983), the main donors agreed to an important increase in their aid programs, including a large amount of balance of payments support in the form largely of commodity assistance. This additional assistance forms an integral part of the program, both for the financing of the balance of payments and the budget. Of the new assistance about SDR 67 million, SDR 64 million in balance of payments support and SDR 3 million in additional project assistance is expected to be drawn in 1983. About SDR 41.6 million of this aid is expected to accrue to the 1982/83 budget.

2. Budgetary policy

The main fiscal objective of the program is a further reduction of the overall budgetary deficit from 6.5 per cent of GDP (7.8 per cent excluding grants) in 1981/82 to 4.7 per cent (6.7 per cent excluding grants) in

Table 3. Kenya: Quantitative Performance Criteria

(In millions of Kenya shillings)

	Dec. 1982	1983/84 Program March 1983	June 1983	Dec. 1983 1/
Total domestic bank credit 2/3/				
Ceiling	--	25,719 4/	24,995	27,671
Actual	25,610			
Net bank credit to Government 2/3/				
Ceiling	--	8,199 4/	7,033	...
Actual	9,196			
New external borrowing contracted or guaranteed by the Government (cumulative) 5/				
1-12 years' maturity				
Ceiling	--	150	150	150
Actual				
1-5 years' maturity				
Ceiling	--	100	100	100

Sources: Letter of Intent, January 28, 1983.

1/ Credit ceilings for December are only indicative.

2/ The definition of domestic bank credit differs from that of the monetary survey in that the former includes the domestic currency counterpart of drawings on Eurocurrency loans.

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

4/ To be adjusted downward by the amount of exceptional financing received prior to end-March 1983.

5/ In millions of U.S. dollars.

Table 4. Kenya: Policy Measures Under the Stand-by Program: Current Status of Implementation

Program	Current status of implementation
1. <u>Fiscal measures</u>	
a. New tax measures to yield K Sh 0.4 billion during December 1982-June 1983: 10 per cent increase in all import duties (expected yield of K Sh 170 million), new rates of sales tax on petroleum products ranging from K Sh 0.1 to K Sh 2.643 per liter (K Sh 160 million), rate of sales tax on beer raised to K Sh 5.78 per liter (K Sh 40 million) and new rate of excise tax on cigarettes ranging from 140 per cent to 155 per cent per thousand (K Sh 30 million).	Implemented effective December 1982.
b. Economies totaling K Sh 0.23 billion in recurrent expenditure chiefly in purchases of equipment, travel and transportation expenses. Principal Ministries affected are Higher Education, Basic Education and Health.	Effective December 1982.
c. Development expenditure cutbacks totaling K Sh 0.545 billion, mainly in transfers and loans to public enterprises, roads and building construction.	Effective December 1982.
d. The recommendations aimed at containing the growth of government expenditure included in the report of the Working Party on Government Expenditure have been approved by the Cabinet and the Parliament. Other recommendations deal with ensuring an adequate expansion of government revenue, improving the efficiency of the public sector, especially of public enterprises. The role of these enterprises in the economy is to be reassessed with a view to restructuring and eventually closing some of them.	Being implemented.
e. Wage increase limited to a fraction of rise in cost of living.	Implemented.

Table 4. Kenya: Policy Measures Under the Stand-by Program: Current Status of Implementation (continued)

Program	Current status of implementation
f. Improved monitoring of fiscal developments, including the creation of a task force to speed-up utilization of available foreign aid.	Implemented.
2. <u>Public enterprises</u>	
a. Approval of the State Corporation Act by Cabinet.	To be implemented before June 1983, the Act will establish a central monitoring of public enterprises, from which management improvement will result.
b. Review of the financial operations of main public enterprises with a view to improving their management, increasing returns to government, and integrating their investment plans in forward budgets.	Under way.
3. <u>Monetary measures</u>	
a. Increase in deposit rates by up to 3 percentage points and in lending rates by 2 percentage points.	Effected December 10, 1982. With the latest upward revision, interest rates have increased by around 9 percentage points since June 1980. All time deposit rates and lending rates are positive in real terms.
b. Limits on overall credit and net credit to Government by the banking system.	Performance criteria in the program.
4. <u>External sector measures</u>	
a. Exchange policy: a further depreciation in the effective exchange rate of the Kenya shilling. The level of the effective exchange rate will be under continuous surveillance during the program period, and subject to the program's reviews.	Exchange rate depreciation made effective between December 10, 1982 and early January 1983. After this move the value of the Kenya shilling vis-à-vis the SDR has depreciated by 39 per cent since early February 1981. The effective exchange rate of the shilling has returned to the

Table 4. Kenya: Policy Measures Under the Stand-by Program: Current Status of Implementation (concluded)

Program	Current status of implementation
b. Trade liberalization.	With Fund and IBRD technical assistance, Kenya is in the process of specifying a new import system which will be characterized by a core list of freely importable items for which foreign exchange will be made readily available by the Central Bank and contain the indications of a further liberalization in the short and medium term. Developments in this area will be reviewed during the program period.
c. A new package of export incentives.	To be discussed with the IBRD and the Fund in the near future.
d. Limits on new indebtedness of the Central Government guaranteed by the Central Government on commercial terms and with maturities below 5 and 12 years.	Implemented.

1982/83 (Table 5). The budget contains estimates of supplementary appropriations, normally granted toward the end of the fiscal year, amounting to K Sh 0.9 billion and includes an appropriation (K Sh 0.4 billion) for the losses expected to be made by the National Cereals and Produce Board on the export of maize and beans; in the past specific provision has not been made for these factors.

Discretionary revenue measures were announced in June 1982 and included higher import duties on several commodities (tires and tubes, paper and several metal products), increased sales taxes on nonalcoholic beverages, sweets, and video equipment, the introduction of a new refinery throughput tax, and higher charges for operating financial institutions and for hotel accommodation. These measures were expected to yield about K Sh 0.3 billion during the 1982/83 fiscal year.

Developments in the external sector and the effect of the August 1982 disturbances resulted in revenue yields in the first quarter of the fiscal year to be below expectations. A full scale review of the 1982/83 budget was carried out in November 1982. Income related taxes were projected to fall from earlier estimates, as a result of the world-wide recession, depressed export earnings, and losses arising from the earlier coup attempt in August. Moreover, the tightening of the import regime was expected to lead to lower import duty collections and the income and sales tax base were estimated to be negatively affected by the fall of activity of the manufacturing sector arising from shortages of inputs and spare parts. These developments were forecast to lead to a total shortfall in revenue estimated at K Sh 1.1 billion in 1982/83.

Effective December 3, 1982, the Government decided to take additional revenue measures. It increased all import duties by 10 per cent, set new, higher rates of sales tax on petroleum products at levels ranging between K Sh 0.1 and K Sh 2.643 per liter, raised the sales tax rate on beer to K Sh 5.78 per liter, and set new, higher rates of excise tax on cigarettes at levels ranging from 140 per cent to 155 per cent per thousand units. The total yield expected from these new measures is estimated at K Sh 0.4 billion during December 1982-June 1983. In addition, certain unexpected, but favorable revenue developments emerged: viz the remittance in October 1982 of the government share of profits made by the Central Bank (K Sh 0.12 billion) and by some public enterprises (K Sh 0.12 billion). There was also additional foreign grants arising from the response from traditional donor countries to a plea made by Kenya in the aftermath of the August disturbances. Grants are now projected at K Sh 1.5 billion in 1982/83, compared with K Sh 0.9 billion in the previous year. Total revenue and grants are now estimated at K Sh 19.5 billion, or 17.5 per cent above those of fiscal year 1981/82.

The revisions of 1982/83 budget carried out in November 1982 seek also to curb expenditure. Budgetary appropriations for 1982/83 were reduced by K Sh 0.8 billion (equivalent to 3.7 per cent of total 1981/82 outlays).

Table 5. Kenya: Central Government Finances, 1979/80-1982/83

	1979/80	1980/81	1981/82 Revised program	1981/82 Provisional outturn	1982/83 Program (Postdevaluation)
	(In billions of Kenya shillings)				
Total revenue and grants	12.3	14.8	16.4	16.6	19.5
Total revenue	12.0	14.3	15.9	15.7	18.0
Grants	0.3	0.5	0.5	0.9	1.5
Total expenditure	15.1	20.2	20.6	20.9	23.2
Recurrent expenditure	11.4	14.0	14.2	15.0	16.4
Development expenditure	4.4	5.7	6.4	6.4	6.8
Adjustment (net expenditure (-)) 1/	0.7	-0.5	--	0.5	--
Overall deficit	-2.8	-5.4	-4.2	-4.3	-3.7
(In per cent of GDP)	(-5.7)	(-9.6)	(-6.4)	(-6.5)	(-4.7)
Financing	2.8	5.4	4.2	4.3	3.7
Foreign (net)	2.0	2.8	1.7	1.1	1.9
Drawings (gross)	(2.4)	(3.5)	(3.0)	(2.2)	(3.5)2/
Repayments	(-0.8)	(-0.7)	(-1.3)	(-1.1)	(-1.6)
Domestic (net)	0.8	2.6	2.5	3.2	1.8
Nonbank	(0.8)	(1.0)	(1.5)	(1.5)	(0.8)
Bank and CSFC	(--)	(1.6)	(1.0)	(1.7)	(1.0)
Overall deficit excluding grants	-3.1	-5.9	-4.7	-5.2	-5.2
(In per cent of GDP)	(-6.3)	(-10.4)	(-7.2)	(-7.8)	(-6.7)
Total GDP at current market prices	49.0	56.5	65.3	66.4	77.9
	(In per cent of GDP)				
Memorandum items:					
Total revenue	24.5	25.3	24.4	23.6	23.1
Of which: tax revenue	(21.2)	(22.0)	(...)	(20.8)	(...)
Total expenditure	30.8	35.8	31.6	31.5	29.8
Bank and CSFC	--	2.8	1.5	2.6	1.3

Source: Based on information provided by the Kenyan authorities.

1/ Reflects the fact that the revenue and expenditure data are not strictly on a cash basis. A negative adjustment item is treated as expenditure, whereas a positive item is treated as revenue.

2/ Includes only the first tranche of the IBRD SAL.

After allowing for the above adjustments and the effect of the latest devaluation of the Kenya shilling, which increased expenditures by K Sh 160 million, total expenditure is projected to grow by only 11 per cent and its ratio to GDP to decline from 31.5 per cent in FY 1981/82 to 29.8 per cent. Consequently, since fiscal year 1980/81 this ratio will have dropped by 6 percentage points. Development outlays were reduced by K Sh 545 million. The largest reductions related to appropriations for the National Agricultural Chemicals and Fertilizers Company (NACAF) (K Sh 28 million), road construction (K Sh 159 million), the building of the National Sports Complex (K Sh 45 million), and a loan to Kenya Airways (K Sh 30 million). A budgeted loan of K Sh 33 million and several other development-related operations estimated to cost K Sh 45 million in 1982/83 were cancelled. Recurrent appropriations for all the spending units were cutback. Government entities most affected were the Ministry of Higher Education (K Sh 102 million), the Ministry of Health (K Sh 15 million), and the Ministry of Basic Education (K Sh 10 million). Recurrent provisions for the Office of the President were also reduced (K Sh 28 million). In terms of functional classification of recurrent expenditure, the reductions were mainly in purchase of equipment, travel, and transportation expenses. The spending units were advised of the cutbacks through circulars issued in December 1982. Monitoring and control procedures put into place in 1981/82 will continue to be implemented in 1983. These measures will continue to limit unauthorized expenditure. Particularly important are the weekly visits by Treasury officers to spending ministries to check their cash books. In order to further strengthen the expenditure-control mechanism and budgetary planning, on December 3, 1982 the Treasury issued Circular No. 9 to all accounting officers of spending ministries and chief executives of public enterprises. This circular containes guidelines for making, reviewing, and submitting projections of expenditure, foreign grants, and loans within the framework of an improved multiyear budget forecasting procedure. In particular, the circular stipulates that the projected investment outlays of the 32 main public enterprises are to be included in the Forward Development Budget, within the expenditure ceilings of the supervising ministries. These changes will facilitate the formulation of the 1983/84 budget.

Despite substantially larger amortization payments (some earlier Eurocurrency borrowing begins to be amortized in 1983), net foreign financing is expected to increase by a large amount in fiscal year 1982/83, despite the recent exchange rate action. Net foreign financing is estimated at K Sh 1.9 billion reflecting larger inflows of concessionary loans, and the drawing of K Sh 0.9 billion on account of the first tranche of the IBRD SAL (the second tranche has been excluded to avert a resource shortfall in case of disbursement delays). Nonbank financing is estimated to fall by 47 per cent to a level of K Sh 0.8 billion, mainly on account of sharply higher amortization of stock issues. As a result, domestic bank and CSFC financing of the deficit is expected to fall from K Sh 1.7 billion (2.6 per cent of GDP) in 1981/82 to K Sh 1.0 billion (1.3 per cent) in 1982/83, equivalent to 5.5 per cent of the stock of money and quasi-money at the beginning of the fiscal year, compared with 14.6 per cent in the previous fiscal year.

Further adjustments in the overall budgetary deficit will be required in fiscal year 1983/84 with the aim of reaching a budgetary deficit in fiscal 1984/85 which is sustainable on the basis of concessional long-term finance. On the basis of present estimates of exceptional finance to be received during the program period, a reduction in the overall deficit ratio to about 4.5 - 4.0 per cent of GDP (including grants) appears necessary in FY 1983/84. The Kenyan authorities are aware that a deficit in this range involves substantial adjustment in light of the anticipated decline in grants as the flow of exceptional finance slows; and are committed to adjust as exceptional finance diminishes. The continued implementation of the report of the Working Party on Government expenditure is expected to lead to further expenditure savings and to the improvement of the structure of government outlays. The automatic hiring of graduates of government sponsored schools will also be reviewed.

3. Policies toward public enterprises 1/

Public enterprises play a major role in Kenya's economy. These enterprises, which include 147 statutory boards, 47 wholly-owned enterprises, and more than 100 companies with government majority or minority participation, are engaged in a wide variety of economic activities (commercial, financial intermediation, and development).

Until recently, the financial relations between the Government and the public enterprises have not been properly defined. Several steps have been taken recently in order to redress the situation. They include the creation in the Ministry of Finance of an Investment Division and the issuance of guidelines to all public enterprises. These guidelines stipulate that all government funds appropriated for public enterprises must be released through the Investment Division in order to facilitate their accounting and monitoring.

In order to strengthen the information base on public enterprises, the Investment Division has undertaken case studies of some major public corporations and has begun to compile and review the financial accounts of a large number of these enterprises. It is also in the process of making preliminary forecasts of the financial investment requirements of 32 public enterprises with a view to incorporating them into the government budget (from 1983/84 onward) and into the next economic development plan. While several public enterprises have been self-financing or have been able to secure domestic commercial bank loans, a number of others have relied on government guarantees and government transfers to carry out their activities.

A few public enterprises have experienced serious financial difficulties in recent years. Of these, the National Cereals and Produce Board (NCPB) and its financing company, the Cereals and Sugar Finance Corporation

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1/ See SM/83/26 for more details about public enterprises.

(CSFC), have had to rely on government funds to finance large inventories of food crops (maize and beans) arising from the unusually abundant 1982 harvest. Transfers amounting to nearly K Sh 0.4 billion are expected to be granted to these two enterprises during 1982/83. In contrast, loans and other transfers to several public enterprises, particularly Kenya Airways, have been reduced--reflecting the December 1982 fiscal austerity measures. This trend is in line with the reduction of the Government's involvement in the domestic economy, as stipulated by the report of the Working Party on Government Expenditure, which calls for the closure of some enterprises and for the transfer of ownership of others to the private sector. Enterprises retained by the Government in whole or in part will be managed by the stipulations of the State Corporation Act, expected to be approved in 1983, whereby a central monitoring unit of public enterprises, directed at improving their management, will be established.

4. Monetary and credit policies

Financial policies for 1983 aim at decelerating total domestic credit growth, with a shift in its composition from the Central Government to the rest of the economy, limiting the rate of expansion of broad money to less than that of nominal GDP, and maintaining real positive interest rates. These policies, coordinated with exchange rate and budgetary policies, are expected to result in a better utilization of financial resources, an improved mobilization of financial savings, and a more stable price level. The ceiling on overall credit for June 1983 implies a target growth rate of 17.1 per cent of the stock of broad money at the beginning of the period, compared with a growth rate of 26.7 per cent during the year ending in June 1982 (Table 6). Overall credit growth is expected to further decelerate through the end of 1983. This outcome is possible because of a sharp reduction in the growth of net banking system claims on government stemming from the narrowing budgetary deficit. Credit to the Government will rise by the equivalent 5.5 per cent of the stock of broad money over fiscal 1982/83, down from 14.6 per cent in fiscal 1981/82. Meanwhile, the private sector will be allowed a moderate expansion of credit through June 1983 of 11.6 per cent of the stock of broad money at the beginning of the period, from 11.2 per cent in the previous 12 months. With nominal GDP growth slowing, as the rate of inflation falls, the growth of private sector credit attempts to balance the need to contain aggregate demand, while providing funds to private firms, in need of inputs for a speedy recovery in production. Money growth will be held steady at around 13 per cent throughout 1983, somewhat less than the expected growth of nominal GDP. Velocity is expected to rise only marginally in 1983 further approaching more normal long-term levels.

A decline in economic activity in the first half of 1982/83 produced slippages in revenue, which led to a rapid expansion of government credit through December 1982. However, with the revenue and expenditure measures taken in December 1982, the additional foreign assistance recently granted, and the seasonal increase in revenue in the second half of the fiscal year,

Table 6. Kenya: Summary Accounts of the Banking System, 1981-83

(In millions of Kenya shillings)

	1981				1982				Proj. 1983		
	March	June	Sept.	Dec.	March	June	Sept.	Proj. Dec.	March 1/	June 1/	Dec. 2/
Net foreign assets	1,898	1,265	176	514	-452	-919	-1,893	-1,341	-1,500	-1,400	-1,466
Total domestic credit	17,397	17,016	19,319	19,668	21,219	21,599	24,441	25,610	25,558	24,794	27,510
Government (net)	5,078	4,531	6,633	6,178	7,553	7,028	9,585	10,210	9,219	8,053	...
Public entities	441	460	438	465	370	626	585	800	600	626	...
Private sector	11,878	12,025	12,248	13,025	13,296	13,945	14,271	14,600	15,739	16,115	...
Other items (net)	2,070	1,135	1,633	1,356	1,828	1,974	2,675	2,999	2,600	2,200	2,200
Money and quasi-money	17,225	17,146	17,802	18,826	18,939	18,706	19,873	21,270	21,458	21,194	23,844
(12-month rate of growth)	(7.6)	(7.1)	(9.9)	(12.9)	(9.9)	(9.1)	(11.3)	(13.0)	(13.3)	(13.3)	(12.1)

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

1/ Program.
2/ Indicative target.

(as a result of the concentration of corporate income tax collections in this period) a sharp reversal in net government credit is expected in the second half of 1982/83. Consequently, net credit to government (according to monetary survey definition) is expected to fall from K Sh 10.2 billion in December 1982 to K Sh 9.2 billion in March 1983 and to K Sh 8.0 billion in June 1983.

On December 10, 1982 the Central Bank of Kenya increased the minimum savings rate paid by commercial banks by 2.5 percentage points. This pulled up other deposit rates; in particular time deposit rates rose by more than 3 percentage points. This increase follows three other increases totaling over 5 percentage points which were made between June 1980 and September 1981. Consequently, the minimum savings rate is now 12.5 per cent, while time deposit rates range between 13.75 and 15.50 per cent. The maximum lending rate was increased by 2 percentage points to 16 per cent. Given that consumer prices rose by 14 per cent in 1982, deposit and lending rates are positive in real terms, except for the savings rate which is marginally negative. The level of interest rates will be carefully assessed during the mid-term review, in pursuit of the objective of maintaining interest rates positive in real terms.

5. Balance of payments policies

The goal of Kenya's external policies is to reach a sustainable current account deficit by 1985. The current account deficit is estimated to have narrowed to SDR 424 million in 1982, representing 7.1 per cent of GDP, down from SDR 586 million (10.2 per cent of GDP) the year before (Table 7). To achieve this reduction, however, it was necessary to tighten significantly the import licensing system, as the appreciation of the real exchange rate throughout the year had threatened to widen the trade gap. Consequently, it did not prove possible to sustain the initial pace of liberalization in light of scarce foreign exchange.

In 1983 the current account deficit is targeted to decline to SDR 352 million or some 6 per cent of GDP (7 per cent excluding grants) (Table 8). Most importantly, a more flexible exchange rate policy, the tariff rate increases and the cautious fiscal and monetary policies which support them, are intended to sharply diminish the extent to which this deficit is constrained by quantitative restrictions. The improvement in 1983 will reflect increases of 7.5 per cent in the SDR value of exports, of 9 per cent in net services, and of less than 1 per cent in the SDR value of imports. Coffee exports, which are not responsive to price changes in the short run, are expected to fall 6 per cent in volume terms following the cyclical pattern expected after a record crop year in 1982 (Table 9).

The growth in aggregate exports is expected on the basis of improved tea sales and substantial growth in nontraditional exports. The main products in this category which are projected to register large increases are horticultural products, both as a result of better weather conditions and

Table 7. Kenya: Balance of Payments, 1980-83

(In millions of SDRs) 1/

	1980	1981		1982		1983
	Actual	Program	Actual	Revised program	Preliminary estimates	Program
Current account	-686	-589	-586	-470	-424	-352
Trade balance	-1,068	-965	-933	-878	-696	-640
Exports, f.o.b.	(954)	(1,005)	(923)	(992)	(916)	(985)
Imports, c.i.f.	(-2,022)	(-1,971)	(-1,856)	(-1,870)	(-1,612)	(-1,625)
Services (net)	275)	377	270	274	188	205
Transfers (net)	107)		76	134	84	83
Capital account	543	432	388	301	278	310
Public long-term	303	265	175	177	129	161
Private long-term	147	174	139	124	112	116
Other 2/	85	-7	67	--	37	33
SDR allocations	7	7	7	--	--	--
Overall balance	-142	-149	-198	-169	-146	-42
Increase in official NFA (-)	142	149	198	169	146	42
Change in gross reserves	104	66	176	-26	4	-13
Use of Fund credit	44	83	23	195	132	55
Other liabilities	-6	--	-1	--	10	--

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

1/ Conversion rates: K Sh 9.66=SDR 1 for 1979 and 1980; K Sh 10.60=SDR 1 for 1981; K Sh 12.07=SDR 1 for 1982; and K Sh 14.06=SDR 1 for 1983.
2/ Includes errors and omissions.

Table 8. Kenya: Summary of External Portion of Program for Stand-By Arrangement for 1983

Assumptions:

Terms of trade change: -1.0 per cent (1982: 1.4 per cent).

Exchange rate (year average): SDR 1 = K Sh 14.06 (1982: SDR 1 = K Sh 12.07).

Targets:

Current account deficit (excluding grants): SDR 422 million, or 7.1 per cent of GDP (1982: SDR 496 million, or 8.3 per cent of GDP).

Current account deficit (including grants): SDR 352 million, or 5.9 per cent of GDP (1982: SDR 424 million, or 7.1 per cent of GDP).

Overall balance of payments deficit: SDR 42 million (1982: SDR 146 million).

Principal elements:

Exchange rate: 15 per cent devaluation (foreign currency terms) against the SDR between December 1982 and early January 1983, and the maintenance throughout 1983 of flexible exchange rate policy, which prevents undesirable real appreciation of the Kenya shilling. Developments in this area will be reviewed during program period.

Foreign debt: New commitments of loans on commercial terms of 1-12 years' maturity limited to US$150 million; and of 1-5 years' maturity limited to US$100 million during the 18 months ending June 1984.

Exchange and trade system: The Government will liberalize the exchange restrictions on certain imports and on dividend remittances as is permitted by the availability of foreign exchange throughout the program period. Progress in this area will be reviewed during the program period jointly by the IBRD and the Fund. The Government will not introduce nor modify any multiple currency practices; impose any new restrictions on payments and transfers for current international transactions or intensify existing ones; enter into any bilateral payments agreements with Fund members which are inconsistent with Article VIII; or introduce any new or intensify any existing restrictions on imports for balance of payments reasons.

Table 9. Kenya: Exports, f.o.b. and Imports, c.i.f., 1981-83

(Value in millions of SDRs; price, volume and terms of trade changes in per cent)

	1981	1982 Revised program	1982 Estimate	1983 Program
Value				
Exports	923	992	916	985
Of which:				
Coffee	(208)	(250)	(245)	(232)
Tea	(116)	(129)	(119)	(131)
Petroleum and byproducts	(223)	(215)	(192)	(194)
Imports	1,856	1,870	1,612	1,625
Of which:				
Mineral fuels	(650)	(633)	(591)	(591)
Prices				
Exports	-5	5	1	4
Of which:				
Coffee	(-16)	(12)	(4)	--
Tea	(4)	(3)	(3)	(1)
Petroleum and by-products	(25)	(-1)	(4)	--
Imports	16	4	--	5
Of which:				
Mineral fuels	(17)	(-1)	4	--
Volume				
Exports	--	6	-1	3
Of which:				
Coffee	(11)	(7)	(15)	(-6)
Tea	(1)	(10)	(1)	(8)
Petroleum and byproducts	(-20)	(--)	(-17)	(1)
Imports	-21	-3	-13	-4
Of which:				
Mineral fuels	(-2)	(-2)	(-12)	--
Terms of trade	-19	1	1	-1

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

price competitiveness, meat and meat products, which will recover somewhat from the drought period of 1980-81, and cement, largely as a result of new price competitiveness, specially in the Middle East markets.

On the basis of the projected balance of payments, import growth will be minimal in SDR terms, but the import level will more closely approximate the actual level of demand. Demand for imports is expected to be depressed by the tariff and exchange rate actions, as well as, by a tight monetary policy, while direct government demand will be reduced as well. The service account is expected to improve with increased transportation and tourism earnings more than offsetting higher interest payments on external debt.

Official capital inflows are expected to recover in 1983 to SDR 161 million from the very low level experienced in 1982. This amount includes SDR 46 million from the World Bank under the second Structural Adjustment Loan to Kenya and SDR 64 million in special balance of payments support. Kenya sought and received pledges for exceptional finance from a number of western industrial nations; most of this finance is of a nonrecurring nature and will be received in 1983. In the present estimates it is anticipated that this finance will take the form of soft loans, although in fact some will be in grant forms. Private capital inflows are expected to rise slightly, reaching SDR 149 million this year, as the recent exchange and interest rate actions and tight domestic monetary conditions should attract an inflow of capital. On the basis of the above estimates, the overall deficit will fall to SDR 42 million in 1983 from SDR 146 million in 1982, largely to be financed by the Fund. On this basis Kenya's gross reserves will remain at the equivalent of over 7 weeks of imports at year-end.

The magnitude of the external payments imbalance is not yet sustainable in 1983, as is made clear by the need for exceptional financing and the anticipated although diminished, reliance on quantitative import restrictions. Nevertheless, this year's position represents an improvement over those of past years and is viewed as a transitional step in an adjustment effort which will culminate in a sustainable balance of payments in 1985. The objectives of external policy in the medium term are for further small reductions in the ratio of the current account to GDP in 1984 and 1985. On the basis of present estimates, this path would require an adjustment of the current account deficit to under 5 per cent of GDP in 1984 (including grants). These objectives will be supported by a flexible exchange rate policy, a monetary policy geared to bring inflation down to manageable levels, further adjustment in the budgetary imbalance, and a longer term process of import liberalization.

The thrust of Kenya's exchange rate policy is to maintain an exchange rate which provides a competitive position for Kenyan exporters, drawing resources into this sector, and discouraging excessive import demand. This policy was strengthened by a 15 per cent devaluation of the Kenya shilling and a 10 per cent rise in import duty rates in December 1982. The real exchange rate will be under constant review by the Kenyan authorities and adjustments will be made when necessary to ensure that it does not unduly appreciate.

With regard to the import policy, the liberalization of the import licensing scheme will proceed as is permitted by foreign exchange availability. Furthermore, moves will be taken to restore automaticity in the granting of import licenses and the allocation of foreign exchange in order to eliminate the input shortages which resulted during most of the latter part of 1982. In addition, the advance import deposit scheme--Kenya's sole multiple currency practice--was eliminated on January 31, 1983. Remaining exchange restrictions are the foreign exchange quotas for imports and restrictions on dividend and rental remittances. These have been employed to help manage the scarcity of foreign exchange, and will be relaxed as balance of payments conditions permit.

Kenya's public and publicly-guaranteed debt has been traditionally low, but has grown to be more of a burden in recent years and stood at about US$2.6 billion (34 per cent of GDP) at the end of 1982, of which only about one third is on commercial terms. The debt service ratio (including the Fund) has risen rapidly from 12 per cent of exports of goods and services in 1980 to 22.1 per cent in 1982. This ratio is expected to rise slightly to 22.4 per cent in 1983, continue upward through 1985, and subside thereafter (Table 10). To ensure this course, the Government intends to limit the contracting of public and publicly-guaranteed external borrowing on commercial terms in the maturity range of 1-12 years to US$150 million, and in the maturity range of 1-5 years to US$100 million in the 18 months ending June 1984.

Table 10. Kenya: Debt Service Payments on Medium- and Long-Term Public and Publicly Guaranteed Debt, 1982-86

(In millions of SDRs)

	Debt service on:				
	Existing debt, excluding IMF	IMF	Additional financing required 1/	Total	Debt service ratio 2/
1982	300	41	--	341	22.1
1983	295	65	15	375	22.4
1984	304	96	27	427	23.2
1985	326	116	35	477	23.5
1986	311	147	45	503	22.5

Sources: Data provided by the Kenyan authorities; IBRD External Debt Division; IMF, Treasurer's Department; and staff estimates.

1/ Under medium-term scenario.

2/ In per cent of exports of goods and nonfactor services.

IV. Staff Appraisal and Decision

Beginning in December 1982, Kenya moved vigorously and decisively to tackle the internal and external disequilibria which had been allowed to build up in the second half of 1982, especially after the coup attempt in August. Through these corrections, the Government has reestablished the thrust of its adjustment policies on the medium term track began in fiscal year 1981/82, for which Fund support was granted in the form of a one-year stand-by arrangement in January 1982. The authorities aim at adjusting the balance of payments, so that by 1985 the current account deficit will be sustainable.

Given the difficulties faced in the second half of 1982, particularly the political disturbances, the Government of Kenya requested extraordinary balance of payments support from its main donor countries to help make up for the losses suffered during the coup attempt and to assist the economy's return to its previous adjustment track. During two Donors' Conferences, the first one held in London in November 1982 and the second in Nairobi in January 1983, the main donor countries reviewed Kenya's request. At these Conferences, participants recognized the very difficult situation through which Kenya was passing. There was clear support for helping the Government cope with its present problems. In particular, donors welcomed Kenya's recent efforts to readjust its economic policies. Despite budgetary difficulties in the donor countries themselves, they were able to pledge an important increase in development assistance and balance of payments support for Kenya. On the basis of the policy measures undertaken already by Kenya, the additional balance of payments support granted by donors and the stand-by arrangement requested from the Fund, the balance of payments for 1983 is financeable.

The Government's objective of transferring resources to the export sector to generate a resurgence of growth and balance of payments adjustment has been substantially supported by the exchange rate action undertaken in December. The maintenance of the competitiveness achieved by these measures is an important policy objective in the period ahead and the staff welcomes the authorities' commitment to follow a more flexible exchange rate policy. This policy, in an environment of cautious fiscal and monetary policies, will also help to curb excessive import demand and in turn allow the authorities to rely on a less restrictive import policy. This will be important in reducing the misallocation of resources and allow the private sector the elements to better plan their investment and production.

The thrust of budgetary policies builds upon the successful accomplishments made by Kenya in the 1981/82 budget, involving a reduction in the ratio of the overall budgetary deficit to GDP by 3 percentage points. Importantly, the policies in place over these two fiscal years, go a long way in furthering the Government's aim of reducing the participation of government in the economy.

The program projects a further almost 2 percentage point reduction in the ratio of the overall budgetary deficit to GDP to a level of about 4.7 per cent in 1982/83 and a reduction of over 1 percentage point to 6.7 per cent excluding grants. To bring about this reduction, the Government put into effect additional revenue and expenditure measures, when it had become clear that the tax base had weakened as a result of recent economic and political events. In addition, the Government is counting on some increased foreign support. Since fiscal year 1980/81 the level of government expenditure to GDP will have been reduced from about 36 per cent of GDP to 30 per cent. The authorities are to continue to move vigorously in this area through the implementation of the report of the Working Party on Government Expenditure, particularly with regard to the management of public enterprises.

The staff feels that the program's credit policy balances the need for caution to contain price increases, while providing credit resources for the productive sectors. The recent adjustment in interest rates will help in the allocation of resources in the economy. Their review and adjustment from time to time is essential in order to maintain this progress.

The balance of payments has already registered an important adjustment during 1982. The adjustment in the overall deficit targeted for 1983 is a necessary element in keeping Kenya's medium term policy objective of achieving a sustainable balance of payments by 1985. On the basis of the 1983 target, the current account deficit will have been reduced by over 5 percentage points since 1980.

The execution of the program is not without its dangers. The margin of maneuverability enjoyed by the authorities is severely limited by the continued recession in the international economy, which hinders Kenya's foreign exchange earning capabilities, by the low level of gross foreign assets, and by the possible difficulties which can be encountered in drawing down the new assistance granted to Kenya. The need to closely monitor developments will weigh heavily on the Government, so that appropriate adjustments are made as needed. It is hoped that donor countries, which have already responded to Kenya's request for additional assistance, will see to it that this aid is released in a timely fashion throughout the year, to allow a more regularized flow of imports, which is vitally needed to improve the confidence of the private sector and to allow this sector to move with vigor to take advantage of the new export incentives.

To meet the Government's medium-term objectives, further adjustment will be necessary in 1984 and 1985. This will require additional adjustment measures in both the budget and balance of payments when the exceptional financing of 1983 runs out. The Kenyan authorities recognize the importance of this effort and its magnitude and are committed to reach sustainable budgetary and payments positions in 1985 and as this adjustment process proceeds they intend to gradually liberalize the import system.

The staff believes that the measures incorporated into the program are appropriate to Kenya's prevailing circumstances and the degree of caution demonstrated in the fiscal and monetary policies are adequate to bring about the targeted adjustment in the balance of payments. The staff welcomes the authorities' emphasis on appropriate pricing policies, with adequate incentives for the agricultural sector and looks forward to the gradual liberalization of the import system. The staff believes that the program represents a substantial effort on the part of Kenya and merits Fund support. The staff expects to remain in close contact with the Kenyan authorities regarding the implementation of the program, including during two interim reviews.

Accordingly, the following draft decision is proposed for adoption by the Executive Board:

1. The Government of Kenya has requested a stand-by arrangement for the period from   to   for an amount equivalent to SDR 175.95 million.

2. The Fund approves the stand-by arrangement set for in EBS/83/41.

3. The Fund waives the limitation in Article V, Section 3b (iii).

Kenya: Relations with the Fund 1/

Status:	Article XIV
Date of membership:	February 3, 1964
Quota:	SDR 103.5 million
Fund holdings of currency as per cent of quota:	SDR 411.11 million (397.21 per cent of quota)
Of which: oil facility	SDR 0.39 million (0.37 per cent of quota)
compensatory facility	SDR 120.75 million (116.66 per cent of quota)
credit tranche ordinary resources	SDR 93.76 million (90.59 per cent of quota)
credit tranche supplementary financing	SDR 94.82 million (91.61 per cent of quota)
Holdings of SDRs:	SDR 7.21 million, or 19.5 per cent of net cumulative allocation (SDR 36.99 million)
Loan disbursements under the Trust Fund:	SDR 46.91 million
Direct distribution of profits from gold sales:	US$7.61 million
Gold distribution (four sales):	41,079.961 ounces
Exchange arrangement:	Pegged to the SDR at K Sh 14.059 = SDR 1
Intervention currency and rate:	U.S. dollar; K Sh 12.941 = US$1
Last consultation (Article IV):	In several stages during June-December 1983, to be discussed by the Board.

1/ As of January 31, 1983.

Kenya--Stand-By Arrangement

Attached hereto is a letter dated January 28, 1983 from the Minister of Finance and the Governor of the Central Bank, requesting a stand-by arrangement and setting forth the objectives and policies which the Government of Kenya intends to pursue. To support these objectives and policies, the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For a period of eighteen months from ________, 1983 Kenya will have the right to make purchases from the Fund in an amount equivalent to SDR 175.95 million, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund.

2. Purchases under this arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 45.2 million until April 15, 1983, SDR 73.4 million until September 2, 1983, SDR 101.6 million until November 2, 1983, SDR 129.8 million until April 2, 1984, and SDR 152.8 million until July 15, 1984. None of these limits shall apply to a purchase under the stand-by arrangement that would not increase the Fund's holdings of Kenya's currency in the credit tranches beyond 25 per cent of quota or increase the Fund's holdings of that currency resulting from purchases of supplementary financing or borrowed resources beyond 12.5 per cent of quota.

3. Purchases under this arrangement shall be made from ordinary resources until total purchases under this arrangement reach the equivalent of SDR 359,348, then from ordinary resources and with borrowed resources in the ratio of 1 to 1.2 until purchases under this arrangement reach the equivalent of SDR 21,007,615; and then with borrowed resources; provided that any modification by the Fund of the proportions of ordinary and borrowed resources shall apply to amounts that may be purchased after the date of modification.

4. Kenya shall not make purchases under this arrangement that would increase the Fund's holdings of its currency in the credit tranches beyond 25 per cent of quota, or increase the Fund holdings of that currency resulting from purchases of supplementary financing or borrowed resources beyond 12.5 per cent of quota:

(a) during any period in which the data at the end of the preceding period indicate that the limit on total domestic credit of the banking system or the limits on net credit from the banking system to the Government, both described in paragraph 13 of the letter of January 28, 1983, are not observed; or

(b) during any period after September 1, 1983, or January 15, 1984, respectively, in which suitable performance criteria have not been established in consultation with the Fund as contemplated by paragraph 16 of the letter of January 28, 1983, or after such performance criteria have been established, while they are not being observed; or

(c) during the entire period of this stand-by arrangement, if Kenya

(i) fails to observe the limit on the contracting of public or publicly guaranteed external debt on commercial terms, described in paragraph 14 of the attached letter, or

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

(iii) introduces or modifies multiple currency practices, or

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

(v) imposes or intensifies import restrictions for balance of payments reasons.

When Kenya is prevented from purchasing under the arrangement because of this paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and Kenya and understandings have been reached regarding the circumstances in which such purchases can be resumed.

5. Kenya's right to engage in the transactions covered by this arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Kenya. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 5, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Kenya and understandings have been reached regarding the circumstances in which such purchases can be resumed.

6. Purchases under this arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in SDRs if, on the request of Kenya, the Fund agrees to provide them at the time of the purchase.

7. The value date of a purchase under this stand-by arrangement involving borrowed resources would be normally either the 15th day or the last day of the month, or the next business day if the selected day is not a business day. Kenya will consult the Fund on the timing of purchases involving borrowed resources.

8. Kenya shall pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

9. (a) Kenya shall repurchase the outstanding amount of its currency

that results from a purchase under this stand-by arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchase as Kenya's balance of payments and reserve position improves.

(b) Any reductions in Kenya's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purchase at the time of the reduction.

(c) The value date of a repurchase in respect of a purchase financed with borrowed resources under this stand-by arrangement will be normally either the 6th day or the 22nd day of the month, or the next business day if the selected day is not a business day, provided that repurchase will be completed not later than seven years from the date of purchase.

10. During the period of the arrangement Kenya shall remain in close consultation with the Fund. These consultations, including those pursuant to the provisions of paragraph 17 of the attached letter, may include correspondence and visits of officials of the Fund to Kenya or of representatives of Kenya to the Fund. Kenya shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Kenya in achieving the objectives and policies set forth in the attached letter.

11. In accordance with paragraph 17 of the attached letter Kenya will consult with the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria in paragraph 4 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Kenya has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Kenya's balance of payments policies.

CONFIDENTIAL

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

Dear Mr. de Larosière:

1. The Kenyan economy has been severely affected by exogenous factors for a number of years. The external terms of trade have deteriorated significantly, drought conditions in 1979 and 1980 have caused substantial variations in agricultural output, and worldwide recessionary forces have curtailed demand for principal export commodities. Externally generated adversities have been aggravated by increasingly severe structural problems in the domestic economy as the import substitution policy pursued successfully during the 1960's and 1970's evolved into a system of import restrictions under which inefficient domestic producers were shielded excessively from foreign competition. The result has been progressively more severe balance of payments difficulties, increasing reliance on external borrowing, and a growing external debt service burden.

2. There was also a weakening of the domestic financial position, with the overall budgetary deficit rising to the equivalent of 9.6 per cent of GDP in 1980/81 and the overall credit expansion to 17 per cent of the stock of money and quasi-money at the start of the fiscal year. Meanwhile, the growth of the economy slowed down to about 4 per cent in 1980 while more intense pressures were felt on prices, with the consumer price index rising by less than 13 per cent. Despite the restrictive stance on imports, the balance of payments weakened continually. The current account deficit of the balance of payments rose to the equivalent of 11 per cent of GDP in 1980 and 10 per cent in 1981 and sizeable overall balance of payments deficits were generated. At the end of 1981, Kenya's gross official foreign reserves had been substantially depleted and stood at the equivalent of only 1.6 months of imports, while the foreign debt outstanding had risen at a fast rate, partly as a result of commercial borrowing. With the rise of the debt service ratio to 20 per cent in 1981, the scope for additional borrowing was constrained.

3. The Government's efforts to launch a medium-term program to correct the structural imbalances in 1980 (supported by a stand-by arrangement covering FY 1980/81 and FY 1981/82) were undermined by the inability to stabilize the overall financial situation and by a further, unexpected weakening of the balance of payments. The deteriorating situation led the Government to restructure its policy stance in 1981 and to adopt a more strict and encompassing stabilization program, which aimed at correcting the critical financial situation, and strengthening the medium-term

structural adjustment effort with the view toward improving the growth potential of the economy. Consequently, a revised program was launched in late 1981, for which the authorities requested a new stand-by arrangement with the Fund, while cancelling the previous arrangement, under which only SDR 90 million were drawn. This adjustment program was also supported by a structural adjustment loan from the IBRD, of which the first tranche (US$80 million) has been disbursed.

4. The new program gave immediate attention to reducing the financial disequilibrium. Consequently on the basis of strictly enforced expenditure limitations, supported by new monitoring mechanisms, the overall budgetary deficit was targeted for a reduction from the equivalent of 9.6 per cent of GDP in FY 1980/81 to 6.4 per cent in 1981/82. The overall credit expansion was to be significantly reduced, while promoting larger access by the private sector to bank credit.

5. Significant policy actions were also taken along the lines of the 1980 program to strengthen the balance of payments and, over a medium-term period, to overcome the recognized structural imbalances. Of major importance was the strengthening of export incentives, the rationalization of the import system in order to reduce its discretionary nature, with the institution of automaticity in the import approval process, and the containment of import demand. On September 21, 1981, the Kenyan shilling was depreciated by 15 per cent in foreign currency terms, following a 5 per cent depreciation earlier in the year. A new import scheme was put into effect, following further adjustments of import tariffs. Thus since 1979 1,700 tariff items (70 per cent of the total) have been adjusted upwards. Producer prices were raised and various controlled prices were increased to more realistic levels. The rate of growth of GDP remained at about 4 per cent in 1981, and inflationary pressures strengthened, with consumer prices rising by about 20 per cent, in part reflecting the exchange rate action and the adjustment of controlled prices.

6. Significant progress was made in implementing the program through a reduction in real government expenditures of about 12 per cent, the overall budgetary deficit was reduced to the equivalent of 6.5 per cent of GDP in 1981/82. Important in the attainment of this objective were certain expenditure control measures taken by the Treasury. The current account deficit of the balance of payments is projected to fall from 10.2 per cent of GDP in 1981 to 7.1 per cent in 1982. The growth performance of the economy also improved in 1982, partly on the basis of a bountiful agricultural harvest aided by good weather conditions and the price incentives put into effect earlier. Inflationary pressures, however, remained strong, with consumer prices rising by about 14 per cent compared to 16.8 per cent anticipated earlier.

7. However, the implementation of the program was hindered by the lengthing of the world recession, by the continuation of domestic price pressures, reduced capital inflows, and the real appreciation of the Kenya

shilling. Moreover, the lower than expected foreign capital inflows plus an inability to place as many Treasury bills in the nonbank sector, despite substantial increases in Treasury bill rates, did not permit the observance of the credit ceilings established in the stand-by arrangement for the end of June 1982. Kenya drew SDR 90 million under the program and an additional SDR 60.4 million under the CFF, corresponding to an export shortfall for calendar 1981. Meanwhile, despite the significant adjustment effort which was registered previously, balance of payments pressures resurfaced, in part through a weakening of the capital account. To protect gross official reserves, the import system was tightened and the current account deficit was lower than it would have been otherwise.

8. The Government of Kenya recognizes that the very difficult current economic and financial situation requires the strengthening of the Government's adjustment and stabilization policies in order to reach the goal of a sustainable balance of payments position in the medium term, while maintaining a growth rate of about 3 per cent in 1983, and improved levels in future years. In this regard the Government aims at a further reduction of the current account deficit of the balance of payments to about 6 per cent of GDP in 1983 and about 5.5 per cent in 1984, with additional adjustment in the subsequent years. In order to bring this adjustment about, resources need to be transferred to the external sector to encourage export activities, while pursuing the reduction of imports by means of aggregate demand restraint and price incentives. In this regard the Government intends to reverse the real appreciation of the Kenya shilling which has occurred since October 1981, through a depreciation of the shilling. Effective December 10, 1982 the exchange rate was depreciated by 13 per cent in foreign currency terms. The Government intends to keep the exchange rate under continuous review and to take further action as needed to regain the previous real effective exchange rate. A further constraint on import demand has been established by a 10 per cent rise in all import duties, effective on December 3, 1982. In addition demand of imported petroleum products will also be checked by an increase in the sales tax put into effect on the same date. The Government will henceforth adjust the exchange rate periodically, taking into account movements in relative prices in Kenya and in its main trading partners, Kenya's balance of payments needs, and the movement in key international currencies, in order to safeguard Kenya's export incentives and to match import demand to available foreign exchange. The additional shilling costs associated with the exchange rate will be fully passed to consumers and producers, in particular with respect to energy products. Moreover, producer prices will be reviewed and maintained at realistic levels in accordance with the Government's policy of not subsidizing consumer prices.

9. As a result of the lower level of development outlays which has taken place, the inflow of development capital has been reduced from the anticipated levels. This will inevitably reduce growth prospects, but the Government of Kenya appreciates the need to place part of the adjustment burden on development outlays. In order to promote an orderly adjustment, without an abrupt economic contraction, the Government has requested its traditional

donors for special balance of payments assistance in the form of new aid or through the conversion of resources previously committed to projects to balance of payments support. About SDR 90 million is expected to be pledged by these donors for 1983, which in conjunction with the planned utilization of Fund resources will satisfy Kenya's balance of payments financing needs for 1983. In the event that the expected amount of additional resources does not materialize, the Government of Kenya is prepared to take additional measures to offset any resulting shortfall.

10. In 1981 a set of import schedules aimed at rationalizing and liberalizing import procedures were put into effect. A further liberalization was carried out in June 1982 with the transfer of 20 per cent of items (317 items) from the controlled schedules to the liberalized schedule. The severe balance of payments pressures which emerged in the second half of 1982 did not permit the continued utilization of the schedules, which in fact reflected a too rapid pace of liberalization, given the foreign exchange availability. The Government of Kenya attaches great importance to the establishment of rationalized and nondiscriminatory import procedures and in conjunction with the exchange rate and tariff measures detailed above, plans to reduce the present administrative discretion and to further remove quantitative restrictions on imports as the balance of payments prospects permit. In this regard the Government of Kenya intends to review import procedures with the IBRD, as required in the current Structural Adjustment Loan. The Government intends to reach understandings with the Fund on import policy prior to September 1, 1983.

11. The revised budgetary proposals for 1982/83 aim at carrying forward the adjustment efforts achieved in 1981/82. The overall budgetary deficit is expected to be further reduced to 4.7 per cent of GDP from 6.5 per cent in the previous year. In order to achieve these objectives the Government of Kenya raised excise duties on cigarettes, sales taxes on beer and petroleum products, and increased all import duties on December 3, 1982. These measures are estimated to yield K Sh 400 million in the remainder of the fiscal year and to partly offset the loss of revenue exhibited so far. Consequently revenues are now estimated at K Sh 17,970 million for the fiscal year. Cuts in expenditure from the original budget have also been put in place. Specific items have been identified in the recurrent budget to generate savings of K Sh 230 million while certain projects and programs in the development budget have been cut, with an expected savings of K Sh 545 million. As a result total expenditure is expected to be limited to K Sh 23,200 million, after taking into account the exchange rate action, representing a reduction of 2 per cent in real expenditure. These estimates take into account K Sh 380 million for the National Cereals and Produce Board (NCPB) to stockpile and export maize and beans. Specific allocations have also been made for the Cereals and Sugar Finance Corporation (CSFC). Given the expected foreign financing, excluding the second tranche of the SAL loan ($50 million), but including the additional assistance recently granted, domestic financing is projected to be only K Sh 1,810 million, of which K Sh 1,025 million will come from the banking

system. This represents the equivalent of 5.5 per cent of the stock of money and quasi-money at the start of the fiscal year compared to 14.6 per cent in the previous fiscal year. Accordingly, the Government of Kenya intends to limit the overall deficit to K Sh 3,175 million through March 31, 1983 and K Sh 3,660 million through June 30, 1983. Moreover, the Government will strengthen its monitoring procedures to ascertain that the deficit is contained within these targeted levels. The Government will take additional measures if needed to keep the overall deficit to the agreed targets. During 1983/84 the Government of Kenya intends to take action to further reduce the overall deficit to about 4-4.5 per cent of GDP. The Government will reach understandings with the Fund prior to September 1, 1983 on the budgetary policies to be put into place for FY 1983/84. The report of the Working Party on Government Expenditures has been approved by Parliament. The Government of Kenya is committed to implement the recommendations of this report as quickly as possible. In particular, the cabinet will review the State Corporation Bill recommended in that report before June 1983. Other recommendations which can be implemented quickly, including some relating to budgetary accounting purchases and personnel recruitment will be included in the 1983/84 budgetary proposals. While aware of the weakness of the export compensation schemes, the Government has felt it necessary to reinstate it after it was suspended at the beginning of the current fiscal year given the closure of some export-oriented industries. However, the Government intends to expedite the study of alternative methods for export promotion and review the continuation of the export compensation scheme in the context of the flexible exchange rate system, which the Government intends to introduce. The Government will also reinforce its forward budgetary procedures.

12. The Government intends to continue its policy of wage restraint, which only compensates wage earners in part for increases in the cost of living.

13. As a result of the budgetary targets described above, the banking system will be able to better finance private sector activity. In 1982/83 private sector credit will be allowed to grow by the equivalent of 11.6 per cent of the stock of money and quasi-money at the start of the year, compared to 12.2 per cent in the previous fiscal year. Taking into account the planned government borrowing, these targets are consistent with a net domestic credit expansion similarly measured of 17.1 per cent over the fiscal year compared to 26.7 per cent in 1981/82 and an estimated growth of nominal income of 17 per cent. Accordingly, net domestic credit of the banking system which was K Sh 24,441 million on September 30, 1982 will not be allowed to exceed K Sh 25,558 million on March 30, 1983 and K Sh 24,794 million on June 30, 1983. Net bank credit to the Government, net of the deposits of the Cereals and Sugar Finance Corporation (CSFC) with the Treasury and including any further use of Eurocurrency borrowing after June 30, 1982, which was K Sh 8,695 million on September 30, 1982 will not be allowed to exceed K Sh 8,198 million on March 31, 1983 and K Sh 7,032 million on June 30, 1983. The ceilings on net domestic credit and net credit to government for March 31, 1983 will be reduced by

the amount of exceptional financing received prior to that date. Although between June 1980 and September 1982 interest rates have been increased by over 5 percentage points, the high rate of domestic inflation in 1982 has meant that deposit rates and the maximum lending rates have continued to be negative in real terms, with a negative impact on financial savings and the allocation of credit resources. Consequently, on December 10, 1982 the Central Bank of Kenya announced an increase in the minimum savings rate of 2.5 percentage points. This will have an upward effect on other rates, specially time deposit rates which will go up by no less than 3 percentage points. Therefore, given the present estimates for inflation, time deposit rates are now positive in real terms. The Government intends to keep int erest rates under continuous review to ensure that time deposit rates remain positive in real terms.

14. In 1982 Kenya's debt service (including IMF) is estimated at 22 per cent, a level requiring increased caution. Consequently the Government intends to limit the contracting of public and publicly guaranteed external borrowing on commercial terms in the maturity range of 1-12 years to US$150 million and in the maturity range of 1-5 years to US$100 million in the 18 months ending June, 1984. Moreover, the Government does not intend to increase its recourse to short term borrowing above the annual inflows utilized in previous years.

15. Also, for the duration of the program period, the Government of Kenya does not intend to introduce any new multiple currency practice, impose new or intensify existing restrictions on payments and transfers for current international transactions, conclude bilateral payments agreements which are inconsistent with the Fund's Article VIII, or introduce new or intensify existing restrictions on imports for balance of payments reasons.

16. In order to adequately monitor the progress in implementing the program, the Government of Kenya intends to reach understandings with the Fund prior to September 1, 1983 and again prior to January 15, 1984 on the fiscal, monetary, import and exchange and interest rate policies in the light of the objectives stated in this letter. Moreover, prior to the former date the credit ceilings applicable for September 30, 1983 and December 30, 1983 will be agreed, while the ceilings for March 31, 1984 and June 30, 1984 will be agreed at the latter review date.

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

Yours sincerely,

/s/

P. Ndegwa
Governor of the Central
Bank of Kenya

/s/

Arthur K. Magugu
Minister of Finance