

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 82/79

10:00 a.m., June 9, 1982

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

Executive Directors

M. Abdollahi
J. Anson
A. Buira

B. de Maulde
R. D. Erb

T. Hirao
J. C. Iarèzza
R. K. Joyce
A. Kafka

S. Kiingi
G. Laske
G. Lovato
S. Nana-Sinkam
M. Narasimham
Y. A. Nimatallah
J. J. Polak
A. R. G. Prowse
J. Sigurdsson
Zhang Z.

Alternate Executive Directors

O. Kabbaj
C. Taylor
M. A. Senior
O. Üçer, Temporary
A. Le Lorier
T. A. Connors, Temporary
T. Alhaimus
T. Yamashita

J. R. Gabriel-Peña
V. Supinit
F. Sangare

C. P. Caranicas
A. Alfidja

S. El-Khourî, Temporary
T. de Vries
B. Legarda
L. Vidvei
Tai Q.

L. Van Houtven, Secretary
M. P. Blackwell, Assistant

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Also Present

African Department: J. B. Zulu, Director; R. J. Bhatia, Deputy Director; E. L. Bornemann, F. d'A. Collings, C. N. Egwim. J. M. Jimenez, S. M. Nsouli, J. D. Simpson. Asian Department: K. Meesook. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; S. Eken. External Relations Department: A. M. Abushadi. Fiscal Affairs Department: L. K. Doe. IMF Institute: S. K. Anzagi, Participant. Legal Department: G. P. Nicoletopoulos, Director; J. G. Evans, Jr., Deputy General Counsel; R. C. Effros, A. O. Liuksila, S. A. Silard. Middle Eastern Department: G. Tomasson. Research Department: G. I. Brown, K.-Y. Chu, L. U. Ecevit, N. M. Kaibni, G. Khatchadourian, T. K. Morrison, B. R. H. S. Rajcoomar. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; D. Williams, Deputy Treasurer; A. M. Al-Samarrie, D. H. Brown, A. G. Chandavarkar, W. L. Coats, Jr., D. S. Cutler, L. E. Escobar, H. Flinch, R. B. Hicks, J. T. McDonald. A. F. Moustapha, T. M. Tran. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: S. R. Abiad, E. A. Ajayi, C. J. Batliwalla, C. Bouchard, A. B. Diao, L. Ionescu, M. A. Janjua, S.-W. Kwon, P. D. Peroz, F. A. Tourreilles. Assistants to Executive Directors: E. M. Ainley, L. E. J. Coene, R. J. J. Costa, F. G. Guena, A. Halevi, Jiang H., J. M. Jones, P. Kohnert, W. Moerke, J. A. K. Munthali, V. K. S. Nair, J. R. Novaes de Almeida, Y. Okubo, J. G. Pedersen, C. N. Pinfield, J. Reddy, J. Schuijjer, D. I. S. Shaw, P. S. Tjokronegoro, J. F. Williams, A. A. Yousef.

1. KENYA - REVIEW OF STAND-BY ARRANGEMENT, AND PURCHASE TRANSACTION -
COMPENSATORY FINANCING FACILITY - EXPORT FLUCTUATIONS AND
FLUCTUATIONS IN COST OF CEREAL IMPORTS

The Executive Directors considered a paper on a review of the stand-by arrangement for Kenya (EBS/82/91, 5/11/82; and Cor. 1, 5/14/82; Cor. 2, 5/26/82; and Cor. 3, 6/7/82). They also considered a paper on a request from Kenya for a purchase equivalent to SDR 60.375 million under the decision on compensatory financing of export fluctuations and fluctuations in the cost of cereal imports (EBS/82/84, 5/11/82; and Sup. 1, 6/8/82).

The staff representative from the African Department said that he had been informed that day by the Kenyan authorities that the outturn of budgetary operations for the first ten months of the current fiscal year was in line with the end of year target. Revenues were exceeding expectations by 8 per cent, and the overall economic performance of the country was better than described in EBS/82/91 on the basis of the results of the first seven months of the fiscal year. The better revenue performance meant that despite the continuing shortfall in net foreign financing, the sum of revenues and net foreign financing and net nonbank financing would be less than 4 per cent below target. Overall expenditure continued to be higher than forecast, largely because of the need to finance cereal purchases, and of the higher debt service payments resulting from the continuing high level of interest rates in the international market. The Kenyan authorities had restated their determination to meet the ceilings agreed in the program. The information available on banking system credit for the same period confirmed that credit variables were in line with the target agreed in the program.

Mr. Kiingi made the following statement:

The economic problems confronting Kenya in recent years were highlighted in my statement at Executive Board Meeting 82/2 on January 8, 1982 on the occasion of the Board's discussion of the current one-year stand-by arrangement with Kenya. These included a deterioration in the Government's financial position and serious balance of payments problems. A financial program supported by a one-year stand-by arrangement was adopted by the authorities to deal with the situation. It may be recalled that the stabilization program aimed, among other objectives, at strengthening the balance of payments and restoring domestic financial stability.

In order to achieve these objectives, the authorities took a number of measures before the Board's approval of the stand-by arrangement in January this year. The measures included two devaluations of the Kenya shilling of 5 per cent and 15 per cent in terms of the SDR; the introduction of expenditure monitoring and control techniques; increases in the prices of petroleum products as well as of other consumer goods; upward adjustment in producer prices; substantial increases in interest rates and import tariffs; and the replacement of a number of quantitative restrictions by tariffs.

I am glad to state that all the performance criteria set for January 1982 were met. Total government expenditures are on track while recurrent revenues are running slightly ahead of projections. On April 28, 1982 the excise tax rates on beer and cigarettes were increased. Projects that have not secured external funding are frozen and steps are being taken to accelerate the rate of disbursement of foreign grants and loans. However, the overall fiscal deficit for 1981/82 is expected to exceed the program projection because of the rebuilding of cereal stocks after years of drought, the reconstitution of stocks involving substantial financing by the Treasury, and a substantial shortfall in foreign grants. The financing of the deficit was complicated by the unexpected shortfall in foreign capital inflows, including the delay in the disbursement of the second structural adjustment loan by the World Bank. The increases in interest rates, including treasury bill rates, enabled the Government to increase its borrowing from nonbank sources, which in turn helped to restore a more balanced growth in bank credit between the private and government sectors. While the authorities consider the overall level of domestic interest rates as adequate, they have nonetheless stated that interest rate policy would be kept under constant review with a view to making real interest rates positive.

In the external sector, the current account deficit in the balance of payments is expected to narrow from about 11 per cent of GDP in 1981 to 8 per cent in 1982, reflecting in the main the 1981 depreciation of the Kenya shilling and anticipated increases in the world prices of coffee and tea. However, because of a substantial shortfall in capital inflows, the overall balance of payments deficit is projected to be substantially higher than was originally envisaged. The debt service ratio is expected to peak at 15 per cent in 1983 and thereafter to taper off to as low as 9 per cent in 1987. In the meantime, the authorities are determined to monitor developments in the exchange rate of the Kenya shilling with a view to maintaining the competitiveness of exports. The import liberalization policy is being implemented. It is expected that by the end of June 1982 about 20 per cent of imports still subject to quantitative control will be freed from restrictions. Already, some 240 import items have been identified for this purpose.

The authorities have reiterated that they would not hesitate to take any further measures, if necessary, to achieve the program's objectives. I will therefore commend to the Board the adoption of the proposed decision on page 19 of EBS/82/91.

The request for the use of Fund resources in the amount of SDR 60.4 million under the compensatory financing facility decision is to compensate for the bulk of the SDR 65.8 million estimated net shortfall in respect of excess cereal imports and merchandise exports for 1981. SDR 31.6 million of the intended purchase is accounted for by excess imports of maize, wheat, and rice occasioned by two

consecutive years of drought. The remaining SDR 28.8 million is in respect of merchandise export shortfalls attributable mostly to coffee and tea exports. The coffee shortfall arose in the main from lower international prices, while the tea shortfall is due to reduced output caused by adverse weather conditions.

The balance of payments need of Kenya justifies the proposed request. The staff agrees with the authorities that the shortfalls are due largely to factors beyond the control of the authorities, temporary in character, and reversible. With the improvement in weather conditions during the last crop season substantial increases in the output of maize have already been reported. Furthermore, the authorities expect some improvement in the world price of coffee and tea. This, coupled with the increase in Kenya's coffee quota from 67,000 tons in 1980/81 to 87,000 tons in 1981/82, will go a long way toward improving earnings from merchandise exports.

The Kenyan authorities are cooperating with the Fund in finding solutions to the balance of payments difficulties, as is evidenced by the stand-by arrangement performance, which is on track. In the circumstances, I recommend for approval the draft decision on pages 16-17 of EBS/82/84.

Mr. Alfidja remarked that almost six months had elapsed since the Executive Board had discussed and approved a one-year stand-by arrangement with Kenya (EBM/82/2, 1/8/82). It was gratifying to note that thus far the program had been successfully implemented. He commended the authorities for having implemented courageous and far-reaching measures prior to the approval of the Fund program; in doing so they had shown their determination and willingness to overcome the serious imbalances in the economy. Because those imbalances were deep-rooted and structural, requiring adjustment in a medium- to long-term framework, he had some reservations about the suitability of the country's present program. In reviewing performance under a Fund-supported program, Executive Directors should always be prepared to accept realistic changes in targets set at the inception of the program whenever they seemed necessary in a medium-term perspective.

Because of the authorities' restrictive fiscal policy, the successful monitoring and control of public expenditure, and improvements in revenue collection, Mr. Alfidja continued, Kenya's overall budget deficit was projected to be equivalent to 7.8 per cent of GDP in 1982, compared to 10.6 per cent in 1981. That success, when combined with the effects of changes in interest rates, would, it was to be hoped, bring about a more balanced distribution of credit between the public and private sectors of the economy.

A substantial amount of adjustment was taking place in the external sector, where the authorities were firmly committed to a policy of liberalizing imports and promoting exports, Mr. Alfidja noted. The current account deficit was to be reduced to 8 per cent of GDP in 1982, in comparison with 11 per cent in 1981 and 13 per cent in 1980. Fortunately, the

debt service ratio remained manageable, despite the supplementary burden for Kenya imposed by high interest rates and exchange rate fluctuations of major currencies. In view of that burden, it was understandable that many developing countries should be reluctant to have recourse to the Eurocurrency market, notwithstanding relatively good creditworthiness ratings. He would appreciate further details on Kenya's recent relations with the Eurocurrency markets.

Concern about the worsening of inflation was justified, but should not be overstated, Mr. Alfidja observed. The increase in the rate of inflation from 12 per cent in 1981 to an estimated 14 per cent in 1982 was due mainly to the effects of the devaluation of the shilling and the substantial increases in administered prices. However, the authorities should continue to exercise vigilance, in order to keep price developments under control and in line with those prevailing in the country's major trading partners. Incidentally, he would appreciate further information on Kenya's consumer price index and the rationale behind the choice of the weights attached to different components of the index.

He found Kenya's request for a purchase under the compensatory financing facility to be fully justified, Mr. Alfidja concluded. The authorities deserved commendation for their close collaboration with the Fund. For further progress, Kenya needed and deserved continued external support. He could support the decision relating to the review of the stand-by arrangement.

Mr. Connors said that he would make only brief comments since it was evident that Kenya's stand-by program was on track. He hoped that after its next visit to the country, the staff would be able to provide firm information on the composition and value of the shift in imports from the restricted to the unrestricted schedule. It would also be useful to know whether the staff believed that any changes in the tariff structure would be advisable. On a related subject, he hoped that Kenya's export subsidy scheme could be abolished by the time of the next review. Besides its distorting effect on trade, it had undesirable budgetary consequences. An appropriate exchange rate policy should make the export compensation scheme unnecessary.

He had some reservations about the cereal import cost component of Kenya's request for a drawing under the compensatory financing facility, Mr. Connors continued. While he agreed with the staff that the excess of cereal imports was largely beyond the control of the authorities, because of the drought, it was noteworthy that the authorities had set producer prices, at least for part of the five-year period under consideration, at levels that discouraged production. It would be interesting to know exactly to what extent grain prices were subsidized, and how producer and consumer prices for grains in Kenya compared with international prices. Without that information, it was difficult to determine how government action affected production and consumption decisions.

He did not believe that the Kenyan case was unreasonable, Mr. Connors said. He could support Kenya's request for a drawing under the compensatory financing facility, and he had raised the issue of price controls on grains because the Executive Board would have to deal with such issues in a future request containing a cereal import cost component. There seemed to be a general problem in evaluating such cases when national authorities had intervened in grain markets. He would prefer authorities who intervened in grain markets in such a way that domestic prices differed substantially from international prices to refrain from requesting compensation for increased cereal import costs. After all, government pricing was instrumental in determining the consumption and production of grain.

Mr. Taylor expressed his general agreement with the staff appraisal of economic developments in Kenya and his support for both the proposed decisions. The authorities deserved commendation for the resolve they continued to demonstrate in implementing their economic program. Preliminary indications were that the Kenyan economy was responding well to the corrective measures that had been implemented and to the overall framework of macroeconomic policy. The country's slow overall growth, sluggish agricultural performance, and balance of payments difficulties were all fairly typical of the problems experienced by many sub-Saharan economies. Those problems were, however, rather less pervasive in Kenya than elsewhere, possibly because of Kenya's intrinsically stronger economic base and relatively well-developed infrastructure; in that way Kenya stood out from its neighbors and should have a greater capacity to overcome its economic problems.

The Fund should keep in mind the distinction between the very poorest of the sub-Saharan economies and the "middle-income" economies such as Kenya, Mr. Taylor continued. The fact that countries in the latter group had a slightly greater capacity to overcome adverse economic conditions should be reflected in the design of Fund programs; multiyear programs could be contemplated with more confidence in such countries than in the very poorest countries of the region. However that might be, it was still crucial that policies of fiscal restraint and trade liberalization should be continued and be accompanied by structural changes, especially changes designed to diversify the export base.

There were major structural weaknesses in the Kenyan economy that needed addressing, Mr. Taylor noted. However, in the narrow perspective of a one-year stand-by arrangement, it was difficult to assess the scope and the adequacy of the adjustment effort. It would be helpful, therefore, if at the time of the next review, the staff could give some indication of how the economy was progressing in both a medium- and a long-term perspective, and perhaps even of whether further Fund assistance was contemplated. In the original letter of intent, the Kenyan authorities had proposed reviewing the need for the continuation of the export compensation scheme and the adequacy of producer prices for major food commodities. Perhaps the staff could say whether those issues had been discussed during the present review and whether any decisions had been reached.

He welcomed the authorities' determination to keep the fiscal deficit down to a sustainable level, Mr. Taylor said. It was reassuring to note that the fiscal objectives for 1981/82 were likely to be broadly achieved; to a large extent that success reflected the effectiveness of the improved expenditure monitoring techniques that had been introduced with the Fund's assistance, and the tight control now exercised over public sector wages and manpower. Given the critical importance of reducing the overall budget deficit, he welcomed the authorities' renewed assurance that they were prepared to take further measures should the need arise. As for monetary policy, the authorities' departure from their traditional policy of low interest rates was praiseworthy. The recent move to positive interest rates should encourage domestic savings and reverse the trend toward financial disintermediation. The small adjustments to the indicative credit ceilings, which reflected the need to finance the unexpectedly high accumulation of cereal reserves as well as the delays in disbursements under the second structural adjustment loan, seemed reasonable, but they did create the presumption of a substantial reversal later on in the year.

Significant progress had been made in the external sector, particularly with regard to import liberalization, Mr. Taylor considered. Further liberalization would be necessary, however, if the projected expansion of exports was not to be delayed by capacity constraints within the domestic economy. He welcomed the authorities' intention to keep the exchange rate under careful review, and he would be interested to know whether the authorities had given any consideration to some form of floating exchange rate. Breaking the peg to the SDR might allow the exchange rate to respond gradually to market conditions, while avoiding the sudden shocks to the economy inherent in sharp exchange rate adjustments.

The debt service ratio, although not critical, had been deteriorating slowly and was not expected to improve greatly in the near future, Mr. Taylor noted. Could the staff say whether Kenya's short-term debts were large enough to pose a problem in the future? There had been significant shortfalls in capital inflows during the current year; there again, some staff comments would be interesting.

He had no major difficulty in approving Kenya's request for a drawing under the compensatory financing facility, Mr. Taylor remarked. He had been pleased that the authorities had been able to export a substantial amount of coffee outside the quota markets to nonmember countries; however, Kenya had been forced to carry high levels of coffee stocks in recent years, and if exports to nonmember countries continued to decline--as the staff anticipated--the need to hold substantial stocks at significant cost might persist for some time. He would be grateful if the staff could comment on that prospect, and in particular on whether the Kenya Coffee Board should attempt to dispose of more surplus coffee on world markets or whether the surplus might in due course have to be dealt with by other means--for instance, by the orderly reduction of coffee production or crop diversification.

Mr. de Vries commented that in the past Kenya's economic problems had been caused by a mixture of external and domestic factors. The previous stand-by arrangement had broken down because of overexpansionary fiscal policies and it was, therefore, encouraging to note that the government budget was now firmly under control. The monitoring and control of budgetary expenditures had played an important part in the continuing decline in the government deficit as a proportion of GDP. There had also been improvements on the monetary side. However, interest rates were perhaps still slightly negative and at best only zero in real terms. It was important that the authorities should pursue their objective of real positive interest rates.

His main concerns about the Kenyan economy were in the external field, Mr. de Vries continued. There had been some import liberalization, but not as much as could have been hoped for; he hoped that the transfer of items from the restricted to the unrestricted list would soon take place. According to the staff, import reform depended to a large extent on the availability of foreign exchange. In the long term, however, it might be better to view the question from a different angle: the availability of foreign exchange would increase with a more market-oriented import and export policy. If the authorities waited to receive sufficient foreign exchange before taking the necessary measures, they might never be able to take them. It was discouraging that the levels of both imports and exports had fallen in volume terms. Actions to reverse that situation should be given high priority. With all the restrictions in the Kenyan economy, the impression was given that the exchange rate was at an inappropriate level. The real exchange rate had, in fact, appreciated since the beginning of the year. The devaluations that had taken place during 1981 had been moves in the right direction, but since the beginning of the year prices in Kenya had risen faster than in competing countries, while the exchange rate had remained nominally fixed. In his view, the real exchange rate was moving in the wrong direction and some adjustment was called for. Perhaps, as Mr. Taylor had suggested, some progress could be made by breaking the link between the shilling and the SDR.

He could support Kenya's request for a drawing under the compensatory financing facility, although he noted the general point of concern raised by Mr. Connors, Mr. de Vries continued. It was certainly not appropriate for a country to seek Fund assistance for excess cereal imports, when the authorities of that country had set producer prices that discouraged home production. Although such requests might be justified by factors such as a drought, it did seem rather inappropriate for the Fund to finance increased costs for imports of foodstuffs, when those imports might not have been necessary if more adequate agricultural pricing policies had been in place. The problem raised by Mr. Connors might usefully be discussed by the Executive Board at a future date.

Mr. Laske observed that Kenya's stabilization program appeared to be progressing well and, in view of the authorities' commendable perseverance and resolution, the prospects for a successful completion of the stand-by

arrangement were promising. The improvements made in the fiscal area were particularly noteworthy; both revenue and expenditure appeared to be moving roughly in line with program projections.

Interest rate policy was an important element in the adjustment strategy, Mr. Laske considered. Both lending and deposit rates had been revised upward by the authorities, but it was not clear from the papers whether the present level was adequate in view of the present and probable future rate of inflation; deposit rates, in particular, seemed to remain negative in real terms. He strongly endorsed the staff view, therefore, that interest rate levels should be reconsidered, especially if inflation should continue to rise. In his view it would be beneficial to make the rate of interest on the Government's treasury bills more attractive, so as to ensure that as large a part as possible of the domestically financed public sector deficit could be met by recourse to nonbank funds.

He agreed with the staff that the exchange rate was adequate at present, even though the shilling had appreciated in real terms over the first few months of the year, Mr. Laske remarked. That appreciation might have put in jeopardy the gains in international competitiveness that the economy had derived from the previous downward exchange rate adjustments. An important part of the authorities' adjustment strategy would have to be a flexible attitude vis-à-vis the exchange rate, particularly when there was a danger of a deterioration in competitiveness. The fact that there was likely to be a relatively large deficit in the balance of payments rather than the originally programmed small surplus made it all the more necessary to strengthen the current account. The authorities should therefore pay close attention to the exchange rate question and should continue efforts to achieve their objectives in the external sector.

He would be grateful if the staff could explain why the structural adjustment loan agreed with the World Bank had been reduced, Mr. Laske said. Finally, he could support both proposed decisions.

Mr. Prowse said that he also could support both decisions. It was evident that the Kenyan economy was heading in the right direction, although further adjustment was required. The authorities had raised interest rates, taken measures to reduce the budget deficit, and succeeded in meeting all performance criteria. It was notable that despite external difficulties, the country had managed to maintain a reasonably strong rate of economic growth.

He had some concern about trends in the balance of payments, Mr. Prowse stated. The fact that most of the problems in that area were external in origin did not allow the authorities to relax. The continuing increase in inflation was a particular source of concern, as was the recent appreciation in the real exchange rate. He agreed with the staff that the present rate of exchange was probably appropriate; however, efforts should be made to prevent any further slippages that would lead to an effective appreciation.

With regard to the request for a drawing under the compensatory financing facility, all of the technical criteria for eligibility had been met, Mr. Prowse stated. He agreed with previous speakers that the general question of pricing policy should be examined. However, it was important to understand that there should be no automatic presumption that by intervening in agricultural markets a government would do more harm than by not intervening. It was established practice for governments in developing countries to take stabilizing action with regard to their primary producers; indeed, from time to time, the Fund itself recommended such action. Intervention in the area of primary products was widespread and not confined merely to developing countries. In a very broad sense, it might well be that the developing countries gained more than they lost by government intervention. In principle, therefore, he had no difficulty in accepting that the Kenyan authorities should make those efforts to stabilize prices and encourage production that seemed the most appropriate to them. He had been rather concerned to note that, even after a strong recovery in crop production in 1981, crop prices had been increased again by some 37 per cent at the beginning of 1982. Such a large increase might encourage a surge in production that would lead in turn to a downward adjustment in prices and a subsequent drop in domestic production, thus generating some kind of cycle. Could the staff give some reassurance that such a reaction would not occur?

Mr. Joyce recalled that when they had first discussed Kenya's request for a stand-by arrangement (EBM/82/2), Executive Directors had welcomed the steps planned, and already taken, by the authorities in an effort to get the country's economy back on track. Several Executive Directors had recognized at the time that a number of Kenya's problems were of a long-term structural nature and that they could not be resolved within the program period itself. After the first few months of the program, it was now evident that all the performance criteria set for January 1982 had been met. Total government expenditures were in line with projections, while recurring revenues were running slightly ahead of projections. Of course, it was not surprising that the authorities had met the January 1982 performance criteria, since the arrangement had begun in that month; a more crucial test would be whether the country met the targets laid down for June 1982.

It seemed likely that the overall fiscal deficit for 1981/82 would exceed program projections, in part because of the recovery of agricultural production after the drought, which had permitted the rebuilding of cereal stocks but which had caused some additional expense to the Treasury, Mr. Joyce noted. The higher fiscal deficit could also be attributed in part to a substantial shortfall in foreign grants, which had contributed to the higher overall balance of payments deficit. He wondered to what extent the shortfall in foreign grants was due essentially to short-term forces that were likely to be corrected. There had been some suggestion that the shortfall resulted in part from delays in completing negotiations on the structural adjustment loan from the World Bank. Moreover, a statement in the letter of intent that Kenya would be making extra efforts to speed up the process of claiming foreign grants and loans made him wonder

whether the reduction in capital flows might reflect a failure on the Kenyan side to move rapidly enough in claiming advances to which the country was entitled. Could the staff specify how far the shortfall was attributable to unexpected cutbacks by bilateral donors, and how far to the slow progress made in the undertakings financed by private capital. Was the shortfall likely to continue? If so, what would be the implications for the sustainability of the still fairly large current account deficit that was likely to remain after the completion of the program?

He could accept the staff's conclusion that some adjustment in both the fiscal target and indicative credit ceilings originally proposed for June 1982 would be appropriate in the circumstances, Mr. Joyce continued. If the new target were met, it would still result in a lower deficit for 1981/82 in terms of GDP than for the previous year. The present review had been designed to provide the opportunity of setting credit ceilings for the end of June 1982, and also an opportunity to review exchange rate and interest rate developments, the fiscal outlook, and the progress being made in import liberalization.

Both the authorities and the staff believed that the present exchange rate provided adequate incentives to exporters as well as realistic levels of import prices, Mr. Joyce observed. However, the value of the Kenya shilling had appreciated in both nominal and real terms during 1982, and the situation needed careful monitoring. Like Mr. Prowse, he would be interested to know what steps the authorities might take with regard to the exchange rate if the level of inflation turned out to be higher than currently anticipated.

The authorities had raised interest rates on treasury bills in January 1982 and had clearly increased their ability to tap the nonbank market, Mr. Joyce remarked. They believed, as did the staff, that the overall level of domestic interest rates was adequate at present, despite the higher than anticipated rate of inflation. If the rate of inflation did not ease as was expected, a further upward adjustment in interest rates might need to be considered. While the actions taken to date in that area were commendable, it was evident from Chart 3 on page 16a of EBS/82/91 that deposit rates in Kenya had been consistently negative and that lending rates had become negative once again. If that situation were allowed to persist it was difficult to see how Kenya could obtain a projected increase in gross domestic savings to 19.1 per cent in 1982 from the estimated level of 16.2 per cent in 1981. Some comments from the staff would be appreciated.

On the fiscal side, Mr. Joyce continued, the authorities were to be commended for the resolute way in which they had tried to ensure that objectives would be met. The monitoring and control of public expenditures had improved significantly, and the authorities had increased revenues by increasing excise taxes on beer and cigarettes. At the same time, they had cut back fairly sharply on development expenditures, partly for direct budgetary reasons, but also because of the reduced flow of funds from foreign sources. Clearly, that cutback had been painful for

the authorities, but he agreed with them that there appeared to be no real alternative in the circumstances. It could only be hoped that the flow of overseas assistance would be restored and that in the meantime the authorities would try to sharpen their development objectives and work out priorities so that any additional funds becoming available could be put to the best use.

He welcomed the assurances given by the authorities that they planned to announce in the forthcoming budget the transfer of some 20 per cent of restricted items to the unrestricted import list, Mr. Joyce remarked. He remained concerned, however, about the lack of progress in eliminating the export compensation scheme and in making further improvements in producer prices. Any additional information the staff could provide would be useful. Finally, he believed that the request for a drawing under the compensatory financing facility was justified and should be approved.

Mr. El-Khoury expressed support for both proposed decisions. The request for a purchase under the compensatory financing facility met all the requirements. In looking at the figures, he had been surprised at the time lag in the reporting of actual exports. Kenya was generally considered to have a good statistical base, and it could have been expected that data for actual exports for some months after June 1981 would now be available.

At EBM/82/2 (1/8/82) he had expressed some reservations about the performance criterion relating to the expansion in net bank credit to the Government for the seven-month period ending January 1982, Mr. El-Khoury recalled. He had supported the request for a stand-by arrangement at that time, however, because the indicative subceiling for the whole fiscal year had been consistent with the stabilization objectives. The credit ceilings for the end of June 1982 had now been adjusted upward somewhat, because of what the staff termed unanticipated strains on the budget and the financial system. He could support the new proposed ceilings.

He had been glad to note on page 11 of EBS/82/91 that the 20 per cent of import items that would be shifted to Schedule 1 would be significant in terms of the actual or potential value of imports, Mr. El-Khoury remarked, although the matter was not specifically mentioned in the letter of intent.

Miss Le Lorier said that the review of Kenya's stand-by arrangement revealed some encouraging first results, but also some uncertainties about the forecast for the overall balance of payments. On the fiscal side the reduction of the deficit by an amount equivalent to nearly 3 per cent of GDP was impressive. The authorities deserved commendation for having put into place improved monitoring and control procedures for regulating budgetary expenditures. It was clear that such tight control of expenditure had been the key to the authorities' success. Nevertheless, from the broader standpoint the reduction in the growth of expenditure following a slowdown in the implementation of development projects already begun was to be regretted.

On the external side, the projections for 1982 showed that the current account deficit in the balance of payments was being reduced in line with the program target, Miss Le Lorier continued. However, due to a sharp decline in net capital inflows, the outlook for the overall balance of payments was a deficit equivalent to about SDR 169 million. It would have been useful if the staff paper could have made some projections for 1983, since the adjustment effort would presumably have to be pursued over a number of years, as pointed out by Mr. Alfidja. The authorities planned to transfer 20 per cent of all import items now subject to quotas to the unrestricted schedule at the time of the budget in mid-June 1982. Unlike Mr. de Vries, she wondered whether that liberalization might not have to be delayed or at least stretched out over time. Table 5 (EBS/82/91) showed that gross reserves would only reach the equivalent of 1.5 months of imports by the end of 1982. She agreed, therefore, with what was said on page 17 of EBS/82/91 to the effect that the pace of import reform would depend to a large extent on the availability of foreign exchange. Could the staff say whether any assessment had been made of the impact of the import liberalization that had already occurred on the rate of growth of the relevant imports and on export-related producing sectors?

The relative share of nonbank financial intermediaries in the financial sector was increasing at the expense of the banking sector, Miss Le Lorier noted. Could the staff say what advantages or disadvantages those changes were likely to bring.

She had no difficulty in going along with Kenya's request for a drawing under the compensatory financing facility, Miss Le Lorier concluded. She agreed with Mr. Prowse that the Executive Board should not have any a priori bias against government intervention in the primary products market.

Mr. Narasimham expressed support for both proposed decisions. Over the past year agricultural production had rebounded to the point where the ceilings had had to be revised upward. Total imports of cereals had been worth less than SDR 5 million in 1979, but they had risen to about SDR 85 million in each of the two following years. With the improvements in production in 1982, some downward adjustment of the projections for imports in that year might now be necessary. He would be interested to know whether, if such a downward adjustment were made, it would be necessary to revise upward the calculation of the shortfall in 1981 itself. He agreed with Mr. Prowse and Miss Le Lorier that it would be wrong to make a standard judgment about the impact of government intervention with regard to producer prices in examining requests for drawings under the compensatory financing facility. It would be naive to suggest that international prices did not reflect government intervention in exporting countries. He knew that many developing countries imported grain at prices that were supported in one way or another by the grain exporting countries. It was not at all certain that international prices could be said to reflect truly the international marketplace. In his view, such

questions should be treated with caution. Like Mr. Prowse, he would be interested to know whether recent producer price increases in Kenya had reached the point at which they might lead to a problem of oversupply.

The extent of import liberalization in Kenya would have to be related to the availability of foreign exchange, Mr. Narasimham considered. In fact, he could see no inherent contradiction between short-term concern about the availability of foreign exchange before proceeding with import liberalization, and longer-term concern about the need to liberalize the import regime to augment the availability of foreign exchange.

Mr. Vidvei indicated his support for both proposed decisions. It had been noted in the staff paper that the rebuilding of cereal stocks would be financed by the Cereals and Sugar Finance Corporation (CSFC) through sales of CSFC promissory notes to the nonbank sector, but that given the magnitude of the required financing it might become necessary for the CSFC to seek government financing as well. The implications of that financing requirement for the quantitative performance criteria relating to the fiscal budget, money supply, and balance of payments in 1982 were not clear. In Table 3 of EBS/82/91 the ceiling of "net bank credit to Government" was defined as net credits from the banks plus deposits from the General Account of the CSFC. If the CSFC was a public entity controlled by the Government, that particular choice of performance criterion might not be useful. For example, if at the beginning of the period the Government deposited money in the CSFC General Account and that money was withdrawn either to buy sugar from the farmers or to repay possible debt to the Government, the Government would then be able to borrow more from the banks without exceeding its ceiling. In fact, the performance criterion seemed extremely elastic and not capable of constraining the Government's financial resources. It would seem more appropriate to have a performance criterion specifying a ceiling for pure bank lending to the Government; and, if the CSFC was in fact controlled by the Government, to treat it as a part of the public sector, or at least to treat it completely separately, in view of the important role it played in Kenya's financial situation.

He had been rather puzzled by Mr. Kiingi's statement that the overall fiscal deficit for 1981/82 was expected to exceed program projections because of the rebuilding of cereal stocks after years of drought and stock depletion, which involved substantial financing by the Treasury, Mr. Vidvei continued. How could the depletion of stocks involve substantial financing by the Treasury? What had happened to the revenue derived from the sales of stocks? It was evident from the staff papers that lending to the Government from nonbank sources was to increase sharply. Why was there no quantitative performance criterion relating to such lending if it was intended to limit the Government's financial resources? In asking such questions he did not intend to argue for more restrictive performance criteria. The Kenyan authorities had shown a commendable determination in strengthening their country's economy. He doubted, however, whether the performance criteria were well balanced. It seemed that fairly tight restrictions had been agreed in some areas in the credit

field, while wide openings had been left in others. Staff comments on that point, and also about the role that the Central Bank would play in implementing the present program, would be welcome.

Kenya's request for a drawing under the compensatory financing facility met the criteria for eligibility, Mr. Vidvei commented. The calculations on the amount of compensation related to cereal import costs were based on the actual costs of those imports for the whole of calendar year 1981, but data for merchandise exports in the second half of that year were based on estimates. Could the staff say why actual data on merchandise exports from July 1981 onward were not yet available? In general, in presenting such requests to the Board, it would be useful if the staff could comment on the quality of the economic statistics that were provided by the members.

Mr. Kabbaj expressed support for Kenya's request for a drawing under the compensatory financing facility. The country's balance of payments need was evident, and the test of cooperation had been fully met. He had been gratified to note that the stand-by program was on track following favorable developments in the agricultural sector and the implementation of a number of major policy decisions. He had two technical questions to pose to the staff. First, he had understood from recent discussions that the staff had tried to harmonize the presentation of budget statistics, and would show the effects of foreign grants in national budgets. He had been surprised, therefore, to see that once again grants had not been counted in the budget in the staff's presentation on Kenya. It was most important that, to avoid misunderstanding, statistics should be presented in a standard way. Second, could the staff comment on the expected reduction in grants to Kenya and on the likely timetable of disbursements of the World Bank structural adjustment loan? Finally, he would be interested to hear some comments from the staff or from Mr. Kiingi on Kenya's prospects for 1983.

Mr. Buira said that in discussing Kenya's request for a stand-by arrangement at EBM/82/2 (1/8/82) he had commended the strong policy stance adopted by the authorities with regard to the exchange rate, import liberalization, interest rates, and the adjustment of regulated prices. The stand-by program called for a substantial fiscal adjustment involving a reduction of the overall deficit by some 3 per cent of GDP, meaning a decline in real government expenditure. Given the progress already recorded, the proposed small adjustment to the fiscal objective and to the indicative credit ceiling seemed entirely reasonable. Such flexibility was justified in view of the country's need to finance the accumulation of grain stocks after several years of drought. It was important that the Fund should respond positively to such cases; perhaps it should consider making similar adjustments on a more automatic basis. It was probably difficult for the Kenyan authorities to plan their economic policies, not knowing for certain whether the program would be adjusted or how the Fund would respond to changing needs.

He supported Kenya's request for a purchase under the compensatory financing facility, Mr. Buirira remarked. Production shortfalls in maize and wheat were due to two years of drought and the resulting famine conditions in certain parts of the country. At the beginning of 1980 producer prices for maize had been raised from K Sh 720 to K Sh 1,000 a ton, and although as a result there had been a substantial increase in acreage, production had increased only slightly because of the drought. Producer prices had been raised again to K Sh 1,050 a ton at the beginning of 1981 and, together with an improvement in the weather, the new prices had resulted in an excellent crop. The higher level of imports, however, had still been necessary in 1981, since the crop for that year had been largely set aside for consumption in 1982. During 1980/81 and 1981/82, producer prices had, therefore, been set with substantial flexibility, and by increasing them well in excess of the rate of domestic inflation the authorities had provided strong incentives to production. He agreed with some previous speakers that the Executive Board should have no preconceptions on the merits of government intervention in the markets for agricultural products.

Mr. Tai noted that the performance criteria set for January 1982 had been met, and that substantial progress had been achieved in some areas of the Kenyan economy. The program was now well on track, and the authorities had stated that they would take further measures, if necessary, to achieve the program targets. As to the request for a drawing under the compensatory financing facility, it was evident that the shortfalls were due to factors beyond the control of the authorities and were temporary in nature. He could, therefore, support both proposed decisions.

The staff representative from the African Department confirmed that the Kenyan authorities were preparing the list of import items that would be shifted to the unrestricted schedule. They had indicated to the staff that the value of those imports would be significant, and that in some cases the shift would be accompanied by an increase in tariffs. Although the level of international reserves would be a limiting factor, it was felt that shifting the items to the more liberal schedule would not lead to an unanticipated increase in imports if tariffs were adjusted appropriately. As to the export compensation scheme, the staff had discussed the matter with the authorities, who had stated that it would be given attention in the context of the budget for 1982/83. A change in the scheme would require parliamentary action and it would be convenient for it to take place as part of the budget action.

Food prices were not subsidized in Kenya at present, and in the past had only been so in the case of emergency, the staff representative remarked. However, under the structural adjustment loan with the World Bank, the authorities were committed not to resort to subsidies. If subsidies became necessary as a result of emergency imports, they were to be explicitly included in the budget. The large increase in grain production during the current year had been largely the result of improved weather. It should be noted, however, that even after the present stocks were accumulated, they would be below the country's normal stocking levels.

During December 1981 the producer prices of grains had been increased by a substantial margin. The authorities were confident that those increases had been necessary to maintain the relative competitiveness of grains vis-à-vis other agricultural products.

In determining the appropriate level of interest rates, the authorities believed that the current rate of inflation should not be used as the main indicator, but that more attention should be paid to the likely future movement in the inflation rate, the staff representative said. The authorities believed that the devaluation of 1981 and the large adjustments in both producer and consumer prices had caused a large bulge in the inflation rate. As that bulge receded into the past, the rate of inflation would decline and, in consequence, interest rates would become positive.

The expected decline in capital inflows had three causes, the staff representative observed. First, there had been a decline in bilateral capital from official sources. Second, the timing of disbursements under the World Bank structural adjustment loan had been stretched out; the disbursements envisaged for 1982 would now take place during 1983. Third, the authorities had not wished to go to the Eurocurrency markets to the extent that they thought would be necessary at the outset of the program. While it was true that part of the shortfall could be explained by Kenya's inability to claim reimbursements in a rapid manner, it was also true that the authorities had been careful not to begin new development projects without first being certain of the availability of foreign resources and of the feasibility of the projects concerned. It was expected that there would be an increase in bilateral official capital flowing into Kenya following the recent meeting of the Consultative Group for Kenya in Paris. The outlook for the capital account for 1983 was somewhat more promising, largely because of the disbursement of the structural adjustment loan and the likely pickup in bilateral official capital. However, the authorities would need to continue with their stabilization policies in order to reduce further the current account deficit in the balance of payments.

Thus far the new import system had functioned successfully, the staff representative stated. The number of import licenses approved had increased substantially over the past few years. In consequence, many commercial, industrial, and agricultural firms had been given the assurance that the raw materials and capital goods that they required would be made available to them.

In setting a credit ceiling as a performance criterion, the staff always tried to work within the institutional structure of the country involved, the staff representative remarked. The Cereals and Sugar Finance Corporation maintained an account with the Kenyan Treasury, and borrowing by the Corporation could be utilized to reduce the level of bank credit to the Government unless the Corporation's borrowing was monitored. The staff had opted to take a neutral position vis-à-vis the Corporation. For that reason Executive Directors would notice that in changing the ceilings the impact of the Corporation's needs was only being reflected

in the overall credit ceiling and not in the net credit to the Government. In response to the question about the growth of nonbank intermediaries, the growth of intermediation as a development objective was always welcome. However, intermediation should always be accompanied by control by the monetary authorities. For some time in Kenya some of the nonbank financial institutions had operated outside the control of the monetary authorities; that situation was changing as a result of the more stringent application of liquidity ratios, which allowed the Government to place additional resources with those institutions.

The staff shared the concern mentioned by several speakers on the exchange rate and on interest rate policies, the staff representative commented. During the forthcoming mission to Kenya both topics would be discussed with the authorities. It was hoped that by then a clearer picture of the prospective inflation rate for 1982 would have emerged. As to the desirability of having a floating exchange rate for Kenya, the authorities were insistent that for reasons of domestic confidence they wished to continue to peg the shilling to a recognizable currency or basket.

It had been the policy of the authorities to try to dispose of coffee stocks in the international market to the extent that they were able to obtain an appropriate price, the staff representative from the African Department stated. Their record in that regard had been good in the past in the sense that they had managed to dispose of important quantities of coffee in nonquota markets. The present large output reflected new plantings in 1977, when there had been a boom in the coffee market. The authorities did not expect the volume of coffee production to continue growing as it had over the past year, as there had been no further large plantings since 1977. Finally, the consumer price index was based on a survey carried out several years before, which had shown that in all income groups food accounted for the greater part of income. In the lower income groups food accounted for up to 40 per cent of all income.

The Deputy Director of the Exchange and Trade Relations Department explained that the staff believed that Kenya's present exchange rate was appropriate, although it had viewed the modest degree of appreciation that had occurred during the early part of the year with some concern. The staff welcomed the import liberalization that had been implemented so far. The publication of the import schedules and the important automatic element in those schedules were in line with the authorities' commitment to further liberalization. Obviously, much remained to be done in the external field. The export compensation scheme was still in existence and important measures of import liberalization remained to be taken. Many of those measures ought to be taken in the near future; the changes in tariff policy that would need to accompany them were under examination and were being discussed by the Kenyan authorities and the World Bank. As the country's external system was undergoing such large changes, an appropriate exchange rate regime was of fundamental importance.

There was to be another review of Kenya's stand-by arrangement quite soon, and it would focus more specifically on import policy, the Deputy Director continued. At the time of that review, Executive Directors would

also have the occasion to discuss the Article IV consultation. By then the staff would try to consider a number of matters in a medium-term context, as some speakers had requested.

The two upward adjustments in the indicative ceilings for total domestic bank credit were both temporary, the Deputy Director explained. One related to the temporary increase in food stocks, but out of K Sh 1.1 billion of additional credit that the Food Authority needed, the credit ceilings would allow for only K Sh 220 million. The staff understood that that sum would be repaid and that ceilings would, therefore, be lowered again for September 1982. The other adjustment related to the disbursement of the structural adjustment loan. Discussions on that subject with the World Bank had been rather more protracted than had been initially expected, and the disbursements would not be made until the September quarter. The indicative ceilings in the program had therefore been adjusted to meet those two factors. The staff was not proposing any further adjustments for shortfalls in foreign assistance, nor any adjustment in the credit ceilings for any further food stocks. The authorities had already taken offsetting measures by cutting back on expenditures and raising new taxes, and by higher domestic nonbank borrowing. There had been considerable pressure on government finances as a result of the foreign assistance shortfall and the increased crop financing.

The questions posed by Mr. Vidvei concerning the specification of the performance criteria were most interesting and should be discussed, although perhaps at a future time, the Deputy Director said. The question could indeed be posed as to why, if limits were imposed on various sources of government finance, they should not be specified for all. One way of doing something of the sort would be to have a performance criterion relating to a budget deficit. In the past, when there had been performance clauses relating to the overall budget deficit, it had been found to be crucially important to have suitably accurate and up-to-date data. In many cases the limit on the overall budget deficit was constructed from all the financing elements for the budget.

The staff found it useful for the purpose of internal comparisons to set out the budget position excluding grants, the Deputy Director of the Exchange and Trade Relations Department explained. That did not mean that that the budget position including grants was not a matter of interest. While the staff considered it valuable to compare the degree of domestic adjustment from country to country, it did not underestimate the significance of external grants. In Kenya, whether the grants were included or not did not make much difference in the year-to-year comparisons. The staff would try to ensure that the data for different countries would be comparable.

The staff representative from the Research Department commented that cereal producer prices in Kenya had tended over time to follow changes in the world market prices. On some occasions there had been a delay in allowing producer prices to rise to international levels, and on others, as had perhaps occurred early in 1982, the increases might have exceeded

increases in world market levels. The motive for the reduction in producer prices in 1979 had been to improve the stability of cereal supplies in the country. There had been a temporary bulge in supplies, and the authorities, in trying to overcome that problem had unintentionally contributed to a much greater fall in output than had been expected. The staff had concluded that adverse weather over two consecutive years had been the main cause of output problems and the consequent increase in cereal imports. Kenya had by and large achieved self-sufficiency in cereals and the fine-tuning of producer prices sometimes resulted in an instability that was not intended. If output increased more sharply than expected over the coming two years, the level of imports might well be lower than projected, and the excess of cereal imports justifying the compensatory drawing would have to be somewhat larger than currently estimated. The projected increase in cereal production, particularly in maize, was in any event modest, particularly for 1982/83.

Most coffee exporting countries were now facing the problem of what to do with supplies in excess of the quota that had been imposed for two years in succession, the staff representative explained. Some countries had been more successful than others in selling coffee in nonquota markets--i.e., the markets of nonmember countries of the International Coffee Agreement. Kenya had been successful in that respect, but since those markets accounted for only about 10 per cent of world coffee imports, they provided limited scope for exporters. The solution to the problem of surplus stocks would have to involve some improvement in the balance between world supply and demand. It was expected that prices would continue to improve, perhaps more sharply in the second half of the current year, and that with the improvement in prices, quotas under the International Coffee Agreement would be relaxed and the problems that many countries had been facing would be gradually relieved. It would be difficult to bring about a long-term balance between supply and demand for coffee, a crop for which brief periods of shortages in supplies and high prices tended to be followed by long periods of production surpluses and depressed prices. Finally, delays in the availability of data hampered the staff in a large number of countries. The delays in Kenya had been caused in part by a breakdown in a computer service. Perhaps the country could benefit from technical assistance.

Mr. Kabbaj, returning to the question of how grants should be treated in the budget statistics, suggested that it would be useful if in future papers, as a standard practice, the staff could present total budget figures with and without grants. When grants formed an important part of an economy, as in Kenya where they were equivalent to 2 per cent of GDP, it was important to show their influence on the budget.

Miss Le Lorier asked whether the response by the Deputy Director of the Exchange and Trade Relations Department implied that there would be no further adjustments in credit ceilings for Kenya, however justified they might appear in the future.

The Deputy Director of the Exchange and Trade Relations Department said that he found that Mr. Kabbaj's proposal was entirely reasonable. The staff would try to make the disaggregation suggested by Mr. Kabbaj in future papers. In response to Miss Le Lorier's question, there could be no further adjustment to the ceilings for June 1982. As yet, no ceilings had been recommended for September 1982.

Mr. Nana-Sinkam remarked that the budget situation was one of the major problems confronting the Kenyan authorities. In his view, therefore, the foreign assistance grants should not appear in the budget as revenue, but as a means of financing. If they were shown as revenue, the picture would be completely unrealistic.

Mr. Vidvei said that he would welcome the opportunity of discussing the consistency of performance criteria at a later date, as suggested by the Deputy Director of the Exchange and Trade Relations Department. He had not been entirely convinced by what the staff representative from the African Department had said about the way in which bank lending and the Cereals and Sugar Finance Corporation's lending to the Government had been mixed together. He found it difficult to understand the rationale for mixing the private and the public sectors in that way.

The staff representative from the African Department responded that the impact of the operations of the Cereals and Sugar Finance Corporation were difficult to foresee a year ahead, particularly because of the importance of climatic factors on grain production. The Corporation was a government agency and the problem was not so much of how closely the Government controlled it, but of how to estimate its cash needs during the season. For that reason, the staff had projected a neutral impact on the budget.

Mr. Kiingi thanked Executive Directors for the support that they had expressed for the Kenyan authorities. He would draw his authorities' attention to several of the comments made, particularly with regard to the level of producer prices and the importance attached to making interest rates positive, and including those on the exchange rate and the possibility of floating the shilling. He would also report to them the calls for further liberalization of imports, although it should be realized that they were already moving in that direction.

The Chairman remarked that the questions regarding methodology raised by Mr. Vidvei would be looked at further. Efforts would be made in future staff papers to present the budget statistics in the way suggested by Mr. Kabbaj. Executive Directors had expressed a number of concerns about Kenya's external sector--about the flexibility of the exchange rate, liberalization of the trade system, and the abolition of the export subsidization mechanism. On the domestic side, calls had been made for the authorities to pursue and perhaps to reinforce demand management measures. The importance of fiscal policy had been emphasized. It should not be forgotten that it was slippages on the fiscal side that had caused a previous Fund program to be halted. The strong recovery in budgetary control

was most commendable and would need to be continued with perseverance, and perhaps even stepped up. Clearly the fiscal sector had to be closely monitored. In fact, there should be a continuing dialogue between the Fund and the Kenyan authorities. The present discussion would provide valuable inputs for the forthcoming staff mission.

The point made by Mr. Connors that a government's pricing policy could deter production of cereals was valid, the Chairman continued. In evaluating a request for compensatory financing justified by a shortfall in cereal production, the question should be asked whether that shortfall was the result of the government's policies. He agreed that the Fund should take no automatic position with regard to government intervention in grain producer prices, but at least there should be some evaluation of the effects of such an intervention. The question would be looked into further.

The Executive Directors then approved the following decisions:

Review of Stand-By Arrangement

1. Kenya has consulted the Fund in accordance with paragraph 4(b) of the stand-by arrangement for Kenya (EBS/81/241, Supplement 2, January 12, 1982) in order to reach understandings subject to which purchases may be made by Kenya under the stand-by arrangement.

2. The letter from the Minister of Finance and the Governor of the Central Bank of Kenya, of May 28, 1982, shall be annexed to the stand-by arrangement for Kenya, and the letter of December 3, 1981, attached to the stand-by arrangement, shall be read as supplemented by the annexed letter.

3. Accordingly, the Fund finds that no further understandings are necessary on the basis of the first review of the program, and that paragraph 4(a) of the stand-by arrangement shall be amended to read:

(a) during any period in which the data at the end of the preceding period indicate that the limit on total domestic credit of the banking system or the limit on net credit by the banking system to the Government, both described in paragraph 7 of the Policy Memorandum and in paragraph 6 of the annexed letter of May 28, 1982 are not observed; or

Decision No. 7126-(82/79), adopted
June 9, 1982

Purchase Transaction - Compensatory Financing Facility

1. The Fund has received a request from the Government of Kenya for a purchase equivalent to SDR 60.375 million under the decision on compensatory financing of export fluctuations and fluctuations in the cost of cereal imports (Executive Board Decision No. 6860-(81/81), adopted May 13, 1981).

2. The Fund notes the representation of Kenya and approves the purchase in accordance with the request.

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

Decision No. 7127-(82/79), adopted
June 9, 1982

2. FUND INCOME POSITION FOR FINANCIAL YEARS 1982 AND 1983, AND POLICY ON SALES OF SDRS AND CURRENCIES IN GENERAL RESOURCES ACCOUNT

The Executive Directors considered a staff paper reviewing the Fund's income position for the financial years 1982 and 1983 (EBS/82/75, 4/29/82; and Sup. 1, 5/21/82). They also considered a proposed decision on the level of the Fund's SDR holdings over the coming 12 months (SM/82/46, Sup. 2, 6/7/82). They had before them a staff paper reviewing the policy on sales of SDRs and currencies in the General Resources Account (SM/82/46, 3/1/82; Cor. 1, 4/22/82; and Sup. 1, 5/3/82).

The Chairman made the following statement:

At the end of our Board discussion on Wednesday, June 2, 1982, I proposed a package solution which would include the following elements:

(i) The level of SDR holdings by the Fund would be reduced over the next 12 months to a level of SDR 4 billion; 1/

(ii) The net income earned during the past financial year would be placed to reserves and would contribute to the formation of the 3 per cent increase in reserves aimed at according to Rule I-6(4)(a);

(iii) Consequently the rate of charge effective May 1, 1982 would be fixed at 6.6 per cent.

1/ This would imply an average level of holdings of about SDR 4.25 billion over the financial year.

For the time being, the rate of remuneration would not be changed. But a number of Directors felt strongly that the present discrepancy between the rate of remuneration and the SDR rate should be reduced as soon as circumstances permitted it.

Furthermore, the discussion showed clearly that there was a strong desire to maintain the system of fixing yearly the rates of charges in order to build up reserves at a rate of 3 per cent a year.

But at the same time, it was also clear that in the present circumstances--where a prospective deficit follows an unforeseen surplus--the retroactive change in the rates of charge and remuneration was not favored by the majority of the Board and a desire was expressed to avoid the uneven pattern of charges which would have resulted from the strict yearly application of the present rules. The staff was asked how to achieve such an aim without disturbing the fundamental objectives of the system introduced in 1981.

To this effect, the simplest solution would be to add a further paragraph (d) to Rule I-6(4) as indicated below:

(d) If the Fund's net income for a financial year is in excess of the target amount for that year, the Executive Board may, if it does not decide to have recourse to the adjustment action under (c) above, for the purposes of the determinations and estimates referred to in (a) and (b) above in respect of the immediately subsequent financial year, decide to deem any part of the excess over the target amount that has been placed to reserve (i) as income for that subsequent financial year and (ii) as not being part of the Fund's reserves at the beginning of that year.

The following decisions are recommended for adoption by the Executive Board. Decisions I and III, to be adopted, require a 70 per cent majority of the total voting power.

Fund Income Position for Financial Years 1982 and 1983 - Proposed Decisions

The Executive Board adopts the following decisions:

- I. In order to facilitate the achievement of the objective of the 3 per cent increase in the Fund's reserves referred to in subparagraph (a) of Rule I-6(4) of the Fund's Rules and Regulations, that Rule shall be amended by the addition of the following subparagraph:

(d) If the Fund's net income for a financial year is in excess of the target amount for that year, the Executive Board may, if it does not decide to have recourse to the adjustment action under (c) above, for the purposes of the determinations and estimates referred to in (a) and (b) above in respect of the immediately subsequent financial year, decide to deem any part of the excess over the target amount that has been placed to reserve (i) as income for that subsequent financial year and (ii) as not being part of the Fund's reserves at the beginning of that year.

II. The net income for the financial year ending April 30, 1982 shall be placed in the Fund's special reserve.

III. (a) Pursuant to Rule I-6(4)(d), it is decided that for the purposes of the determinations and estimates referred to in (a) and (b) of the same Rule in respect of the financial year 1983, an amount equal to SDR 92 million that has been placed to reserve at the end of the financial year ending on April 30, 1982, shall be deemed (i) as income for the financial year ending April 30, 1983 and (ii) as not being part of the Fund's reserves at the beginning of that financial year.

(b) Pursuant to Rule I-6(4)(a), it is decided that, effective May 1, 1982, the rate of charge shall be 6.6 per cent per annum.

Mr. de Maulde remarked that although the proposed additional paragraph (d) to Rule I-6(4) would achieve the appropriate end, he had some reservations concerning the means involved. In reaching decisions on the Fund's income position, the Executive Board had to keep two goals in

view: first, to keep the rate of charge reasonable and stable; and second, and at least as important, to build up the Fund's reserves by 3 per cent a year. Although a regular increase in reserve was essential if the Fund's creditworthiness was not to be placed in jeopardy, the figure of 3 per cent did not need to be rigid. After several years of fairly substantial net income the possibility of aiming at a lower increase in reserves than 3 per cent for a subsequent year should be considered.

He had some difficulty in going along with the Chairman's suggestion that a part of the amount effectively placed into reserves should be deemed as income for the coming fiscal year, even if such a course of action could be construed as consistent with the provisions of Rule I-6(4)(b), Mr. de Maulde stated. Under Rule I there were two ways of dealing with a surplus: first, it could be distributed retroactively to those borrowers and lenders that had produced it over the course of the year; second, if a retroactive distribution was not approved by the Executive Board, it could be placed to reserves, from where it could not be distributed except to all members of the Fund. The third method now proposed by the Chairman, by which the surplus for FY 1982 would be used as a subsidy for borrowers and lenders during FY 1983, was complex and its justification was difficult to follow, particularly from the viewpoint of outside observers. If the staff's projection for the Fund's income position for FY 1983 were accurate--something that he doubted--the predicted deficit of SDR 100 million would be reduced to SDR 8 million after the surplus of SDR 92 million made in FY 1982 was deducted. If that were done, and if the rate of charge were increased as proposed, the Fund would finish FY 1983 with a surplus of SDR 25 million. In consequence, if the Chairman's proposal were followed, the Fund's reserves would amount to SDR 843 million at the end of FY 1981, SDR 843 million at the end of FY 1982, and SDR 868 million at the end of FY 1983. The staff's figures, however, seemed to show that the reserves would rise from SDR 843 million at the end of 1981 to SDR 935 million at the end of FY 1982, and would then fall to SDR 868 million at the end of FY 1983.

Since his proposal for a retroactive distribution of the Fund's surplus income made at EBM/82/75 (6/2/82) had not met with the approval of the Executive Board, and despite his doubts about the staff's forecast for the Fund's income position during FY 1983, he could go along in general terms with the proposal made by the Chairman, Mr. de Maulde said. In specific terms, however, the Chairman's objective could better be met by amending paragraph (a) of Rule I-6(4) rather than by adding an additional paragraph. The end sought by the Chairman could be met by amending paragraph (a) to read:

The rate of charge shall be determined at the beginning of each financial year on the basis of the estimated income and expense of the Fund. During the year the target amount of net income for each financial year shall be 3 per cent of the Fund's reserves at the beginning of the year or such other percentage as the Executive Board may determine.

Finally, in view of his reservations about the staff forecast for FY 1983, he would prefer to leave any decision about an upward adjustment of the rate of charge until the midyear review of the Fund's income position; nevertheless, he would not object to increasing the rate of charge to 6.6 per cent should such a move receive the broad support of the Executive Board.

The Treasurer responded that, if it followed Mr. de Maulde's proposal in not deeming the surplus for FY 1982 as income for FY 1983 and in not raising the rate of charge, the Fund would necessarily be setting a net deficit target for FY 1983.

The Director of the Legal Department noted that the figure of 3 per cent referred to in Rule I-6 related to the Fund's reserves; while it was possible to talk of zero per cent of the Fund's reserves, he found it difficult to see how it would be possible to work for a target of minus 2 per cent or minus 3 per cent of reserves. So while it would be possible to conceive of a "net income target" in negative terms, he did not see how a negative percentage could be pursued as an objective.

Mr. de Maulde remarked that he felt certain that if there were to be a deficit in FY 1983, it would not occur during the first part of that year; Executive Directors would have ample time to adjust the rate of charge and to take other steps necessary to avoid a deficit at the time of the midyear review of the Fund's income position.

Mr. Narasimham said that he could accept the Chairman's proposed paragraph (d). He would, however, suggest that in the text of the paragraph reference be made to "special reserve" rather than merely "reserve." He would make the same proposal with regard to the text of the third decision proposed by the Chairman. In listening to Mr. de Maulde's intervention, he wondered whether some of the problems could be overcome by referring to the special reserve as a "suspense account." As to the rate of charge, he wished to defer his position.

The Director of the Legal Department explained that, according to the Articles of Agreement, net income could either be distributed to the members or be placed to reserve. It was not legally possible to establish suspense accounts.

The Treasurer said that there was no problem in using the special reserve to cover any deficit in the Fund's income position. In fact, any deficit that occurred was provisionally charged to the special reserve until a final decision was taken by the Executive Board. The Executive Board had to decide what should be done with a surplus at the end of the year. Should it be placed to the special reserve as the staff recommended? Or should it be placed to the general reserve? If it were placed in the general reserve, then it would be available for distribution to all members in proportion to quota.

Mr. Laske said that he agreed with Mr. de Maulde that in reaching decisions on the Fund's income position the Executive Board had to make attempts to keep the rate of charge reasonably stable over time and to make an addition to the Fund's reserves sufficient to maintain the Fund's creditworthiness and financial strength. With those considerations in mind, he could accept the proposals made by the Chairman. He found it somewhat regrettable, however, that in the first year after establishing a method of dealing with surplus income, the Executive Board was choosing not to follow it. The reason that such a course of action had become necessary was that developments relating to the Fund's income over the fiscal year had been radically different from what had been expected. He had no objection to applying the surplus income to offset the expected deficit for FY 1983, but he had some difficulty with the proposal that, contrary to the spirit of Rule I-6(4)(a), no additions would be made to the Fund's permanent reserves. He would have preferred that a sum equivalent to 3 per cent of the Fund's total reserves be added to the Fund's general reserve, and that only the remaining portion of the surplus for FY 1982 be applied to offset the expected deficit for FY 1983.

By following that course of action, Mr. Laske continued, the rate of charge for FY 1983 would need to be raised to the point at which the Fund's estimated income for FY 1983 would be sufficient to allow a sum equivalent to 3 per cent of total Fund reserves to be added to the general reserve. More specifically, he was proposing that out of the SDR 92 million surplus made during FY 1982, SDR 25 million--the equivalent of 3 per cent of the Fund's total reserves at the beginning of FY 1982--should be added to the general reserve, bringing the level of the general reserve up to SDR 880 million. The Fund would then set an income target for FY 1983 of a sum equivalent to 3 per cent of SDR 880 million, which would be added to the general reserve at the end of FY 1983. Following that course of action would make it necessary to raise the rate of charge to a somewhat higher level than 6.6 per cent. However, he could go along with the decision proposed by the Chairman, should that be the wish of the majority of the Executive Board. Incidentally, during an earlier review of the Fund's charges in 1981 (EBM/81/3, 1/7/81), he had proposed adding an additional subparagraph to Rule I-6(4) similar to the one now proposed by the Chairman, but his proposal had not been accepted by the Executive Board at that time.

Mr. de Maulde said that he found Mr. Laske's proposal quite attractive. From an accounting and a presentational viewpoint it would be better to make the clear distinction between the general and the special reserve. Mr. Laske had remarked that his proposal might involve raising the rate of charge, but that might not prove necessary during the first part of FY 1983.

The Treasurer remarked that the Rules and Regulations required the staff to make an estimate for the Fund's income position for the year as a whole. However, should the Executive Board so require, the staff could make calculations on a half-yearly basis.

The Chairman said that the staff would make some calculations of the implications of Mr. Laske's proposal in time for the meeting of the Executive Board in the afternoon. In view of Mr. Laske's proposal, it would be useful if the staff would also present some figures on a compromise solution, which would involve splitting the portion of the surplus for FY 1982 equivalent to 3 per cent of total reserves between the general and the special reserves according to a pro rata rule. It might well be that in following that course of action it would be possible to avoid raising the rate of charge beyond 6.6 per cent.

Mr. Narasimham inquired whether splitting the 3 per cent and placing part of it in the special reserve did not go against the concept of the special reserve, which, unlike the general reserve, was supposed to be used for a very specific purpose. He found the justification for adding a part of the 3 per cent referred to in Rule I-6 to the special reserve unclear. His first reaction to Mr. Laske's suggested approach was negative.

Mr. Joyce asked the staff whether, in preparing figures concerning Mr. Laske's proposal, it could show what the rate of charge would need to be if the target income was to be equivalent to 3 per cent of total reserves at the beginning of FY 1983, and also if the target were to be 2 per cent or 1 per cent of that level. According to Rule I-6 the target figure could be less than 3 per cent.

The Chairman said that such calculations could be made.

Mr. Prowse recalled that Executive Directors had shown little enthusiasm for making a retroactive adjustment of the rate of charge and the rate of remuneration for FY 1982 because of the bookkeeping problems involved, and because of the sharp difference in the rate of charge that would then become necessary between FY 1982 and FY 1983. However, he wondered what would happen if there was once again a substantial surplus in income at the end of FY 1983. Would the Fund once again prefer to use that income as a means of offsetting possible future deficits, instead of adjusting the rate of charge? In the interest of long-term consistency, and in the spirit of Rule I-6, might it not be worth reconsidering the benefits of making retroactive adjustments?

The Executive Directors agreed to continue their discussion of the Fund's income position and level of SDR holdings in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/82/78 (6/7/82) and EBM/82/79 (6/9/82).

3. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment set forth in EBAP/82/190 (6/2/82).

Adopted June 7, 1982

4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/82/199 (6/7/82) is approved.

5. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/82/198 (6/7/82) is approved.

APPROVED: November 9, 1982

LEO VAN HOUTVEN
Secretary

