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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/50

10:00 a.m., March 21, 1983

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
	C. Taylor
	H. G. Schneider
	A. Le Lorier
	C. A. Salinas, Temporary
	C. Dallara
	M. A. Janjua, Temporary
A. H. Habib	Jaafar A.
T. Hirao	T. Yamashita
	G. W. K. Pickering, Temporary
	J. R. N. Almeida, Temporary
	W. Moerke, Temporary
G. Lovato	C. P. Caranicas
R. N. Malhotra	A. S. Jayawardena
	S. El-Khouri, Temporary
J. J. Polak	
	K. G. Morrell
G. Salehkhou	O. Kabbaj
F. Sangare	E. I. M. Mtei
	E. Portas, Temporary
	A. Lindø
Zhang Z.	

J. W. Lang, Jr., Acting Secretary
R. S. Franklin, Assistant

Also present

African Department: R. J. Bhatia, Deputy Director; L. M. Goreux, Deputy Director; O. B. Makalou, Deputy Director; R. O. Carstens, C. N. Egwim, A. G. A. Faria, A. Jbili, J. M. Jimenez, G. M. P. Namakando, M. Sidibe, A. C. Woodward. Asian Department: D. A. Scott. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; S. Mookerjee, Deputy Director; D. K. Palmer, Deputy Director; S. Kanesa-Thasan, D. Lipton. Fiscal Affairs Department: H. R. De Zoysa, L. K. Doe. Legal Department: Ph. Lachman. Research Department: K.-Y. Chu. Western Hemisphere Department: S. T. Beza, Associate Director. Finance and Development: J. M. Landell-Mills. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: A. A. Agah, E. A. Ajayi, H.-S. Lee, I. R. Panday. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. Bulloch, T. A. Connors, R. J. J. Costa, G. Ercel, C. Flamant, I. Fridriksson, G. Gomel, A. Halevi, M. Hull, Jiang H., J. M. Jones, P. Leeahtam, V. K. S. Nair, Y. Okubo, J. K. Orleans-Lindsay, J. G. Pedersen, J. Reddy, H. Suzuki, M. Toro, J. C. Williams.

1. KENYA - 1982 ARTICLE IV CONSULTATION, AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1982 Article IV consultation with Kenya, together with a proposed decision concluding the 1982 Article XIV consultation (SM/83/24, 2/2/83; and Sup. 1, 3/18/83), and a request by Kenya for an 18-month stand-by arrangement in an amount equivalent to SDR 175.95 million (EBS/83/41, 2/23/83; and Cor. 1, 3/18/83). They also had before them a report on recent economic developments in Kenya (SM/83/26, 2/10/83).

Mr. Sangare made the following statement:

I should like, on behalf of the Kenyan authorities and myself, to thank the staff for the papers that have been prepared on Kenya in connection with the 1982 Article IV consultation and the request for a stand-by arrangement.

The task of adjustment in Kenya has not been easy, considering the adverse impact of the world recession on domestic economic activity and the difficulty the authorities have experienced in reducing pressure on the budget. Nevertheless, it is to the credit of the authorities that they have remained generally committed to the implementation of their stabilization program which began in 1979 and received support from the Fund under various stand-by arrangements.

Although not all the specific targets have been achieved, the trend has been progressively in line with the program's objectives, and developments during the past year indicate that the perseverance of the authorities has begun to show positive results. First, it is to be noted that the ratio of the overall budgetary deficit to GDP in fiscal year 1981/82 was reduced by 3 percentage points from the level in the previous year, which was in line with the target set in the revised budget, and that this development occurred despite the fact that the authorities were unable to obtain the level of foreign financing projected for the program period. Second, there was significant improvement in the current account deficit of the balance of payments, leading to a reduction in the ratio of the deficit to GDP to 7.1 per cent in 1982 from 10.2 per cent in 1981. The third area where material progress was achieved related to inflation, with the rate of increase in the composite consumer price index declining from 20 per cent in 1981 to 14 per cent in 1982, and it should be mentioned that most of the increase appeared to result not so much from excess liquidity in the economy as from the lifting of price controls on a large number of items, the devaluation of the Kenya shilling, and the increase in excise taxes.

The agricultural sector provided the major impetus to the economy in 1982, with an increase in value added of about 7-8 per cent. This situation reflected mainly the response of farmers to increased producer prices and the impact of good weather conditions after several years of drought. However, the rate of growth of real GDP, at 4.5 per cent, remained low compared with the average of 8 per cent for the period 1977-78. The authorities are concerned about this slowdown in economic activity given the rapid growth in population, estimated at 3.8 per cent a year.

For the immediate future, the Kenyan authorities recognize the need to consolidate the gains recorded thus far and have therefore adopted a program for the ensuing 18 months for which they are requesting a stand-by arrangement in the amount of SDR 175.95 million. The objective of the program is to continue the balance of payments adjustment and lay the foundation for raising the growth rate to more adequate levels over the medium term.

The Government is in the process of reviewing the current development plan, which has been in effect since 1979 and expires this year, to see what lessons can be learned that will be helpful in formulating a strategy for economic growth in the next plan period. In the meantime, priority is being given to the agricultural sector with the aim of maintaining self-sufficiency in food production and increasing the export of agricultural products. In this connection, the authorities increased further the producer prices of the main crops in February this year: maize by 22 per cent, wheat by 15 per cent, rice by 18 per cent, and cotton by 13 per cent. Producer prices of milk and livestock were also increased by 12 per cent and 15 per cent, respectively. They also intend to increase public sector outlays related to the development of the agricultural sector. In setting credit guidelines, the needs of the agricultural sector will also receive appropriate consideration.

The strategy for economic growth also involves the strengthening of the industrial sector, particularly those concerns that produce export commodities for which Kenya has a comparative advantage. The authorities expect the efficiency and competitiveness of this sector to be improved by the flexible exchange rate policy that has been adopted and by the move toward a more liberal import system. A study on export incentives is under way that should assist the authorities in formulating detailed proposals in the near future.

The aim of fiscal policy is to intensify the adjustment effort by means of a further reduction in the overall budgetary deficit. No general wage increase is envisaged during the period, and loans to statutory organizations provided by the Ministry of Finance have been reduced. Meanwhile, new revenue measures were taken in December 1982 to supplement the initiatives announced earlier in the year. These include a 10 per cent increase in import duties and higher sales taxes on cigarettes, beer, and petroleum products. These measures were to bring in K Sh 500 million and revenues were forecast to reach K Sh 18 billion in fiscal year 1982/83, up 15 per cent from the previous fiscal year. However, in February this year it became clear to the Government that revenues were falling far short of the targets established last December. At the end of January actual revenues were estimated at K Sh 1,194 million below the projections, while estimates for the end of June revealed a shortfall of K Sh 2,484 million. The situation is due to the low level of economic activity, which has affected all revenue sources, and the low volume of imports in the fourth quarter of 1982. In response to the emerging problem, the Kenyan Cabinet met on March 4 to approve measures aimed at curbing expenditures sufficiently to keep the budgetary deficit at a level equivalent to 4.7 per cent of GDP as agreed with the Fund staff in November 1982. The decision of the Cabinet provides that there will be no supplementary appropriations on either the recurrent or development accounts and that recurrent expenditure will be limited to essential services only. Foreign travel has been reduced to the barest minimum, use of government vehicles restricted, and a general freeze on employment in the civil service imposed. The austerity measures also provide for saving in the development budget. Development expenditures are being held to an average of K Sh 162 million a month, and only those projects promising early productivity are to be implemented. The improvement in the budget will limit government borrowing from the banking system and the Cereals and Sugar Finance Corporation (CSFC) to K Sh 1.0 billion, compared with K Sh 1.7 billion in 1981/82.

Measures aimed at improving the monitoring and control of the financial operations of public enterprises are continuing as a part of the Government's strategy to strengthen its financial position and rationalize the allocation of its resources. Following the recent establishment of the Investment Division at the Ministry of Finance, guidelines have been issued to all public enterprises requiring them to fill out a standardized application for the release of government funds. The Investment Division is also in the process of making preliminary forecasts of the investment needs of about 30 public enterprises with a view to incorporating some of these projections into future budgets as well as the next development plan.

Monetary policy in 1983 will remain cautious in keeping with the need to alleviate the pressure on the balance of payments and further reduce the rate of inflation. The increase in total domestic credit is therefore targeted to be less than the amount estimated for 1982 and the rate of expansion of broad money will be limited 13 per cent, less than the expected growth of nominal GDP. In an effort to limit credit expansion to the private sector and raise the level of nonbank financing of the budget, the minimum liquidity requirement was raised to 20 per cent for commercial banks and 24 per cent for nonbank financial institutions. The savings rate was raised last December by 2.5 percentage points, following three previous increases totaling over 5 percentage points between June 1980 and September 1981. Consequently, the minimum savings rate now stands at 12.5 per cent, while time deposit rates range between 13.75 per cent and 15.50 per cent. Lending rates have also been raised to 16 per cent. The authorities intend to continue with the flexible policy they have adopted in setting interest rates with the aim of maintaining them at positive levels in real terms.

A further improvement is expected in the current account of the balance of payments in 1983, reflecting a moderate increase in the SDR value of exports and an improvement in the services account due to increased earnings from transportation and tourism. The deficit is expected to decline to about 6 per cent of GDP. Official capital inflows are expected to increase sharply from SDR 129 million in 1982 to SDR 161 million. In all, the overall balance of payments deficit is projected to fall to SDR 42 million in 1983 from SDR 146 million in the previous year.

The Kenya shilling was devalued by 13 per cent in SDR terms in December 1982. The adoption of a flexible exchange system has meant a further depreciation of the Kenya shilling by 2 per cent in January 1983. The authorities considered these moves to be necessary in order to encourage export activities, while containing the growth in imports. The Government intends to keep the exchange rate under continuous review and will make adjustments as may be warranted, taking into account movements in relative prices in Kenya vis-à-vis its main trading partners, the country's balance of payments position, and the movement in key international currencies. The increase in prices associated with the exchange rate action, particularly with respect to energy products, will be fully borne by consumers and producers, but the authorities do not foresee any dramatic impact on inflation, which is projected at 13 per cent in 1983/84.

New arrangements and procedures were introduced in January aimed at quickening the processing of import license applications. All applications received at the Central Bank by December 1982 have now been processed and dispatched to the applicants. Dividends outstanding since 1980 and 50 per cent of those due in 1981 have been repatriated. Other payments for loans, interest, royalties, management fees, and film rentals have also been remitted. The advance import deposit scheme put into effect in 1979 was abolished on January 31, 1983.

Kenya's debt service burden has grown rapidly in the past two years, with the debt service ratio increasing from 12 per cent in 1980 to about 22 per cent in 1982. The authorities are monitoring the situation closely to ensure that the debt burden does not rise beyond a manageable level. Accordingly, the Government intends to limit the contracting of public and public-guaranteed external borrowing on commercial terms in the maturity range of 1-12 years to $150 million, and in the maturity range of 1-5 years to $100 million during the course of the program period.

In conclusion, I would like to state that the Kenyan authorities believe that the policies they have adopted are adequate to meet the objectives of the program. However, they are prepared to take additional measures should it become necessary.

Extending his remarks, Mr. Sangare expressed the hope that, in the light of changing circumstances and a continuing adverse environment, the staff would adopt a flexible approach toward the review under the proposed stand-by arrangement to ensure that the authorities were given full assistance in their efforts to keep the program on track.

Mr. Taylor recalled that his chair had on occasion argued that, in some cases, it was preferable to consider an Article IV consultation before a request for Fund resources was presented to the Board. In the Kenyan case, however, it seemed reasonable to combine the two discussions. Kenya's problems and the nature of the required adjustment were by no means new to Executive Directors; and it was likely that those problems would stretch beyond the immediate period ahead, so that it was helpful to assess them within the long-term perspective provided by the Article IV staff report. As indicated in SM/83/24, Supplement 1, the amount of time that it had taken to reach agreement with the Kenyan authorities on a stand-by program had added to the problems of the economy and had made it necessary for the authorities to take additional measures. It was understandable that both the authorities and the Fund should be cautious in moving to a new program after the failure of three previous programs. However, he wondered whether the process might not have been somewhat faster, especially since the economic objectives under the 1982 program had substantially been achieved. Indeed, if the deviations under that program had been recognized sooner and corrective action had been taken earlier, a waiver might have been justified. While it might be that the authorities should have acted sooner, they could not be blamed for having taken time to assess the consequences of the attempted coup in 1982. It might also be said that the Fund's insistence on securing strong commitments to attain a certain amount of external financing for Kenya was a factor that had tended to prolong the process.

It should be possible to deal with an external financing gap foreseen in connection with a prospective program, either through additional realistically available financing, further adjustment, or some combination of the two, Mr. Taylor continued. That did not necessarily mean that all financing had to be actually assembled before the program was put before the Board. Indeed, in cases in which rapid agreement on a program was necessary to maintain confidence, it might be preferable for the Executive

Board to make its approval of programs contingent on a particular subsequent outcome for balance of payments assistance, or to attach understandings at the time of approval about further adjustment efforts, or to make subsequent drawings conditional on a very early review of the program. Such issues might be looked at in greater detail in the context of the forthcoming discussion on the Fund's relationship with official creditors and commercial banks; however, it was clear that, in current circumstances, it was essential to replace interrupted programs or put them back on track quickly to prevent a deterioration of confidence among external creditors and donors.

He was in broad agreement with the staff appraisals in the two papers and could fully support Kenya's request for a stand-by arrangement as well as the decision to approve the exchange restrictions subject to Article VIII until the end of the year, Mr. Taylor said. He also welcomed the proposed phasing of disbursements under the stand-by arrangement, which took account of the pattern of Kenya's cash needs over the period of the arrangement.

The staff's assessment in the stand-by paper struck a reasonable balance between the need for additional measures and the admitted constraints on those measures that were beyond Kenya's control, Mr. Taylor considered. Nevertheless, he would have welcomed a fuller assessment of the prospects for the real economy and the directions in which the structural adjustment effort needed to progress. In particular, he would have appreciated the staff's views on the orientation of agricultural and industrial policies, bearing in mind the weakness of traditional markets in neighboring countries. Perhaps that matter could be taken up in the context of the first review of the program. Sectoral policies were likely to play an important role in boosting productivity and restoring external competitiveness in the economy; and, at the moment, it was difficult to see where the impetus for structural change would come from.

The fiscal policy stance had been commendably firm in 1982, given the difficult circumstances, Mr. Taylor observed. That posture would need to be continued and strengthened, however, if the overall strategy of securing a sustainable balance of payments position by 1985 was to be achieved and if sufficient resources were to be made available to the private sector to generate adequate output growth. He welcomed the decisive measures that had been taken in recent months--and strengthened in the past few days--to re-establish the thrust of the adjustment policies and to tackle the disequilibria built up in 1982. It was encouraging to note that those measures had been directed at both increasing revenue and curbing expenditure. Further progress on the expenditure side would depend to a great extent on success in restraining public sector wages, and he would welcome some further elaboration by Mr. Sangare or the staff on the current status of wage negotiations in Kenya.

Also to be welcomed was the determination of the authorities to improve efficiency of the parastatal sector and to reduce somewhat the role of the public sector in the economy, Mr. Taylor commented; control of expenditure would be an important element in their effort. He wondered whether the authorities had made any progress with respect to the proposed State Corporation Act, which would provide for the creation of a public enterprise monitoring unit.

The cautious credit stance proposed under the program was appropriate, Mr. Taylor continued, as was the decision to await the review before setting the post-June credit ceilings. It might have been helpful if the staff had displayed indicative figures for credit provided to the Cereals and Sugar Finance Corporation; it was important to monitor that volatile component of credit. The projected channeling of bank credit to the private sector and the interest rate increases that had been introduced at the end of 1982 were welcome features of the program. Having established generally positive real interest rates, the authorities should review them on a regular basis.

In the area of external policy, the authorities had taken a courageous step with the December exchange rate adjustment and its speedy pass-through to domestic prices, and he commended their intention to follow a more flexible exchange rate policy in future, Mr. Taylor said. While the exchange rate adjustment had restored the shilling to its 1981 effective level, it might nonetheless remain overvalued, as seemed to be indicated by the pressure to restore the export compensation scheme and the slower pace of import liberalization. He would appreciate elaboration by the staff on its indication that the present exchange rate provided an adequate incentive for export recovery.

He was pleased that some progress had been made toward import liberalization, Mr. Taylor stated. In particular, the abolition of the import deposit scheme in January and the current review of the import system--with Fund/World Bank technical assistance--were welcome. However, a clearer delineation of future efforts to liberalize imports was overdue. The inclusion in the program of performance criteria relating to public and publicly-guaranteed external borrowing on commercial terms was appropriate, and he was happy to note that the authorities intended to hold the debt service ratio to a manageable level. In that context, he would welcome further information on Kenya's short-term debt position, which he gathered had not been covered in Table 6 of SM/83/24. Finally, he had been disappointed that the staff report for the 1982 Article IV consultation had not detailed reasons for the decline in private capital inflows or prospects for reversing that trend. He wondered whether the authorities saw any scope for more specific policies to stimulate private capital inflows; that matter should be looked at in detail during the review.

Mr. Schneider observed that the Executive Board had approved three stand-by arrangements for Kenya since August 1979. Despite some progress in adjusting the economy, especially in 1981-82, the Fund programs--which aimed at a better allocation of resources, a strengthening of the budgetary situation, and a redressing of the balance of payments position--had not been entirely successful, reflecting in part the difficult economic situation through which Kenya was still passing.

The problems confronting the Kenyan authorities were mainly structural in nature, and most of the measures envisaged under the new program could be expected to have an impact primarily in the medium term, Mr. Schneider continued. The authorities' request for a stand-by arrangement for a period of 18 months seemed to be adequate in its monetary, budgetary, and balance of payments aspects, and deserved the Fund's financial support. The authorities had taken some additional measures--as outlined in SM/83/24, Supplement 1--thus demonstrating their determination to keep the program on track. Noting that the World Bank had extended two structural adjustment loans to Kenya, the second aiming at macroeconomic structural elements, he believed that close coordination between World Bank and Fund programs would help the Government to achieve its medium-term objectives. In any event, close contact between the authorities and the Fund at all stages of the implementation of the proposed program would improve the chances for success.

The expected level of inflation in 1983--estimated at 13 per cent--should permit better macroeconomic targeting of growth, budget, and monetary aggregates, Mr. Schneider considered. The projected real growth rate of 3 per cent for 1983 showed the authorities' intention to restrain domestic demand. Given the incentives adopted for the export-oriented agricultural and agro-industrial sectors, together with the willingness of the authorities to maintain a flexible exchange rate policy, it should be possible to realize the desired resurgence of export production in Kenya. A prompt correction of emerging problems and a stimulation of exports would be essential to the success of the proposed program. In that regard, it was important to make a special effort to expand nontraditional exports, because the policies he had mentioned would likely have a positive effect on the current account situation and on resource allocation only in the medium term.

One major goal of the program was to reduce the overall budget deficit to a sustainable level, which would require additional efforts on both the revenue and the expenditure sides, Mr. Schneider considered. He had been surprised to note that, despite measures taken to improve revenues in December 1982--which, together with foreign grants should produce a 17.5 per cent increase in revenues for 1982/83--both expenditure and total revenues expressed as a percentage of GNP were expected to fall to their lowest level in five years. The implication seemed to be that the policy measures aimed at reducing the budget deficit had been concentrated on restraining expenditures, especially development expenditures, which might have an adverse effect on growth in Kenya.

In the monetary field, recent policy actions by the authorities had led to interest rates on lending and time deposits that were more or less positive in real terms, and should help to improve resource allocation in Kenya, Mr. Schneider observed. At the same time, he was concerned that treasury bill rates, tax certificate rates, and locally registered government stock interest rates were far lower than time deposits and lending rates. He was also somewhat troubled by the rapid proliferation of nonbank financial intermediaries in the Kenyan economy and by certain aspects of their operations that tended to affect the efficiency of monetary control, the security of depositors, and the interest rate policy. Measures had been taken in 1981 and 1982 to control the activities of those depositories, which had a share in total credit to the private sector of more than 30 per cent in September 1982. However, further steps were needed to regulate more closely the allocation of credit and to safeguard the security of deposits. It did not seem to be appropriate to permit the depositories--officially or unofficially--to pay higher rates for deposits than commercial banks were allowed to pay. To control some interest rates for lending and deposits while not controlling others could easily have an adverse effect on resource allocation and monetary control. Finally, like others, he could support the proposed decisions.

Mr. Moerke observed that, following less than successful adjustment efforts in 1979 and 1980, the Kenyan authorities had launched a new stabilization program in late 1981 that had represented a more determined and comprehensive attempt to reduce the financial disequilibria in the economy. The authorities' commendable perseverance and resolution in taking significant policy actions under that program had produced remarkable progress, particularly in substantially reducing the overall budget deficit and the external current account deficit. Two performance criteria for end-June 1982 had been breached, mainly because of the insufficient response of domestic policies to the shortfall in foreign financing; in the circumstances, a continuation of the program through the granting of a waiver and modification might have been expected, although such an approach had become unrealistic following the political disturbances in August 1982.

The difficult current economic and financial situation required further strong adjustment efforts if the goal of a sustainable balance of payments position by 1985 was to be met, Mr. Moerke noted. The policy measures under the proposed stand-by arrangement showed clearly that the authorities were cognizant of the difficult situation and were strongly determined to strengthen their adjustment efforts. The recent austerity measures referred to by Mr. Sangare and by the staff in SM/83/24, Supplement 1 were encouraging in that regard.

A successful completion of the 1983/84 financial program should go a long way toward helping the authorities to meet Kenya's medium-term objectives, Mr. Moerke continued. The bulk of the policy measures seen as necessary to meet the targets for fiscal year 1982/83 had already been implemented and, considering the recent strengthening of adjustment measures, he was confident that the targets would be met; nonetheless, further adjustment in the overall budget deficit in the following fiscal year would be required. A more detailed assessment of the situation would be possible once the policies embodied in the 1983/84 budget were discussed during the important first review of the proposed stand-by arrangement. In general, the dangers entailed in the execution of the Fund program appeared to be large, and the authorities' room for maneuver would be limited, especially during 1983/84 when the exceptional financing ran out.

He fully endorsed the remarks by Mr. Schneider and Mr. Taylor on monetary policy in Kenya, Mr. Moerke said, and he could therefore limit his comments to two questions. First, he inquired precisely how the Central Bank planned to improve the monitoring of commercial bank activities, a move that the staff had noted was important. Second, he wondered whether there was merit in eliminating the margin of deposit rates between commercial banks and nonbanks, either by allowing commercial banks more flexible interest rate policy or by suspending nonbanks' permission to offer higher rates than the commercial banks. Deposits in nonbank financial intermediaries had continued to grow rapidly, mainly because those institutions were still allowed to offer higher rates for deposits than the commercial banks. While the growth of intermediation as a development objective was welcome, they should not operate outside the control of the monetary authorities.

He noted from paragraph 14 of the letter of intent that "the Government does not intend to increase its recourse to short-term borrowing above the annual inflows utilized in previous years," Mr. Moerke said. According to Table 5 on page 11 of SM/83/24, total short-term borrowing had ranged from approximately SDR 140 million in 1975 to SDR 10 million in 1982, with a projected level of only SDR 33 million for 1983. In the circumstances, more detailed information on the amount of official short-term borrowing over the previous few years might be of interest.

Kenya had experienced a bountiful harvest in 1982, exceeding its own consumption needs, Mr. Moerke observed. The only disadvantage of such an event was that part of the harvest needed to be exported at a loss and therefore required budgetary support. According to the staff papers, the situation was not expected to be a recurring one, although he had not seen any explanation by the staff of why that was so. An enlargement of storage capacity or the expected more flexible exchange rate policy might provide some explanation, but he would welcome further comment from the staff or Mr. Sangare. Finally, on exchange rate policies and import liberalization, he could fully support the remarks of Mr. Taylor.

Mr. Tshishimbi noted that the Kenyan economy had gone through a difficult period in recent years, and the authorities had, since 1979, taken a number of courageous measures to establish sustainable economic and financial stability in both the domestic and external sectors. But the adjustment measures, which had been carried out with Fund support under a series of stand-by arrangements, had not been implemented without problems. The harsh international environment had adversely affected Kenya's terms of trade; unfavorable weather conditions had led to shortfalls in agriculture, necessitating the importation of foodstuffs; and import substitution policies pursued in the past had led to a deterioration in the competitiveness of the Kenyan export sector. The industrial sector, which had relied on import protection, had also eventually contracted, and the construction and trade sectors had shown significant reductions in their rate of expansion. As a result, the real rate of growth of GDP had fallen from an average of 8 per cent during 1977-78 to about 4 per cent in 1979-80. Moreover, it had been difficult for the authorities to sustain the measures they had taken to improve the deteriorating balance of payments position, and the current account deficit--which had been reduced from 12 per cent in 1976 to about 8 per cent in 1979--had deteriorated to 12 per cent in 1980.

Some improvement in the current account deficit had nonetheless been achieved in 1981 as a result of the implementation of an appropriate financial program, Mr. Tshishimbi continued. The most significant of the measures taken had been the devaluation of the currency on two successive occasions in 1981, a move that had boosted nontraditional exports. By mid-1982, however, the Kenya shilling had appreciated in real terms and, in order to lessen the reliance on quantitative import crops and give a further boost to the export sector, the authorities had again devalued the Kenya shilling in December 1982 and in early 1983. The authorities were to be commended for those actions, and he welcomed their intention to implement a flexible exchange rate policy in future by keeping the rate under constant review and making adjustments when necessary.

When the Executive Board had considered Kenya's request for a stand-by arrangement in 1982, there had been some debate about the phasing of purchases under the arrangement, Mr. Tshishimbi recalled. At that time, his chair had supported the proposed front-loading, not only because the authorities had already taken measures before coming to the Fund for assistance but also because a major portion of the resources to be made available had been necessary to support the import liberalization scheme begun in June 1982. For similar reasons--the authorities had taken additional measures, and the country had an urgent need for Fund resources--his chair wished to support the front-loading in the proposed stand-by arrangement for 1983.

One of the most positive features of the adjustment effort was the ability of the authorities to deal with the control of public expenditure, Mr. Tshishimbi remarked. They had been able to reduce the ratio of the overall budget deficit to GDP by 3 percentage points from the level in 1980/81, largely through a reduction in public expenditure. That development had been consistent with the targets in the revised budget and had taken place despite a shortfall in the level of foreign financing during the year. The authorities' intention to strengthen their adjustment efforts in the fiscal area by limiting the rates of increase in total expenditure to 8 per cent and by reducing the ratio of the overall budget deficit from 6.5 per cent in 1981/82 to about 4.7 per cent in 1982/83 seemed appropriate. If the authorities were successful in their efforts and continued to pursue a cautious monetary policy, pressures on the balance of payments should be eased and gains achieved in controlling the rate of inflation could be consolidated.

The authorities were placing greater emphasis on the agricultural sector in 1983, with a view to achieving self-sufficiency in food production, Mr. Tshishimbi observed. It was thus expected that they would maintain a pricing policy designed to encourage producers of agricultural products. Finally, there was no doubt that the Kenyan authorities considered the proposed program another step toward a major medium-term adjustment effort and, for that reason, he could support the proposed decisions.

Mr. Polak said that, despite the clarification provided by frequent Board discussions on Kenya, it remained difficult to understand the economic problems besetting the country, and the staff papers had not been as helpful in that regard as they might have been. There were a number of obvious positive elements in Kenya's economic situation and policy: entrepreneurs--both Kenyan and expatriate--were active and should benefit from the measures recently taken by the authorities in the area of prices and exchange rates to improve the external position of the country; the external debt situation was not very serious; and Kenya had been careful to avoid incurring arrears. Moreover, there appeared to be a good administrative infrastructure in Kenya, which had made itself felt in severe cuts in expenditure, particularly development expenditure, and in imports.

In spite of the elements he had mentioned, however, performance in recent years had been poor, Mr. Polak continued. Growth had been slow, and a number of difficulties had arisen with respect to successive stand-by arrangements with the Fund. The balance of payments in 1982 had improved considerably, although not quite up to original expectations, and much of the improvement had to be attributed to the very good harvest. In that respect, he had been surprised at the indication by the staff that the "problems" caused by an exportable surplus of maize would not recur. Another part of the improvement in the balance of payments had been due to the reduction in imports through a retightening of import restrictions, a disappointing reversal of the liberalization efforts begun in the first half of 1982.

On the export side, the export compensation scheme had been reintroduced until a better system of export promotion could be worked out with the World Bank and the Fund, Mr. Polak noted. The staff had indicated that significant progress had been made in implementing the elements of the program in 1982; he himself was not certain that much progress had been made, particularly given the disappointing information on the 1982/83 budget provided in SM/83/24, Supplement 1.

The staff papers offered little detail on structural problems in Kenya or on the need to strengthen the agricultural sector over the medium term and the nontraditional economy over the longer term, Mr. Polak said. Moreover, very little information had been provided on why the structural adjustment loan from the World Bank was being delayed and why the export incentive package was not yet in place.

Supplement 1 to SM/83/24 showed that domestic savings had declined from 27 per cent of GDP in 1977 to 16 per cent of GDP in 1981 and that fiscal developments had fallen off track during the course of the 1982/83 fiscal year, Mr. Polak observed. Fortunately, the monitoring mechanism had picked up the problem and corrective measures had been introduced, but it was sad to note that the program had gone off track in the first place. On a related matter, the staff seemed to be willing to accept monitoring as a substitute for policy in a number of areas, an approach that he found less than satisfactory.

Generally speaking, Mr. Polak concluded, the staff papers on the Kenyan economy could stand some improvement in both content and presentation. Still, they had shown enough positive elements in the Kenyan economy to justify a further stand-by arrangement, and he could therefore support Kenya's request.

Miss Le Lorier stated that, like others, she could support the proposal for a new stand-by arrangement for Kenya, which had a long history of cooperation with the Fund. Unfortunately, since 1979, expectations of progress under Kenyan programs with the Fund had not been fulfilled, and the arrangements had had to be abandoned before all the contemplated purchases had been made. The outcome of the most recent program approved in January 1982 deserved particular attention, however, because it seemed to prove a general point that she had made in the Executive Board in the past, namely, that the nonobservance of performance criteria was not necessarily a signal that little or no adjustment was taking place. Conversely, the observance of performance criteria was not always a sufficient condition for successful adjustment as measured by the meeting of the broader objectives of restoring and sustaining noninflationary growth and external balance. That did not imply that the conditions set out in Fund programs were inappropriate or irrelevant; it was simply that quantitative performance criteria could perhaps not always encompass all aspects of the adjustment process, particularly its timing. Put another way, the performance criteria could not always be adjusted in time to take account of departures from initial assumptions concerning exogenous factors or factors beyond the control of the authorities.

In all Fund programs, an issue of timing was involved, Miss Le Lorier considered. The assumption seemed to be that the observation of performance criteria during a given period would translate at some point into the meeting of broader objectives, such as the attainment of a viable balance of payments position. However, the nonobservance of performance criteria did not always threaten the achievement of those broader objectives; rather, it simply put into question their timing.

The positive results achieved by Kenya during 1982 in the fiscal area and in controlling the current account deficit seemed to demonstrate that no systematic conclusions should be derived from the nonobservance of the performance criteria, Miss Le Lorier said. The waiver procedure was an acknowledgment of that fact, and there was no reason why the Fund should refrain from resorting to the waiver. If, in the Kenyan case, delays in addressing slippages in the fiscal area had not been linked to political disturbances in the country, a waiver of the credit ceiling for June 1982 would have been appropriate, particularly since the breaching of the ceiling had been attributable, to a great extent, to a larger than expected crop yield.

On a related matter, some thought should be given to the time lag associated with exchange rate action, Miss Le Lorier remarked. The Fund often assigned a key role to exchange rate changes in the adjustment process. They were expected to curtail demand for imports and to promote exports. In the case of Kenya and a number of other countries, the Fund was perhaps implicitly relying on too short a time lag between exchange rate changes and their effects on exports. After all, it was not uncommon in distressed countries that were supposedly export oriented to see a delay of more than a year between an exchange rate action and its measurable impact on exports. Indeed, it would not be surprising to see an even longer time lag in an economy like that of Kenya in which the development strategy had for long relied on import substitution. That was not to say that unwarranted departures from a particular exchange rate level should not be corrected and, in that regard, she had no difficulty supporting the exchange rate policy recommended by the staff. However, she was somewhat skeptical about the pace at which the recommended policy could be expected to produce positive effects on exports and on the share of the export-oriented sector of the economy. In that regard, she wondered whether the nontraditional export growth target was attainable.

The effects of exchange rate action on the containment of import demand had to be viewed somewhat differently, Miss Le Lorier considered. There was some question about how far exchange rate management should be relied upon to bring about a desired level of imports and whether that action needed to be supplemented temporarily by restrictions in the import system. Her own view was similar to that of the staff: the pace of liberalization of the import system should be related to the availability of foreign exchange, and a review clause relating to import liberalization was a far better instrument than performance criteria.

Turning more specifically to the proposed stand-by arrangement, Miss Le Lorier indicated that she shared the views expressed in the staff appraisal. The authorities were to be commended for their determination in implementing the various measures contained in SM/83/24, Supplement 1. She would be interested to hear more about the relationship between the proposed stand-by arrangement and the program associated with the World Bank's structural adjustment loan; in particular, she wondered how the recent changes in prices fitted with the conditionality of the structural adjustment loan. Regarding financial aspects of the proposed stand-by arrangement, she found the proposal for a modest front-loading of purchases to be fully appropriate, especially given the importance of the adjustment efforts made by the authorities and the prior action they had taken.

Mr. Lovato observed that the staff had indicated that the crucial targets of the proposed program were related to balance of payments adjustment in the medium term coupled with a stronger resumption of economic growth. The staff had also asserted that the main impetus for growth would stem from exports, mainly of agricultural products. It was thus imperative to determine whether the requirements for setting in motion an export-led growth process were in place in the policies being followed in Kenya. Important in that regard was an educated appraisal of the devaluation implemented in recent months and of the exchange rate policy envisaged by the authorities for the duration of the stand-by program. Information on those points was somewhat lacking in the staff report.

The nominal depreciation of the shilling in 1981 had been more than offset by the unfavorable differences between inflation in Kenya and in its main trading partners, a difference that had caused a real appreciation of the Kenya shilling during 1982, Mr. Lovato said. Some degree of competitiveness had been restored following a further correction in the exchange rate in December 1982; yet, projections for 1983 indicated that sizable inflation was likely to persist even though monetary and fiscal policies had been suitably designed to reduce the inflation rate. While he welcomed Kenya's declared intention to maintain its exchange rate unchanged in real effective terms, he considered that further adjustments might be warranted, given the program's reliance on a pickup in exports. Further incentives would probably be required for exporters to draw more resources into the export producing sector and into new industries, where some potential might exist for price-sensitive exports. An assessment by the staff of the scope for a medium-term supply response by potential exporters to relative price changes would be appreciated.

On a related matter, Mr. Lovato noted that import growth would be constrained in 1983 by increases in import duties, coupled with a lower exchange rate and limited domestic absorption. Less emphasis would thus be placed on the import licensing scheme currently in operation. He would appreciate some indication from the staff of the outlook for imports beyond the program period on the assumption of a continued appropriate relative price structure.

On the fiscal front, the targeted reduction in the overall budget deficit seemed both desirable and feasible, and he appreciated the measures already implemented by the authorities to enhance revenue collection and constrain public expenditure, Mr. Lovato remarked. In the longer run, however, it would be desirable to increase the ratio of income-related taxes to total tax revenue, since the weight given to indirect taxation relative to direct taxation at present appeared excessive. As for monetary policy, the program figures for total domestic credit and net bank credit to the public sector seemed consistent with the authorities' desire to restrain the domestic economy in light of the inflation target in the program. Finally, he could support the proposed decision regarding Kenya's request for a stand-by arrangement.

Mr. El-Khouri observed that, during fiscal year 1981/82, the Kenyan authorities had adopted adjustment measures to deal with rising imbalances in the economy. As a result, the current account deficit and the budget deficit had been reduced during the year. However, a lower than expected level of foreign financing had led to a nonobservance of the ceiling on net bank credit to the Government for end-June 1982. Moreover, the adjustment process had been interrupted during the second half of 1982 by political disturbances. As the authorities had since reaffirmed their willingness to proceed with adjustment, he could warmly support their request for a stand-by arrangement with the Fund.

The proposed program aimed at reducing the ratio of the budget deficit to GDP by about 2 percentage points during 1982/83, Mr. El-Khouri continued. To achieve that reduction, the authorities had adopted important revenue measures in December 1982 and were projecting a decline in expenditures in real terms, which would represent a continuation of the significant fiscal adjustment that had been initiated in 1981/82. The authorities were to be commended for their actions in the fiscal area.

The efforts of the authorities to improve the monitoring of the public sector enterprises and to strengthen the information base regarding their financial operations were welcome, Mr. El-Khouri said. However, there seemed to be scope for greater corrective action. The staff had indicated that the report of the Working Party on Government Expenditure called for the closing of some enterprises and for the transfer of ownership of others to the private sector; the authorities should be encouraged to move rapidly to implement the recommendations of that report.

On the monetary side, Mr. El-Khouri stated that he had no difficulty approving the proposed ceilings for March and June 1983, and he could support the technical understandings regarding the definitions of those ceilings. The staff had mentioned that the end-September and end-December 1983 ceilings would be determined during the first review mission to be held before September 1, 1983; however, if the review mission was to visit Kenya near the September 1 deadline, the end-September ceilings would lose much of their usefulness, since the first two months of the third quarter of 1983 would have elapsed. Furthermore, the Executive Board would be faced by the need to approve end-September ceilings after the end of September. Hence, there seemed to be merit in moving the first review mission forward.

Turning to the external sector, Mr. El-Khouri observed that the Kenya shilling had been devalued by 15 per cent against the SDR between December 1982 and early January 1983. The authorities were committed to the pursuit of a flexible exchange rate policy throughout the program period, a commitment that should go a long way toward helping them to achieve the balance of payments targets of the program. A difficult issue for the authorities was the extent to which the import system could be liberalized, given the foreign exchange constraints. The program seemed to strike an appropriate balance in that regard by calling for gradual progress toward import liberalization, which would be reviewed by both the Fund and the World Bank.

On the matter of structural adjustment in Kenya, Mr. El-Khouri said that he remained unclear about the status of Kenya's relations with the World Bank. He would welcome information about how the World Bank staff viewed the pace of structural adjustment and whether it was felt that additional measures might be needed. His chair had indicated on several occasions in the past the desirability of close coordination between the Fund and the World Bank when an adjustment program was being implemented.

Mr. Dallara considered the case of Kenya to be a complex and difficult one in many respects; hence, while he supported the proposed decisions, he did so only with serious reservations. Admittedly, progress had been made in a number of areas, and the proposed program furnished the basis for continued progress. The authorities were to be commended for their success in reducing the fiscal deficit in 1981/82 and for implementing policies that, if successfully carried through, should result in an additional lowering of the deficit in the current fiscal year. In that regard, the prompt response of the Kenyan authorities to the shortfall in government revenues for the current fiscal year, as detailed in SM/83/24, Supplement 1, gave a further indication of the authorities' determination to meet the fiscal objectives of the stand-by arrangement.

The decision of the authorities not to make a supplementary budget appropriation was also particularly encouraging, Mr. Dallara continued, since such appropriations had in the past been a source of the deterioration in the fiscal position. The remaining months of the current fiscal year should provide time for the authorities to assess the effectiveness of the utilization of its budget resources. The authorities should move promptly, with World Bank assistance, to set priorities for projects within the scope of a detailed investment plan in order that resources could be concentrated on those projects that would provide the greatest economic return.

The recent devaluation of the Kenya shilling and the minor adjustment since that time were welcome, Mr. Dallara remarked. It was to be hoped that those actions signified the willingness of the authorities to follow through on their commitment to implement a more flexible exchange rate policy so as to avoid a repetition of the pattern of events that had followed the September 1981 devaluation. Generally speaking, monetary and credit policies seemed broadly supportive of fiscal targets and were consistent with the objective of containing inflation. In particular, he welcomed the increase in the liquidity ratio of nonbank financial intermediaries, which had been a problem area during 1982. He also commended the authorities for the recent increases in interest rates and encouraged them to ensure that those rates remained positive in real terms. Other aspects of Kenyan policy--including steps toward greater expenditure control, incomes policies, and certain changes in producer prices--also merited support.

With regard to prospects for external financing in 1983, Mr. Dallara noted that the exceptional assistance expected from donors had enabled the authorities to close the balance of payments gap ex ante, and the overall balance of payments deficit was to be reduced from SDR 146 million in 1982 to SDR 42 million in 1983. However, he was somewhat concerned about delays in the disbursement of needed balance of payments support, and he encouraged the bilateral donors--including the United States--to make every effort to ensure timely disbursement of assistance, to improve the financial quality of such assistance where possible, and to direct that assistance toward investments that would facilitate the adjustment necessary for long-term economic growth and medium-term balance of payments adjustment.

On the face of it, the Kenyan program contained many of the elements often looked for in Fund-supported adjustment efforts, Mr. Dallara observed; and Kenya's external situation, while serious, did not appear from the data to be critical. The current account deficit as a percentage of GDP had been reduced in the previous two years and was expected to be reduced further in 1983. Moreover, financing the balance of payments had been difficult but not impossible, there were no external arrears, and Kenya's debt situation appeared manageable; in fact, Kenya had not been forced to resort to debt rescheduling. Fiscal performance had improved of late, and the fiscal deficit projected for 1982/83 was below 5 per cent of GDP, a figure that did not appear grossly out of line. The staff had indicated that both the budget and the balance of payments could be sustainable by 1985 on the basis of long-term concessional financing.

Despite the positive elements he had mentioned, however, he was very concerned about prospects for the Kenyan economy, which needed to grow on a sustainable basis in excess of per capita growth within the framework of a sustainable balance of payments, Mr. Dallara stated. There were many countries--including a significant number in Africa--with payments difficulties that were partly structural, and the establishment of the extended Fund facility in 1974 reflected recognition of that fact. Kenya had been the first country to use the extended Fund facility, in 1975, and the first to receive a structural adjustment loan from the World Bank. Moreover, it had had four stand-by arrangements with the Fund in the past four years that had included important structural adjustment elements. Even the press release following approval of the 1979 stand-by arrangement with Kenya had included the following paragraph relating to structural adjustment efforts:

> The present stand-by arrangement has been approved in support of a government economic stabilization program, which is designed to reduce the balance of payments deficit, to cut the rate of inflation, and to switch industrial policy from a strategy of import substitution to one of broadly based export promotion. To achieve these goals, the Government is seeking an overall reduction in the budget deficit as a percentage of gross domestic product through increases in taxes and excise duties. In addition, net bank credit to the Government will be substantially reduced. Credit policies will be cautious, but will be aimed at allowing a reasonable expansion of private sector credit, and there will also be a progressive relaxation of trade and payments restrictions.

Fund and World Bank documents had included more detailed and technical formulations of those objectives and had set forth strategies and measures to attain them.

Staff in U.S. Government agencies had followed developments in Kenya closely, Mr. Dallara continued and it shared the views of the Fund and Bank staff that import liberalization--together with possible changes in the structure of industry--was critical to the development of an efficient, viable industrial sector that could contribute to the sustainability of the balance of payments in the medium term. Apparently, Kenya's industry had developed in a protected environment, which had not always promoted efficient use of resources. Agricultural growth had slowed considerably from the levels of the 1960s. One reason was the system of protection for industry--which had turned the terms of trade against agriculture--and another was government pricing and marketing policies related to agriculture. A revitalization of the agricultural sector was clearly an important part of Kenya's medium-term balance of payments prospects.

Import liberalization had been an important element in the 1982 stand-by program, and some progress had been made toward that objective, Mr. Dallara noted. Unfortunately, much of the ground initially gained had been lost later in the year. Given the difficulties experienced by Kenya in 1982, the slippage in import liberalization was not altogether surprising. Moreover, progress in reducing the current account deficit in 1982 had, to a significant extent, been attributable to the tightening of the trade and payments regime. What worried him in particular was the lack of a firm timetable providing for a speedy restoration of the process of import liberalization and rationalization under the proposed program. The indication by the staff that the Kenyan authorities would gradually liberalize the import system as the adjustment process proceeded was reminiscent of a statement in the August 1979 program to the effect that the authorities intended to progressively phase out existing restrictions over the program period as balance of payments conditions permitted.

While he could understand the argument that further import liberalization must await easing of the foreign exchange shortage, he was not fully convinced by the point, Mr. Dallara said. Given the disruptive manner in which the system worked and the shortages of critical imports and distortions in resource allocation that had resulted from them, it appeared that the need to eliminate the controls promptly was inescapable. He understood that the devaluation, combined with other recent measures, had reduced the gap between the underlying import demand and visible import demand. He wondered, therefore, whether additional exchange rate changes--accompanied by an appropriate adjustment of tariffs--would not further reduce or eliminate the gap, thus allowing for early and substantial reduction or elimination of trade and payments restrictions that would promote a more efficient industrial sector while curbing import demand through the marketplace.

A further devaluation could have potential benefits on both the import and export sides, Mr. Dallara commented, although the benefits on the export side would probably be felt only in the medium term since supportive structural changes would also need to be made. The reinstitution of the export incentive scheme raised questions in his mind about the appropriateness of the exchange rate. He would appreciate hearing further comment from the staff on the related issues of exchange rate changes, import liberalization, tariff adjustment, and industrial efficiency.

With respect to agricultural policy, the Fund had quite properly looked toward the World Bank to take the lead in providing technical and financial support, particularly in such areas as agricultural pricing, marketing, and management policies, Mr. Dallara said. The Fund should rely on the Bank's expertise in those areas, reserving for itself a review of some of the microeconomic aspects of the structural payments problems faced by members. However, the Fund should assure itself that the appropriate policies were being fully implemented if they were important to the country's medium-term balance of payments prospects. The Fund should ask itself, inter alia, where the increase in exports necessary to promote a sustainable payments position would come from. In that regard, like Mr. Taylor, he had been disappointed that a more detailed presentation of the medium-term outlook had not been included in the staff papers. He had also been disappointed at the lack of information concerning the status of the structural adjustment programs supported by the World Bank. Some method needed to be found by which the Board could receive more detailed information on progress under World Bank programs, especially where the efforts toward structural adjustment were so critical to the objectives of Fund-supported programs.

It was his understanding that key aspects of the World Bank's structural adjustment program with Kenya--including some relating to agricultural pricing and marketing policies that were important to Kenya's economic and balance of payments prospects--were not being implemented on a timely basis, Mr. Dallara continued. It was uncertain, in that regard, whether the second tranche of the structural adjustment loan would be disbursed on schedule, and a Bank staff mission was in the process of assessing the situation. Kenya was a country with structural balance of payments problems, and it was worrying that key aspects of structural adjustment were not being implemented on a timely basis, in spite of financial and policy support by the Fund and the World Bank over a number of years. While the Fund Executive Board should concentrate mainly on macroeconomic aggregates in anaylzing a member's balance of payments problems and prospects, it should on occasion look more closely at microeconomic issues and developments, not only to reach policy conclusions but to gain a concrete sense of what was involved in structural adjustment. Such an approach was taken with some regularity in some cases involving serious structural problems, particularly where pricing of certain commodities was central to export potential.

In the Kenyan case, a number of problems were evident, Mr. Dallara observed; for example, a proposed study of agricultural pricing and marketing arrangements--to which considerable importance had been attached--had lagged significantly behind the originally envisaged schedule. While only one of a number of problems, that particular example was indicative of Kenya's general lack of timely progress toward structural adjustment over a number of years. Kenya had had three upper credit tranche programs with the Fund since 1979--not including the one proposed--and had not fully implemented any of them.

The past failures in program implementation raised two additional issues related to the structure of the proposed program, Mr. Dallara remarked. The first was whether the amount and phasing of the program was appropriate in the circumstances. He had serious doubts that a country with so many structural problems that had yet to be addressed--despite three Fund programs and two structural adjustment loans from the World Bank--should be provided with 42 per cent of the total amount requested under the program during the first month, especially when that country already had outstanding arrears equivalent to more than seven credit tranches, excluding purchases under the compensatory financing facility. He fully recognized that Kenya had critical financing needs that could be ameliorated by early drawings, and that fact should be taken into account; however, he found it very difficult to justify the proposed front-loading, given Kenya's track record with previous Fund programs and the obvious failure fully to implement the policies required under a structural adjustment loan with the World Bank. He would appreciate staff comment on that point.

The overall size of the proposed program was also troublesome from the point of view of the Fund's role in Kenya, Mr. Dallara said. Drawings under credit tranche and related facilities had equaled 315.7 per cent of quota since 1978. Assuming full purchases under the proposed program, drawings would equal 485.7 per cent of quota by the end of the program period. Fund holdings of Kenyan currency would not of course rise as much as drawings under the program, in light of scheduled repurchases of SDR 101 million in 1983 and 1984 from earlier drawings, leaving total Fund holdings of Kenyan currency under the credit tranches at just under 400 per cent of quota at the end of the program period. However, it was clear that the Fund had been providing substantial financing to a country with serious structural problems that had already used a significant portion of its maximum theoretical access to Fund resources without having made great progress in overcoming those problems. Moreover, the country was apparently not in a position to commit itself to early implementation in some of those same areas under the proposed program.

With regard to import liberalization, Mr. Dallara continued, he and the staff were in agreement on three basic points. First, some slippage in the process of import liberalization had been an undesirable, albeit possibly unavoidable, consequence of developments in 1982. Second, the timing and scope of a return to the liberalization process was at present uncertain. Third, the process of import liberalization--as well as other needed structural changes already mentioned--would take a number of years to complete, during which time Kenya might possibly benefit from Fund support. Where he differed from the staff was in the conclusion about the appropriate size of the proposed program to which those points led. As he had already noted, he had serious doubts about the appropriateness of providing 170 per cent of quota during the proposed 18-month program.

The fact that Fund holdings of Kenyan currency were not rising very much did little to alleviate his concern. Moreover, the fact that the discussion was focusing on net financing itself raised questions about whether the Fund was really providing temporary balance of payments financing or was in part serving as a substitute for long-term aid. He recognized that such issues went well beyond the Kenyan request and could not fully be answered in the current discussion, but he wondered whether there was not some inconsistency regarding the Fund's role in the Kenyan case and in other similar cases.

The lack of progress in the area of structural adjustment also raised another concern, Mr. Dallara said. The Fund had been criticized from many quarters for supporting demand management policies that purportedly reduced the rate of real economic growth, particularly in the short run. For a number of reasons, he did not believe such criticism was valid. For one thing, there was the fact that the need for adjustment was created by the circumstances facing a country and not created by the Fund. However, he wondered whether the Kenyan case did not perhaps suggest some of the inevitable trade-offs arising between demand management and supply-side measures in some adjustment programs. It was not necessary to adhere rigidly to the absorption approach presented in literature on balance of payments adjustment to acknowledge that an increase in overall production could minimize the need to restrain absorption in some cases. In the Kenyan case, earlier and more comprehensive implementation of necessary structural measures might have enabled the economy to move toward a sustainable balance of payments position with less reliance on import restrictions and demand restraint.

In sum, Mr. Dallara concluded that he was willing to support the proposed program in light of the numerous positive elements contained therein, although not without serious reservations. He would prefer to see some change in the phasing of disbursements, although he recognized that such a change was not broadly supported by others on the Board. He would also be interested in the possibility of accelerating the review date, as suggested by Mr. El-Khouri. Whatever was decided, Kenya would need to implement promptly and effectively the measures designed to address its structural problems if it was to achieve a sustainable balance of payments position in the medium term while relying on continued support from the Fund.

Mr. Salehkhou observed that, under the previous three stand-by arrangements with the Fund, Kenya had been unable to carry out all the contemplated purchases, as some of the performance criteria had not been observed. However, a distinction should be made between the 1982 stand-by arrangement and the two programs in 1979 and 1980 under which unsatisfactory progress had been made as a result of the limited scope of the measures adopted, the weakness of program monitoring, and, to a large extent, the adverse impact of a number of exogenous factors.

In 1982, Mr. Salehkhou continued, despite a breach in the performance criterion related to net bank credit and the failure to complete the second review of the program, substantial improvements had been achieved with respect to the fiscal situation and the current account deficit of the balance of payments, which had been largely in line with program targets. Developments that had led to the cancellation of the 1982 program had been largely beyond the control of the Kenyan authorities. Approximately half the excess in the overall ceiling on net domestic credit had been due to the Government's additional need for credit when the inflow of external assistance had been severely curtailed or delayed. There had also been a greater increase in credit to the private sector than had originally been assumed, largely because of the rise in agricultural output generated by improved weather conditions in 1982. Moreover, completion of the second review of the program had been delayed as a result of the severe political disturbances, which had been at least partly related to the impact of the painful measures implemented under the program. Given those factors and the continued adverse impact of the international recession on Kenya's exports and tourism receipts, economic performance under the 1982 stand-by arrangement had to a large extent been satisfactory. However, the improvement in the current account of the balance of payments had been partly due to the unavailability of exchange reserves, necessitating a temporary reversal of the authorities' policy of trade liberalization through the adoption of import restrictions.

With regard to the requested stand-by arrangement for 1983, which appropriately continued the cautious adjustment policies of the previous program while taking into account the need for resuming economic growth, Mr. Salehkhou considered that the set of measures contemplated were adequate and comprehensive and should be effective in correcting the internal and external imbalances that had arisen since the previous arrangement had become inoperative. Moreover, the chances for successful implementation of the proposed program were enhanced by the availability of sufficient foreign resources pledged for development assistance and balance of payments support. The set of measures included in the new program were impressive and indicated the continued commitment of the authorities to internal and external adjustment. Table 4 of EBS/83/41 showed the most important elements of the program with regard to all aspects of economic policy.

Despite Kenya's success with respect to the previous year's budget--particularly the substantial reduction in the ratio of real expenditures to GDP--fiscal policy should continue to focus on ways to further curtail public sector expenditures through cutbacks in development outlays, economies in the current account, and improvements in the efficiency of public enterprises, Mr. Salehkhou noted. The fiscal program also included a number of tax measures that should enhance budgetary revenues and help to achieve a further decline in the budget deficit. At the same time, the fiscal program was to be complemented by appropriate monetary measures, including a further upward adjustment of interest rates and a flexible external policy that would involve a new depreciation of the effective exchange rate and a new package of export incentives--aimed at curbing excessive import demand, transferring resources to the export sector, and, more generally, improving the allocation of resources. The flexible exchange rate policy should also allow the Government to rely less on import restrictions so that, as the balance of payments position improved, Kenya could resume its policy of trade liberalization. Finally, taking all the factors he had mentioned into account, he could warmly agree to Kenya's request for a new stand-by arrangement and could support the proposed decisions.

Mr. Malhotra stated that he too could support the proposed decisions. The Government of Kenya had made considerable progress in 1982 in carrying out the adjustment process, although the program had had to be suspended. He could fully endorse the comprehensive intervention by Miss Le Lorier on the general matter of suspending disbursements because of a failure to meet certain performance criteria. In the case of Kenya, he would have been happier if a waiver of the performance criteria had been requested because, in his view, the program had by and large been on track. The Kenyan authorities had taken a number of steps indicating their willingness to pursue the adjustment effort over the program period; as a result, the current account deficit had been reduced considerably in 1982, and a further decrease was envisaged for 1983. The rate of inflation, which had fallen from 20 per cent in 1981 to 14 per cent in 1982, was also likely to be reduced in 1983, although the projected level of inflation was still perhaps on the high side.

The depreciations that had been carried out by the Kenyan authorities had been a major step in the adjustment effort, Mr. Malhotra continued, and he hoped that the authorities would maintain a flexible exchange rate policy in future. Interest rate policy was by and large appropriate, with rates currently at positive levels. The authorities had also been successful in reducing the budget deficit, and monetary policy was properly cautious. In the circumstances, and in view of the prior action taken by the authorities, he could fully support the front-loading of disbursements under the requested stand-by arrangement. In general, when prior action had been taken and a financing need existed, an acceleration of disbursements would seem to be reasonable.

The apparent reversal in Kenyan policy with respect to import liberalization should be looked at carefully before passing judgment, Mr. Malhotra considered. Countries short on foreign exchange faced a difficult choice with respect to the pace of import liberalization; if they were not careful, they could risk adverse effects on the balance of payments in the short term. The Fund was interested in bringing about a viable balance of payments situation, but he doubted that doing away with import controls in Kenya would resolve the balance of payments problems. Moreover, it must be recognized that all governments, particularly those of developing countries, found it necessary to pursue a number of different policies at once, including a diversification of their economies through the establishment of domestic industry. While some of his colleagues might react negatively to the concept of "import substitution," he personally saw nothing wrong with such an approach in developing countries, so long as the import substitution was efficient. Indeed, taking a longer-term view of the balance of payments, he believed that efficient import substitution should be pursued as a matter of policy, not only by the governments themselves but by the international institutions providing support to them.

In reviewing stand-by programs with the Fund, the Executive Board should recognize that most developing countries--especially those in Africa--faced the problem of a lag in the effort to establish domestic industry, Mr. Malhotra commented. In the circumstances, those countries often found it necessary, when the international situation was adverse and protectionism had been growing in stronger economies, to provide some protection to their own industries. It was pointless for such countries to build up productive capacity at considerable sacrifice only to face a situation in which capacity was underutilized, thus incurring criticism that the economy was not operating well. He was in favor of reducing restrictions gradually and testing industries for efficiency, but he could not accept a situation in which, because of structural improvements, the balance of payments of the developing countries suffered more than it would have without such improvements. He was also not in favor of a situation in which the developing countries were unable to diversify their industries. Hence, the Fund should take a more realistic approach to the concept of import substitution and should be flexible enough to recognize that a gradual reduction of import restrictions was more practical than a rapid one.

Mr. Zhang stated that he could fully endorse Mr. Malhotra's remarks on imports and could support Kenya's request for a stand-by arrangement. He too had doubts about whether Kenya's structural problems could be solved by a further or more rapid liberalization of imports or by a further exchange rate depreciation to stimulate exports.

The staff representative from the African Department recalled that a number of Directors had noted that Kenya continued to face difficult problems despite a series of stand-by arrangements with the Fund. Under the first series of arrangements, the Kenyan authorities had been convinced of a fairly rapid recovery in the world economic situation, which would have required very little adjustment of the expansionary policies adopted following the coffee boom. The authorities had also been under the impression that some of the neighboring markets would open up in a short time. In the event, those assumptions had turned out to be incorrect: the recession had lasted longer than anticipated; and the neighboring markets had showed no signs of opening up quickly. Hence, the authorities had embarked on a fairly rigorous stand-by program under which they had made a sincere effort to meet objectives and targets. Considerable adjustment had been made in both the budget and the balance of payments and, while some difficulties had been experienced in meeting the June credit targets, the general thrust of the authorities' efforts had been to reduce aggregate demand and to adjust the balance of payments so that the economy could be self-financing in the medium term.

There had been two impediments to the attempt to put the program back on track, the staff representative continued. First, there had initially been differences of view between the Kenyan authorities and the Fund staff about whether or not the Fund ceilings had in fact been breached. Second, the 1982/83 budget had required some reworking to be consistent with the need for further adjustment. During discussions on the ceilings and the budget, the coup attempt had taken place in August. In order to assess its economic impact, the staff had called for a review to make certain that whatever difficulties might arise from the coup attempt would be taken fully into account in Kenya's continuing adjustment effort.

The Kenyan authorities themselves were strong and objective critics of their own policies, the staff representative remarked, and the staff had used much of the authorities' own criticism in establishing appropriate policies for the proposed stand-by arrangement. As it had done for the 1982 stand-by arrangement, the staff had incorporated in its own documents a number of sections from the authorities' sessional paper No. 4 on industrial policy, a document that recognized the main structural problems faced by Kenya.

When the push toward import substitution had begun in the early 1970s, the approach had been oriented to the East African Common Market, which had existed at the time, the staff representative noted. The various pricing decisions that had been made and the capacity utilization of industries had all been centered on the common market. Once substantial investment had taken place, however, the common market had collapsed, and Kenya had found itself with an import-intensive industrial base that had not been competitive outside the region. In recent years, the authorities had attempted, with varying degrees of success, to reduce the import intensity in the industrial sector, to push toward other markets, and to encourage investment that would not suffer from the same structural problems as investments of the past.

A continuing problem deserving of correction was the maintenance of adequate incentives in the agricultural sector, the staff representative commented. It should be borne in mind that Kenya had a dual agricultural sector. The coffee and tea sectors were extremely efficient and did not require further incentives; indeed, Kenya suffered from overproduction of those products and had some difficulty disposing of them in the market. However, the economy also had a smaller export-oriented agricultural sector for which additional incentives were necessary. Horticultural and vegetable products were exported to Europe, and livestock and meat products were exported to the Middle East. The authorities faced difficulty in putting into effect incentives that would, on the one hand, be sufficient to encourage those products while not overly promoting products like coffee and tea for which sufficient markets already existed. The policies put into place under the previous stand-by arrangement--particularly pricing policies--had been directed toward solving the structural problems. However, the authorities had emphasized to the staff that price competitiveness was not nearly as important for nontraditional exports as were the institutional problems of transport, for example. The authorities had also mentioned that many of the firms operating in Kenya had arrangements with foreign companies that forbade them to launch the export of certain commodities in markets serviced by the parent company. That limitation in particular had adversely affected the ability of Kenyan firms to expand their exports.

The World Bank had placed considerable emphasis on the further liberalization of the import system, the staff representative noted. Import liberalization had been an important element in the previous stand-by arrangement and was part of the proposed arrangement with the Fund as well as of the structural adjustment loan from the World Bank. The efforts taken by the authorities thus far to reduce import restrictions had been reported in part by Mr. Sangare, who had suggested that the authorities had already managed to clear up a large part of the problem of import licenses, the issuance of which had been held up at the end of 1982; and there were indications that they had come close to meeting the import demand that currently existed at the new prices.

Exchange rate measures alone were not sufficient to effect improvements on the import side, the staff representative considered. As Directors would recall, a 10 per cent import surcharge had been adopted in December 1982. That surcharge, together with the exchange rate, meant that the price of imports in local currency had risen in excess of 25 per cent, which had gone a long way toward reducing the visible excessive import demand. The authorities themselves were not happy about reversing the progress toward liberalization begun in 1982, but they felt that it would be unwise to move very quickly toward a further liberalization at present without sufficient foreign exchange to support such a move. In its balance of payments projections, the staff had estimated that the amount of free market imports was very close to the level that had been allocated under the stand-by arrangement; however, those estimates included statistics for an entire 12-month period. Developments in the initial months of 1983 and whether the capital inflows projected for the year would be available early enough to allow them to continue with the liberalization effort were important considerations for the authorities.

As noted, there had been delays in completing arrangements for some of the official balance of payments assistance that had been pledged, the staff representative continued. In fact, there had even been a delay in discussing the staff paper on the proposed stand-by arrangement, which was one reason that the staff had suggested front-loading disbursements under the arrangement. During discussions with the authorities at the beginning of December 1982, the staff had assumed that the donor conference would be held before the end of the year, which would have allowed for presentation of the stand-by request to the Board in early January. Unfortunately, the donor conference had been delayed until end-January, which was why the stand-by request had not been presented earlier.

Regarding questions on the World Bank's view of developments in Kenya, the staff representative observed that it was perhaps too early to indicate the official view; indeed, the Bank mission that was to review the structural adjustment loan would not begin discussions with the Kenyan authorities until March 22. Mr. Dallara had rightly noted an apparent delay in agreement between the World Bank staff and the Kenyan authorities on several important policy items, including agricultural sector pricing and development policies. That delay had mainly been due to some differences of opinion about which consultant should conduct the base study. The Kenyan authorities had chosen a consultant from the original list provided by the World Bank, but the Bank had later rejected that consultant.

Regarding developments through 1985, the staff and the Kenyan authorities agreed that further adjustment in the current account of the balance of payments would be required, together with an adjustment in the budget deficit and an improvement in the productive-oriented policies of the country, the staff representative noted. In its discussions with the authorities, the staff had reviewed several scenarios under which those developments might take place, but the authorities had felt that many of the scenarios included too many uncertain assumptions about developments in the world economy, neighboring markets, and the amount of foreign assistance that might become available. Moreover, there remained some uncertainty about how quickly the authorities would be able to improve operations in the public sector enterprises. Given those differences of view, the staff had concentrated on obtaining agreement about the targets that should be met during the period through 1985 so that the program could be adjusted to meet those targets as time went by. There was, however, no disagreement about the need to reduce the current account deficit to a level that could be financed by long-term capital inflows.

Most of the productive policies--mainly those related to agriculture--were subject to discussions with the World Bank during the review that would begin on March 22, the staff representative added. The staff had felt that agreement on those matters with the Fund should take place only after detailed discussions had been held with the World Bank; hence, the Fund's concern with respect to the agricultural policies would be taken up in conjunction with the mid-term review. Nonetheless, the Fund staff was closely following developments in Kenya; indeed, a Fund staff member was participating in the World Bank mission, and it was possible that, during the Fund review, a Bank staff member would be present.

On the timing of the first review, the staff representative said that a number of considerations had been taken into account in proposing the date of September 1, 1983. First, it was imperative to have a clear indication of how the 1982/83 budget would be finalized, and full information on the budget would not be available until early August. As things stood, the September 1 review date would actually give the staff only a very short time in which to carry out its review. However, there was no risk that the discussion of the review paper would take place after the date for the ceilings had expired; it was the staff's intention to submit the paper to the Executive Board in late August or very early September.

A series of questions had been raised by Mr. Lovato on relative prices, the staff representative recalled. The Kenyan authorities were well aware of the need to maintain an adequate exchange rate, but they had also attached importance to the various institutional problems faced by their export industries, both locally and abroad. The staff agreed with the authorities that, at present, relative prices seemed to be correct and should be maintained, and the authorities had committed themselves to adjusting the exchange rate periodically for the purpose. They were also working closely with the World Bank to develop an export incentives package, which could include such elements as special financing for exports or actions taken in foreign markets by the Kenyan Government to promote exports.

The maintenance of the export compensation scheme was mainly a question of timing, the staff representative considered. The scheme had been reinstated in a revised form before the authorities had begun to think seriously about taking action on the exchange rate. Besides, the export compensation scheme had apparently been recommended to the authorities by a World Bank mission looking at export promotion. The Fund staff was attempting to sort out the matter with the World Bank, and it was to be hoped that the staff would be able to take a firm position on the issue by the time the review took place.

Like Mr. Lovato, the staff was concerned about the movement away from direct taxes toward indirect taxes in Kenya and about the fall in the ratio of taxes to GDP, the staff representative said. In discussions with the authorities, it had been pointed out that the development was occurring mainly because of the response of profit margins to the recession of the past two years. Moreover, there would apparently be no improvement in 1982/83 because many businesses would be offsetting losses incurred in the coup attempt against a taxable income.

In response to Mr. Polak's query about why the staff was placing so much emphasis on monitoring mechanisms, the staff representative noted that, given the set of policies initiated under the proposed stand-by arrangement, the level of the exchange rate, the targets for the budget, and the degree of tightness of credit policy were all essentially correct. It was a matter of record that, in spite of broadly correct policies under the previous stand-by arrangement, the credit ceilings had been broken, although the staff agreed with the authorities that the breach of the ceilings had taken place mainly because developments in the fiscal and monetary areas had not been carefully monitored. The staff felt that, if the authorities were adequately advised of the short-term trends in their economy, they would have the time to take the necessary policy measures to respond to those trends.

Regarding questions on what the staff had meant by increased monitoring in the banking system, the staff representative noted that the Central Bank of Kenya had traditionally not been an active bank. It had provided very little credit to the commercial banks and had not used many of the traditional tools of liquidity and cash ratios to the extent that it might have. One of the problems was that much of the information needed for a more active monetary policy was not promptly provided to the Central Bank. The staff had noted that, despite the 21-day statutory limit for reporting balance sheets, sometimes 40 days passed before the commercial banks submitted the appropriate information. The Central Bank was attempting to reduce the delay to the statutory limit and had, in addition, begun to require commercial banks to report on a bimonthly basis the level of certain key indicators in their balance sheets so that the Central Bank could be better informed about developments.

Mention had been made of the decline in savings in the past four years in Kenya, the staff representative recalled. Going back four years placed one at the heart of the coffee boom in Kenya when exporters had encountered windfall profits, a good portion of which had been translated into savings. It might be better to return to a period prior to the coffee boom to get a more accurate picture of savings; a decline would still be registered, but it would be far less than the decline that was suggested by the 1978/79 base year.

It was understandable that some Directors had encountered difficulty in reading the papers, the staff representative noted. As Directors were aware, Article IV consultation reports and requests for stand-by arrangements were often combined into one report. However, given the delays encountered in finalizing the program and in the donor conference, the staff had felt it important that the Board should be provided with a report on the consultation that would not be further postponed. Also, the staff was aware that the Kenyan authorities were expecting a speedy response to their request for a stand-by arrangement and had therefore wanted to include in the consultation report all the elements that had formed the basis of the stand-by request; it was for that reason that the two papers appeared to be somewhat repetitious.

Questions had been raised about the lack of information in the staff report on short-term capital flows, the staff representative recalled. The political events in August had resulted in some capital outflows, the magnitude of which had been difficult to estimate. The authorities were aware of the problem and considered that the best way to correct the outflows was to develop a serious and comprehensive program that would encourage inflows or at least discourage outflows. However, it was difficult in the balance of payments statistics to estimate with any accuracy what short-term capital inflows were actually occurring in Kenya.

The staff's belief that the current grain marketing problems would not recur was based on the evidence provided by the Kenyan authorities that the current year's harvest was the largest ever recorded in the country, the staff representative said. Nonetheless, the authorities believed that, in order to guarantee self-sufficiency in food--a goal to which they attached considerable importance--it might be a reasonable price to pay if, from time to time, certain excess foodcrops were produced and exported at a loss. Part of the loss in the current year was due to the fact that the Kenyan authorities were not regular exporters of maize and did not have the appropriate international connections for the disposition of the excess products. Moreover, the form in which the products were exported was different from the form in which they were stored and sold domestically, so that the processing and rebagging requirements had added to the export costs.

Regarding the level of interest rates allowed for nonbank intermediaries in Kenya, the staff representative observed that the setting of interest rates took account of the higher cost of funds that was incurred by the nonbanks, which did not have demand deposits that were free of interest payments. The authorities had also pointed out that the savings and time deposit rates were largely minimum rates and that commercial banks, if they were willing to reduce their margin, were often able to match the interest rates charged by the nonbanks. As it turned out, most of the margin enjoyed by the intermediaries did not arise out of the legally set limits but rather from the different methods of calculation used by them. The Central Bank was in the process of standardizing the methods of calculation, which should reduce the margin substantially.

It had been noted by Mr. Schneider that, despite the increases in various deposit rates, the treasury bill rate and the rate on registered stock had not increased, the staff representative remarked. Treasury bills and stocks were sold on the basis of tenders; when the banks and nonbanks had to meet various liquidity ratios, there was a large competition for those bills and stocks, and they were sold at lower rates than might otherwise be expected. However, it was not the policy of the Kenyan Government to keep the rates artificially low; indeed, during June 1982, the banks and nonbanks had chosen not to take up treasury bills, and the rates had increased substantially from about 6 per cent to about 13 per cent.

A number of Directors had expressed a desire for more detailed information on private capital inflows and on the reason those inflows had fluctuated so much according to the balance of payments statistics, the staff representative remarked. In 1979 and 1980, when the level of short-term capital inflows had been large, a compulsory import credit scheme had existed in Kenya that had forced importers to acquire certain minimum financing before being allowed to bring in imports. There had thus been a substantial inflow of capital in those two years; however, when the requirements had been changed, inflows had declined. At present, most of the estimated short-term capital inflows arose from trade and were related to the level of imports targeted in the program. As a rule, there was little short-term borrowing--either private or official--in Kenya; among the exceptions to that rule was the borrowing by some of the statutory corporations, such as Kenya Airways, which incurred short-term credits in the course of its operations. The Government had not been forthcoming in accepting short-term borrowing by the private sector and others, and did not itself borrow on short term.

Wage rate increases in Kenya had long been held to a percentage of the increase in the cost of living, the staff representative noted, and the authorities intended to maintain that policy for the foreseeable future. Indeed, they had gone so far as to state that there would be no wage increase during the 1982/83 budget year and that a wage increase would be considered in 1983/84 only if the financial situation permitted it. In any event, whatever increase was approved would be only a fraction of the cost of living increase.

Regarding Mr. Taylor's request for better estimates of the credit utilization of the Cereals and Sugar Finance Corporation, the staff representative said that it was important to note that the Corporation was in a sense a marginal buyer of many commodities. It was sometimes difficult accurately to estimate how large the harvest would be and what proportion of the harvest would be taken up by the Corporation. In addition, there was some offset; when the Corporation dealt heavily in the market, there was less room for some of the private dealers. Finally, the Kenyan authorities attached considerable importance to the formalization of the State Corporation Act and were in the process of preparing the background studies for the consideration of that Act by the Cabinet. If all went well, it would be adopted by Parliament at about the same time that the 1983/84 budget would be discussed in June.

A Deputy Director of the Exchange and Trade Relations Department, responding to questions about whether a waiver should have been considered for the 1982 stand-by arrangement, observed that the staff had given serious consideration to the question in July 1982 when it had become apparent that some of the performance criteria might be breached. According to practice, the staff had made an effort to determine whether the breaching of the performance criteria would be temporary and whether the parameters of the basic program would remain intact. The staff had been concerned that the positive effects of the December 1981 depreciation of the Kenya shilling had been eroded through price inflation and that nominal interest rates had no longer been as high as the rate of inflation. It had also been concerned that government expenditures had been running at or slightly above budgeted levels, notwithstanding the fact that foreign financing had been falling substantially short of targets. It was not the practice to suggest that, simply because there was a gap in foreign financing, adjustment should not be made; on the contrary, if foreign financing was falling short, adjustments needed to be made. Also of concern to the staff had been the fact that, in July, the Kenyan authorities had been having difficulty in formulating their budget in a way that was consistent with the fabric of the program as it had then existed.

Beyond those concerns, the Deputy Director said, the staff had looked closely at the issue of crop financing. The crop had been abundant, and the Executive Board had in April 1982 already approved an increase in the credit targets for June in order to accommodate what had been perceived to be a temporary increase in credit on account of the crops. In July, the question had not been so much whether the increase in financing had been adequate or not, but rather whether some part of the increase in crops would be held as a permanent grain reserve, a development that would not have been a temporary aberration in the program.

Also taken into account had been the Kenyan track record with the Fund, the Deputy Director noted; the authorities had experienced difficulties in fully observing the performance criteria in a number of programs. While the staff had been considering those matters, the attempted coup in August had taken place and had removed the possibility of an approach to the Executive Board with a request for a waiver. Confidence had been eroded by the attempted coup, and foreign exchange shortages had become acute. With capital outflows taking place, the quantitative restrictions on imports had been tightened; however, in the political circumstances, the authorities had not been able to come to decisions with respect to the budget, the exchange rate, interest rates, and structural reform. A number of Fund missions had visited Kenya to focus attention on those critical problem areas, and a high-level delegation of Kenyan officials had visited the Fund in late November 1982 to discuss them. It had taken until December 1982 for the authorities to adopt the necessary measures.

Even after the actions had been taken, there had been a delay in bringing the program to the Executive Board because the aid meeting in November had not come to precise conclusions, possibly because the Kenyan authorities themselves had not taken needed adjustment actions, the Deputy Director remarked. After taking account of policy actions, the staff had estimated the balance of payments gap at about $100 million, and the management and staff had followed the practice of not bringing the program to the Board agenda until the balance of payments gap had been filled. The January donors' meeting had produced more positive results, with specific pledges for foreign assistance. At that time, the management and staff had had the option of waiting or approaching the Board with a stand-by paper containing a decision that was contingent upon later certification that the pledged amounts would become available. The choice to wait had been based on experience with other cases in which the timing, amount, and precise form of exceptional financing had not been fully identified. The staff had felt it important to submit to the Board only a fully financed program that was viable.

Regarding questions on the review date and the phasing of disbursements under the program, the Deputy Director noted that the Board was to complete the review by September 1, 1983. As the staff representative from the African Department had mentioned, there was always the possibility of bringing the date forward, but it was the view of the staff that September 1 was the earliest date on which the 1983/84 budget could be taken into account in the review. Bringing the date forward would serve little purpose if the staff was unable to report to the Board in its review paper on the nature of the 1983/84 fiscal program.

On the matter of phasing, the Deputy Director continued, the so-called front-loading of the Kenyan program was not inconsistent with general practice. The initial purchase was for 25 per cent of the total but, even taking the first two purchases--which amounted to 41.7 per cent of the total--the proposed phasing was consistent with existing guidelines, since less than 50 per cent was to be made available before the first substantive review. As several speakers had indicated, Kenya had a balance of payments need, and the authorities had taken a number of prior actions even before the paper had been submitted to the Board.

Mr. Sangare remarked that it was clear from the discussion that the economic problems of Kenya were serious, that time would be needed to redress the situation, and that the success of the authorities would depend as much on a recovery of the international economy and the timely provision of assistance as on the implementation of appropriate economic and financial policies. That point was, in his view, borne out by recent developments in Kenya, which threatened the program agreed with the staff in late 1982. In that connection, he took note of the point reported in SM/83/24, Supplement 1, that "the delay in firming up the needed balance of payments support has not permitted an adequate increase in imports so far in 1983." The delay had also hindered economic growth and adversely affected revenue collections.

He would not burden his colleagues with a theoretical discussion of the problems faced by Kenya in picking up the pace of import liberalization, Mr. Sangare continued. Suffice it to say that he could fully support the comments by Mr. Malhotra and others on that matter. He would only underscore the fact that an increasing level of imports could be sustained only through an increase in foreign exchange, which depended on rising exports and capital inflows. It should be borne in mind that the current account deficit had reached the level of 10.2 per cent of GDP in 1981 and that reductions in foreign exchange earnings resulting, inter alia, from a difficult world economic situation, had left Kenya with little room for maneuver. Indeed, there had been no way to maintain the initial phase of liberalization in view of the scarcity of foreign exchange. Even on the basis of balance of payments projections, import growth would in future be minimal, although the import level would more closely approximate the level of demand that was expected on the basis of tariff and exchange actions and other financial policies.

The possibility of a further devaluation had to be viewed from the standpoint of what was practicable, Mr. Sangare considered. He noted that the Kenya shilling had already been devalued by 15 per cent, and that the cost of that devaluation had been heavy. In the circumstances, he felt that the authorities must be careful not to further weaken a fragile situation. The Kenyan authorities had assured the Fund of their willingness to be flexible in the implementation of exchange rate policy, and he hoped the Executive Board would not ask them to move too fast or too soon in that area.

Finally, regarding questions on the subsidy for the export of maize, Mr. Sangare noted that the authorities were aiming at producing sufficient maize for domestic consumption and were not much interested in increasing maize exports. The latest abundant crop had produced an excess, and some way had had to be found to dispose of it. He added that the subsidization of agriculture was a phenomenon with which many Directors were familiar.

The Chairman made the following summing up:

Directors expressed their general agreement with the staff appraisal in the report for the 1982 Article IV consultation with Kenya. While noting the stabilization efforts of the authorities and the progress recorded during 1982, particularly in the areas of the budget and the balance of payments, Directors considered that a further strengthening of the adjustment effort was crucial. They therefore welcomed the fact that a new stand-by arrangement reflecting a strengthened policy stance had been negotiated and was being supported by substantial donor contributions.

Directors were favorably impressed by the courageous and comprehensive measures put in place by the Kenyan authorities in November-December 1982 and by the most recent measures to strengthen monetary policy, producer prices, and the budget. They commended the authorities for their readiness to take additional measures as necessary. It was felt that, on the basis of the new program, the medium-term path of adjustment chosen by the Government of Kenya had been restored. It was observed that corrective budgetary measures had focused importantly on expenditure constraint and reduction; in that regard, some Directors referred to the possibility that the reduction in development expenditures might affect growth potential over the medium term and that this might be taken into account during the mid-term review.

Executive Directors noted the December 1982 devaluation of the Kenya shilling and stressed the importance of the authorities' commitment to follow a more flexible exchange rate policy, which could improve incentives in the export sector and help to reduce import demand to a more manageable level, thus allowing for a better allocation of resources in the productive sectors. Several Directors expressed some doubt that a more flexible exchange rate policy would improve incentives for exporters; some others considered that a further reduction in the real effective value of the Kenya shilling might be appropriate.

Directors welcomed the further budgetary adjustment included in the 1982/83 budget and were pleased that the Kenyan authorities had been able, despite the difficult state of their economy, to take timely additional measures to maintain the original targets set out in the budget. They observed that the timely disbursement of foreign aid, particularly the recently pledged balance of payments support, was also of crucial importance in helping the authorities to maintain the objectives of the stabilization program.

Directors noted the efforts of the authorities to improve the management and the efficiency of public enterprises. They encouraged the authorities promptly to implement measures toward that end; at the same time, they indicated an understanding of the difficulties involved in bringing about the major improvement of the public sector that is being attempted.

Directors took note of the recent further increase in interest rates to positive real levels and agreed that cautious credit and monetary policies were essential to bring about a successful conclusion of the program. In commenting on monetary conditions, several Directors expressed concern at the growth in unregulated nonbank financial intermediaries and urged that appropriate measures be taken to deal with this problem.

While welcoming the authorities' determination in working toward effective demand management, a number of Directors remarked on the seriousness of the structural problems affecting the Kenyan economy, which they felt had not been addressed in a sufficiently convincing manner in past years, in spite of three Fund programs and two World Bank structural adjustment loans. They considered that the medium-term framework of Kenyan economic policy had not been sufficiently delineated in the staff paper and had not been underpinned by structural adjustment measures. They stressed that such measures, particularly those required in the agricultural sector in the context of the present relations with the World Bank under a structural adjustment loan, were overdue, and they asked the staff carefully to review developments in this area. Finally, while several Directors encouraged the authorities to move as soon as possible to adopt a more simplified and less restrictive import regime, some Directors considered that the pace of relaxation depended on the availability of foreign exchange.

The Executive Board then took the following decisions:

Decision Concluding 1982 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 1982 Article XIV consultation with Kenya, in the light of the 1982 consultation with Kenya conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

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

Decision No. 7366-(83/50), adopted
March 21, 1983

Stand-By Arrangement

1. The Government of Kenya has requested a stand-by arrangement for the period from March 21, 1983 to September 20, 1984 for an amount equivalent to SDR 175.95 million.

2. The Fund approves the stand-by arrangement set forth in EBS/83/41, Supplement 1.

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

Decision No. 7367-(83/50), adopted
March 21, 1983

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/49 (3/18/83) and EBM/83/50 (3/21/83).

2. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 82/124 through 82/128 are approved. (EBD/83/66, 3/14/83)

Adopted March 18, 1983

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/83/82 (3/18/83) is approved.

APPROVED: August 23, 1983

LEO VAN HOUTVEN
Secretary