FOR AGENDA

EBS/85/217
Correction 1

CONFIDENTIAL

September 27, 1985

To: Members of the Executive Board

From: The Acting Secretary

Subject: Kenya - Staff Report for the 1985 Article IV Consultation and Review Under Stand-By Arrangement

The following corrections have been made in EBS/85/217 (9/13/85):

Page 13, Table 6, column 4, line 23: for "(30)" read "(-20)"

last line: for "4.6" read "5.2"

Page 21, Table 7: revised

Corrected pages are attached.

Att: (2)

Table 6. Kenya: Balance of Payments, 1981-85

	1981	1982	1983	1984	1985 Prog. 1/	1985 Prog. 2/	1985 Rev.
	(In millions of SDRs)						
A. Exports, f.o.b.	915	846	865	1,009	984	997	981
Coffee	205	240	225	276	245	245	258
Tea	115	129	173	256	232	245	195
Oil products	213	151	174	150	130	126	148
Other	382	326	293	327	337	381	380
B. Imports, c.i.f.	-1,850	-1,559	-1,306	-1,511	-1,657	-1,636	-1,555
Government	-289	-148	-108	-160	-253	-232	-201
Food	(-25)	(-26)	(-12)	(-76)	(-149)	(-128)	(-110)
Other	(-264)	(-122)	(-96)	(-84)	(-104)	(-104)	(-91)
Oil	-652	-566	-469	-464	-495	-495	-459
Other	-909	-845	-729	-887	-908	-908	-895
C. Trade balance (A+B)	-935	-713	-441	-502	-673	-639	-574
D. Services (net)	244	218	208	184	196	196	167
E. Private transfers	19	-7	-5	4	-6	-6	4
F. Official transfers	66	70	113	140	137	164	126
G. Current account (C+D+E+F)	-606	-432	-125	-174	-346	-285	-277
H. Capital account	401	282	214	219	144	189	177
Long-term (net)	347	252	212	248	97	142	160
Official	(210)	(145)	(130)	(159)	(32)	(77)	(39)
Private	(137)	(107)	(82)	(89)	(65)	(65)	(121)
Short-term (net)	54	30	2	-29	47	47	17
Financial institutions	(20)	(-15)	(-5)	(-9)	(...)	(...)	(...)
Other	(34)	(45)	(7)	(-20)	(...)	(...)	(...)
I. Allocation of SDRs	7	--	--	--	--	--	--
J. Overall balance (G+H+I)	-198	-150	89	45	-202	-96	-100
K. Financing	198	150	-89	-45	202	96	100
Gross reserves	176	5	-169	-37	36	56	58
IMF (net)	23	135	88	-11	73	40	43
Other assets (net)	-1	9	-8	3	--	--	-1
To be secured	--	--	--	--	93	--	--
Memorandum items:							
Gross reserves (end of period)	215	210	379	416	367	347	358
Gross reserves (in months of imports)	1.4	1.6	3.5	3.3	2.7	2.5	2.8
	(In percent of GDP)						
Current account deficit							
Including official grants	11.1	7.7	2.3	3.0	5.6	4.6	4.5
Excluding official grants	12.3	8.9	4.4	5.4	7.8	7.2	6.5
Official net capital inflow plus official grants	5.1	3.8	4.5	5.2	2.7	3.9	2.7

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

1/ Projections presented in EBS/84/261 (12/12/84) when the Board approved the arrangement in principle pending closure of the external financing gap.

2/ Projections contained in program that was approved once the financing gap had been closed (EBS/84/261, Supplement 3, 2/8/85).

are presently estimated to rise by a further 1 percent in 1985. The rise in this category reflects the implementation of a new import system initiated in 1983 and the two phases of liberalization which it has undergone.

Net capital inflows have fallen rapidly since 1981 from SDR 401 million to a projected level of SDR 177 million in 1985, largely as a result of a contraction in net official capital inflows. In 1985 these were equivalent to less than half of the 1981 level. The fall in net official capital is the result of a sharp reduction in the Government's drawdown of available loans in line with the reduction of the development program and a large increase in debt amortization. However, some of the fall in the capital account has been offset by an increase in official transfers. As the current Five-Year Plan begins to be implemented, net official capital inflows are expected to rise. At the same time, amortization payments in relation to current account receipts are expected to peak in 1985. Private sector capital inflows fell by only 12 percent and have recorded a turnaround since 1984. As private sector activity rises, increased flows of private sector capital are also projected. Nevertheless, in the coming years it does not appear possible that net inflows of capital and official grants will attain the levels recorded in the 1970s, but are likely to be at a more modest average of about 3.0-4.0 percent of GDP.

The Kenya shilling, which is pegged to the SDR, was devalued by 15 percent (in foreign currency terms) in December 1982. Since then, the authorities have tried to follow a flexible exchange rate policy with the aim of maintaining the real value attained after the devaluation. This has resulted in a further depreciation of the exchange rate in nominal terms of 1 percent in 1983, 2 percent in 1984, and 13 percent between April-July 1985. By the end of July, the real effective exchange rate had regained the December 1982 level, after having exceeded this target at end December 1984 and March 1985 by about 9-10 percent (Chart 1). The depreciation of the real rate, together with the import surcharge in effect since December 1982, has had an important impact on relative prices, influencing the import intensity of production and import demand in general. Export profitability has also improved, as the recent growth in non-traditional exports show.

A new import system was introduced in 1983 and liberalized in June 1984 and more recently in June 1985. Last year 306 items, about one quarter of the items in the restricted schedules, were transferred to Schedule 1B, and in June 1985, 317 items were transferred into Schedule 1A. As a result of these changes, Schedule 1A accounts for 42 percent of all import items. Schedule 1A and 1B together account for almost two-thirds of import items. Items in Schedule 1A are licensed virtually automatically while those in Schedule 1B are licensed liberally. Schedule 2 accounts for 35 percent of items and is divided into Schedule 2A Special with 3 percent of items, which includes items such as petro-

Table 7. Kenya: External Public Debt Operations, 1983-90

	1983	1984	1985	1986	1987	1988	1989	1990
				(In millions of SDRs)				
A. External debt	2,725	2,826	2,910	3,087	3,289	3,432	3,551	3,676
Non-IMF 1/2/	2,327	2,438	2,477	2,694	2,928	3,082	3,256	3,449
Disbursed 3/	(2,327)	(2,438)	(2,195)	(1,973)	(1,747)	(1,509)	(1,266)	(1,039)
Projected	(--)	(--)	(282)	(721)	(1,181)	(1,573)	(1,990)	(2,410)
IMF credit tranches	398	388	433	343	259	187	93	25
Disbursed 3/	(398)	(388)	(318)	(228)	(144)	(87)	(40)	(8)
Projected	(--)	(--)	(115)	(115)	(115)	(100)	(53)	(17)
Financing gap	--	--	--	50	102	163	202	202
B. Principal payments 4/	221	262	313	312	310	322	337	295
Non-IMF 2/	178	204	243	222	226	250	243	227
IMF	43	58	70	90	84	72	94	68
C. Interest/Charges	158	179	162	169	177	185	189	192
Non-IMF 2/	120	136	123	129	140	150	158	167
IMF	38	43	39	37	29	22	14	6
Financing gap	--	--	--	3	8	13	17	19
D. Total debt service (B+C)	379	441	475	481	487	507	526	487
				(In percent of current account receipts) 5/				
Memorandum items								
Total debt service	26.4	26.8	29.7	28.2	25.9	24.8	23.5	19.9
IMF debt service	5.5	6.3	6.8	7.4	6.0	4.2	4.8	3.0
Interest/Charges	11.0	10.5	10.1	9.9	9.4	9.0	8.4	7.8
				(In percent of GDP)				
Total external debt 6/	48.3	47.7	46.4	44.1	42.3	40.2	37.7	35.3
IMF credit tranches 6/	6.5	6.8	6.6	5.7	4.0	2.7	1.5	0.6

Sources: Kenya External Debt Reporting System; and staff estimates.

1/ Includes nonguaranteed debt of public sector in addition to guaranteed and direct government debt.
2/ Includes IMF Trust Fund.
3/ As at end-1984.
4/ Covers payments on medium- and long-term debt only.
5/ Excluding official transfers.
6/ Calculated on basis of average of beginning and end of period stock of debt.

The Kenyan representatives explained that the balance of payments surpluses in 1983-84 had increased gross foreign assets to the equivalent of 3.2 months of imports. As a result of the drought emergency, a reduction in gross foreign assets was projected for 1985, but it was their objective to maintain gross foreign assets at about 2.5 months of imports in the medium term.

The Kenyan representatives said that the large fluctuation in the exchange rate of major international currencies which had taken place in 1984 and in 1985 had made it difficult to implement a flexible exchange rate policy. They felt that frequent movements of the exchange rate--some of which would be offsetting previous actions--added confusion to the trade decisions of the private sector. Consequently, the authorities tried to interject an element of stability in making decisions on the exchange rate. In 1985 exchange rate decisions were also affected by the need for minimizing their impact on domestic price pressures in order to reduce wage demands resulting in some delay in effecting needed changes. Thus for a period of time the real effective exchange rate of the Kenyan shilling appreciated above the target established after the last major devaluation of the shilling in December 1982. However, the target had been regained by the end of July 1985. They stressed that the fact that the exchange rate had appreciated for a period of time did not reflect a change in the Government's commitment to a flexible exchange rate policy, but only some practical difficulties in implementing the policy.

The index being used for the effective exchange rate calculation contains a higher weight for the U.S. dollar than suggested by trade flows. The Kenyan representatives said that this had been done to take account of the dollar's predominance as a form of payment. However, since December 1982, they also tracked other indexes which gave the dollar a lower weight. By and large, all the indexes moved in a similar fashion, and therefore they did not feel it was necessary to change the weighting of their main index. In their view the recent growth of non-traditional exports also reflected an adequate level of competitiveness. Export profitability was also evident from the very rapid growth of tea exports. The decline in 1984 was due to the drought impact on output. The Kenyan representativers pointed out that the prices paid to producers reflected export prices and that care was being taken to improve the timeliness of payments.

4. Medium-term outlook

The medium-term outlook for Kenya's balance of payments (Table 8) remains broadly the same as that presented to the Board in EBS/84/261, if Kenya continues to adhere to the policies and objectives supported by the current stand-by arrangement. This will critically involve the mobilization of additional domestic resources for development purposes. In this regard a further adjustment in the overall budgetary deficit to