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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 82/2

10:00 a.m., January 8, 1982

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	O. Kabbaj
	C. Taylor
A. Buira	M. A. Senior
	H. G. Schneider
	A. Le Lorier
R. D. Erb	
	T. Alhaimus
	H. Suzuki, Temporary
J. C. Iarezza	
R. K. Joyce	
	J. R. Gabriel-Peña
B. Kharmawan	V. Supinit
S. Kiingi	F. Sangare
G. Laske	G. Winkelmann
	C. P. Caranicas
S. Nana-Sinkam	A. Alfidja
M. Narasimham	A. S. Jayawardena
Y. A. Nimatallah	S. El-Khouri
	T. de Vries
	B. Legarda
J. Sigurdsson	
Zhang Z.	

J. W. Lang, Jr., Acting Secretary
M. P. Blackwell, Assistant

Also Present

African Department: J. B. Zulu, Director; O. B. Makalou, Deputy Director; N. Abu-zobaa, P. A. Acquah, E. A. Calamitsis, F. d'A. Collings, S. E. Cronquist, R. E. Daumont, C. N. Egwim, C. Enweze, A. Jbili, J. M. Jimenez, B. Karlstroem, J. W. Kratz, M. Sidibe, J. D. Simpson, R. T. Stillson, D. E. Syvrud, W. B. Tshishimbi. Asian Department: T. T. Gibson, T. J. Rommel, J. Schulz, D. A. Scott. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director. External Relations Department: G. P. Newman. Legal Department: J. M. Ogoola, J. V. Surr. Research Department: L. U. Ecevit, N. M. Kaibni, P. C. Ugolini. Treasurer's Department: A. M. Al-Samarrie, A. G. Chandavarkar, D. Gupta. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Dirctors: E. A. Ajayi, S. E. Conrado, K. V. Jännäri, F. A. Tourreilles. Assistants to Executive Directors: H. Alaoui-Abdallaoui, L. Barbone, L. E. J. Coene, R. J. J. Costa, M. K. Diallo, F. Guena, Jiang H., J. M. Jones, P. Kohnert, J. E. Leimone, J. A. K. Munthali, V. K. S. Nair, J. R. Novaes de Almeida, J. Reddy, J. Schuijer, D. I. S. Shaw, J. F. Williams, A. Yasseri.

1. KENYA - REQUEST FOR STAND-BY ARRANGEMENT, AND EXCHANGE SYSTEM

The Executive Directors considered Kenya's request for a stand-by arrangement equivalent to SDR 151.5 million (EBS/81/241, 12/10/81; Cor. 1, 12/17/81; Cor. 2, 1/6/82; and Sup. 1, 1/7/82), together with a proposed decision extending Executive Board approval of exchange restrictions in Kenya (EBS/81/242, 12/10/81; and Cor. 1, 12/22/81).

The staff representative from the African Department said that he had spoken that morning with the Permanent Secretary of the Treasury in Kenya and had learned that preliminary figures for the budget during the period July to December 1981 were quite encouraging. Recurrent revenue was slightly higher than had been anticipated for the period, and recurrent expenditures were marginally lower. Development expenditure, in particular, was slightly lower than planned. The views expressed in the staff papers were borne out by the latest figures.

Mr. Kiingi made the following statement:

Since the two-year stand-by arrangement was agreed with the Fund in October 1980, the economy of Kenya has experienced some setbacks. Drought necessitated a large outlay on food imports at a time when the volume of the traditional exports of coffee, pyrethrum, and tea was at a low level. The performance of the industrial sector was also below expectations. However, at 4.2 per cent, growth in GDP was slightly higher than in 1980. Inflation remained relatively high at 10 per cent but is expected to decline to 8 per cent in 1982.

Budgetary expenditure was much higher than initially projected. Salary and wage increases for government employees of the order of 20-23 per cent and increased expenditure on defense, internal security, and education, among other items, contributed to the increase. There were overruns on the development program. The increase in revenue was marginal and the overall budget deficit far exceeded the targets set under the arrangement.

The unexpected developments in the budget resulted in the breach of the ceilings set on net bank credit to the Government and, although marginally, on actual total domestic bank credit in June 1981.

The current account of the balance of payments was under pressure, mainly as a result of increased government expenditure which led to a wider budgetary deficit. Heavy expenditure on food and oil imports, sluggish export performance, and further deterioration in the terms of trade of up to 8 per cent, reflecting inter alia a decline in coffee prices, contributed to the pressures. However, heavy capital inflows resulted in a comparatively much lower overall deficit than that recorded on current account.

The authorities agree with the staff that performance under the program has been less than satisfactory. They believe that corrective action is called for and that this will be assisted by a new one-year stand-by arrangement. Some measures have already been taken, including a 15 per cent depreciation of the Kenya shilling on September 21, 1981, following the February depreciation of 5 per cent. Import tariff adjustments have been made and steps are being taken to contain public expenditure and reduce the budgetary deficit from 10.6 per cent of GDP in 1980/81 to 7.5 per cent in 1981/82. Recurrent expenditure is being restrained by curbing recruitment into the civil service, confining wage increases to "in-grade promotions," and effecting economies on defense, education, foreign travel, and replacement of vehicles. Development expenditure has been pruned, and expenditure monitoring and control techniques have been improved with assistance from the Fund. Growth in domestic credit is forecast to slow down, while expansion is expected to favor the private sector. It is noteworthy that interest rates are now positive following increases in the deposit rates quoted by commercial banks, and increases in the lending rates to the maximum level of 14 per cent, in September 1981. Growth in net credit to the Government is expected to decline noticeably from 75 per cent in 1981 to 8 per cent this year. The program implies growth in credit to the private sector of 15 per cent compared to 10 per cent a year earlier.

The tariff adjustments made so far include the issue of new import schedules and the replacement of quantitative restrictions with tariffs. Improvement in the balance of payments in 1982 is expected. Export performance is expected to be favorable both in volume and price, especially in respect of coffee and tea, against marginal increases in imports.

The information provided by the staff in EBS/81/241, Supplement 1, shows that the authorities have recently taken further measures. Increases in producer prices of, inter alia, wheat, rice, sugar, cotton, cashew nuts, and animal products have been announced. Average retail prices of petroleum products have been increased by 19 per cent. Increases have also been effected on a number of consumer goods, which are mentioned in the supplement. Furthermore, revenue collection has picked up, and net bank credit to the Government is tentatively estimated to be on target as at the end of December.

I agree with the appraisal of the staff on pages 17 and 18 of EBS/81/241. The authorities are pursuing the right import policy strategy and taking the right measures in reducing budgetary expenditure and deficit; they are following the right credit, monetary, and interest policies; and they will limit new medium-term external debt commitments to not more than $160 million. I commend to the approval of the Board the request for a new one-year stand-by arrangement for an amount equivalent to SDR 151.5 million as set out in the proposed decision on pages 18 and 19 of the paper.

Extending his statement, Mr. Kiingi expressed the hope that Executive Directors would approve Kenya's request for an extension of approval of exchange restrictions.

Mr. Taylor stated that he could support both proposed decisions. The thrust of the proposed new stand-by arrangement seemed to be in the right direction, and the authorities deserved commendation for the series of measures they had already implemented in preparation for the arrangement. They had made significant efforts to get a grip on the economy at a time when a number of adverse trends had been noticed. Preliminary indications were that the measures they had enacted had taken hold and were working well. It was evident that the authorities were persevering with quite far-reaching administrative improvements, particularly with regard to fiscal and import policies. While the authorities were to be congratulated for those timely corrective actions, there was still cause for considerable concern about the country's long-term prospects. There were deep-rooted structural problems in the economy, but within the narrow perspective of a one-year stand-by arrangement it was difficult to come to a judgment about the scope and pace of the adjustment effort. Could the staff describe how it foresaw the economy developing after the end of the stand-by arrangement, and whether it anticipated that a further arrangement might be requested?

He would appreciate more information on how the phasing of the stand-by arrangement had been agreed, Mr. Taylor said. The schedule of purchases was heavily front-loaded, with the authorities being able to draw on as much as SDR 60 million immediately after approval. He acknowledged that the authorities had already undertaken far-reaching measures and that such an amount would have been available in the same time frame had the previous stand-by arrangement remained in operation. It seemed unusual, however, for such a substantial proportion of total resources to be made available before any performance criteria had been met. It would be unfortunate if that example were to lead to a general expectation that resources that would have been available under failed stand-by arrangements would automatically be carried over into a replacement arrangement.

He welcomed the streamlining of import policy and the September 1981 depreciation of the Kenya shilling, Mr. Taylor observed. In view of the staff's earlier doubts about the sustainability of the current account deficit beyond the short term, he would be interested to hear from the staff whether it believed that the devaluation had been sufficient to ensure a reasonable export recovery both in 1982 and over the longer term. Devaluation should improve trade competitiveness, but with the present depression in world markets and the restrictive trading agreements that affected Kenya's main export products, there might be some considerable lag before export earnings responded to the devaluation. Much would depend on the performance of nontraditional exports. Some comments by Mr. Kiingi or the staff on those points would be of interest.

Kenya's debt service ratio was not excessive, but it had been gradually rising, Mr. Taylor noted. Both the authorities and the staff seemed to feel that the debt service ratio would remain at manageable levels, but he would like to hear staff views on how the balance of payments gap that would emerge over the coming months was likely to be financed. The exchange rate was, of course, a rather sensitive issue to discuss, but he believed it should be asked whether the authorities had considered allowing the shilling to float in world markets or linking it with an adjustable peg, for example, to the SDR. Allowing the exchange rate to respond gradually to market forces might permit the authorities to implement more appropriate internal pricing policies, and might contribute to a better allocation of resources within the economy while avoiding the type of sudden impetus given by a major devaluation.

It would have been helpful if the staff could have made some quantification of the value of the import items due to be moved to nonrestricted categories during the program period, Mr. Taylor continued. Did the authorities plan to reduce the various exchange restrictions and multiple currency practices described in EBS/81/242? The controls on dividend remittances certainly seemed undesirable, even though they might have a role to play in the short term. Their removal could encourage direct investment, which could do much to strengthen the economy. Did the authorities plan to do away with the export compensation scheme? The scheme had not contributed much to export performance and had been a drain on the budget.

The authorities' renewed determination to keep the fiscal deficit to more sustainable levels deserved support, Mr. Taylor remarked. The marked deterioration in the budget position during 1980/81 had been the major immediate cause of the breakdown of the previous stand-by arrangement. The implementation of the sharp budgetary adjustment foreseen during 1982 would be crucial to the success of the new program. For that reason, he welcomed the improved expenditure monitoring techniques that had been introduced with Fund assistance, and the tighter controls over public sector wages and manpower. He wondered whether the steps taken to control departmental borrowing would be adequate. Was the staff confident that the authorities were sufficiently familiar with the new controls and had adequate resources to operate them without Fund or bilateral assistance? The authorities had given emphasis to expenditure control, but he wondered whether there might be some scope also for increasing revenues. Given the critical importance of reducing the budget deficit, he had been gratified to note the authorities' assurances that they were prepared to take further measures should there be any deviation from the targeted path. And he had been pleased to hear Mr. Kiingi's statement of the authorities' determination to exercise control over the budget position.

The authorities' departure from their traditional policy of low interest rates seemed appropriate in the circumstances, Mr. Taylor considered. The move to positive real interest rates should encourage domestic savings and should reverse the trend toward financial disintermediation and distortion in the financial system. It should also serve to strengthen the capital account, and the inflow of private transfers. Was he correct in understanding from the staff paper that a number of deposit rates remained negative in real terms? Could the staff say what proportion of lending rates in the economy were set at the maximum level, and whether there were alternative sources of finance available at reduced rates?

He hoped that the momentum toward adjustment in Kenya would be sustained, Mr. Taylor concluded. It was important that the authorities should respond promptly to any deviation from their targets. For that reason, he welcomed the provision of reviews of the stand-by arrangement in April and August 1982, and he hoped that the World Bank would be associated with those reviews. In discussing them, Executive Directors would need to pay particular attention to the appropriateness of the exchange rate, and to the evidence of further liberalization in imports and in payments.

Mr. Erb commented that Kenya's economic performance over the past year had been disappointing. Although there had been a slight improvement in the current account deficit as a proportion of GDP between 1980 and 1981, there had been a significant deterioration in many other economic indicators; for example, declines had been registered in the rate of domestic savings and of domestic investment, and the budget deficit as a proportion of GDP had increased from 8 per cent to 10.6 per cent. The disappointing results could be explained by factors beyond the authorities' control, such as the drought and external trade and price developments, but also by a number of policy deficiencies, which had been identified during the past Article IV consultation (EBM/81/118, 8/31/81). At that time several Executive Directors had expressed the hope that a stand-by arrangement could be negotiated that would encourage the policy adjustments needed to improve Kenya's balance of payments situation. The proposed stand-by arrangement before the Executive Board had several positive features and merited approval.

One of the most positive features about the stand-by arrangement was the fact that the authorities had already implemented several adjustment measures, Mr. Erb continued. Interest rates had been increased, the exchange rate had been devalued, producer prices had been increased, energy prices had been adjusted, and further steps toward import liberalization had been taken. Such measures had been necessary to demonstrate the authorities' resolve to implement an adjustment strategy, because their credibility had been undermined somewhat with the failure to meet performance criteria under the previous stand-by arrangement. Another feature of the program was the provision of two reviews during the course of the year.

A third positive feature of the program was the establishment of a monitoring and reporting system, Mr. Erb observed. In the past, despite good intentions, the authorities had found it difficult to reduce the growth of government expenditure. The steps envisaged at present for evaluating revenue and expenditure data on a monthly basis should be most valuable. The Executive Board should follow closely the progress of the Kenyan authorities in controlling government expenditures; if the efforts were successful, perhaps other countries in similar situations could benefit from the example.

There were some aspects of the stand-by arrangement that gave grounds for concern, Mr. Erb considered. First, he would have appreciated a more detailed justification of why the stand-by arrangement had been accepted under the enlarged access policy, and why such a large proportion of the proposed drawings would be provided at the beginning of the program. Like Mr. Taylor, he would be most disturbed if it was stated that the SDR 60 million that Kenya could draw on immediately should be viewed as the remaining tranches of the previous stand-by arrangement that had broken down. He had some concern about the absence of specific quantitative performance criteria; he hoped that the problem would be offset by the provision of two Executive Board reviews. On a technical matter, he wondered how government borrowing from nonbank financial institutions, which had increased recently, was treated under the credit ceilings for the Government.

He would have liked to have seen more analysis on why the rate of private investment had been lower than expected, Mr. Erb remarked. The staff had explained it in terms of relatively slow growth and relatively low demand for investment borrowing in the private sector. He wondered whether other factors might not also have been important, given the relatively low overall growth in the economy. On another point, he regretted that there had been no reduction in export subsidies. If export subsidies had been reduced at the same time as the exchange rate devaluation, the appropriateness of the magnitude of that devaluation would have been clearer. In addition, the extent of government expenditures would have dropped.

He would have appreciated more detailed information on why some types of interest rates had been raised and how the ceilings affected interest rates paid on deposits and on lending, Mr. Erb said. He was not convinced that real interest rates had been made significantly positive, because he suspected that the underlying rate of inflation was probably higher than that reflected in the official inflation index.

In its future negotiations with the Kenyan authorities he hoped that the staff would concentrate on a number of particular areas, Mr. Erb stated. He would like to see some clarification of the balance of payments objectives sought by the authorities in both a short-term and a long-term context. The staff had forecast a current account deficit of about 8 per cent of GDP in 1982. Would that be a sustainable current account position or would further adjustments then be necessary? Would the Fund be called on to provide support in a further adjustment program? In addressing the issue of balance of payments sustainability, he wondered why private investment flows had declined in recent years. Were they expected to decline further in the future? Or did the Government anticipate that steps would be taken to improve the climate for foreign investment, thereby increasing such flows?

It would be helpful if, for the coming review of the Kenyan economy, the staff could prepare a detailed statement on future debt service projections, Mr. Erb remarked. Obviously such projections were difficult to make, but they could be most helpful in giving the Executive Board some idea of the problems involved at a time when external debt and larger debt service payments were becoming evident. Looking back over Kenya's past, there had been periods of rising international coffee market prices and an improvement in the external terms of trade that had led the authorities to take decisions that had resulted in greater government expenditures. When coffee prices and other prices had returned to more normal levels, Kenya had found itself in a difficult balance of payments situation. In considering the country's future, it would be helpful if the authorities could elaborate policies that would help the country to adapt to such periodical swings in its balance of payments. One step in that direction might be to improve the management of reserves and external borrowing over time.

One way of reducing the current account deficit beyond the level projected for 1982 would be to reduce further the fiscal deficit, Mr. Erb observed. The fiscal deficit should not be allowed to crowd out investment in those sectors where investment could provide for export growth or import substitution, given the shifts in the import scheme toward tariffs and the recent change in the exchange rate. More specifically, a reduction could be made first of all in the export compensation scheme, with a view both to making a favorable impact on the budget deficit and to improving trade. It would also be helpful in considering further progress under the program to have a more detailed examination of the financial system in Kenya and, in particular, the impact of the interest rates and of the structure of financial institutions on savings and on the allocation of investments. He was not concerned about the process of disintermediation from commercial banks to private institutions, although he believed that commercial banks should charge interest rates that were related to the interest rates charged in nonbank financial institutions. He would like to know more about the interest rate regulations as they affected both the banking sector and the nonbank financial institutions. He agreed with Mr. Taylor that further steps should be taken to remove quantitative restrictions on imports. It was more important to know the significance of those items that were being shifted from the restricted to the nonrestricted list rather than simply the number of items. It would also be helpful to have a detailed description of the tariff structure that the authorities planned to use instead of import restrictions.

In continuing with their adjustment program the authorities should introduce greater flexibility into their procedures so that interest rates and domestic prices could move in step with the market, Mr. Erb concluded. They should also approach exchange rate questions with greater flexibility. It would be helpful if in future staff papers on Kenya the staff could include a chart that would show the evolution of the exchange rate and the weighted real exchange rate over time so as to give Executive Directors a broader background against which to evaluate current developments. Finally, he would be grateful if the staff could explain why grants received by the Government should not be treated as a revenue item under the budget.

Mr. Schneider remarked that since the discussion of the Article IV consultation with Kenya (EBM/81/118) the authorities had adopted a number of policies that should contribute, over the medium term, to a more balanced economic performance. Measures had been taken to redress existing imbalances and to tackle the problem areas identified in the Chairman's summing up of that discussion. He could support the request for a stand-by arrangement. Bearing in mind past experience, the authorities would have to monitor developments in the budget field carefully, because it was from that area that the major economic difficulties and the marked deviations from targets of the former two-year stand-by arrangement had sprung. The two reviews of the requested arrangement were, in consequence, quite appropriate.

The authorities were relying on reductions in expenditures to improve the fiscal imbalance, Mr. Schneider noted. Preliminary data for the present fiscal year indicated that despite some shift in actual revenues and expenditures, net bank credit to the Government was on target. The latest figures given by the staff regarding budgetary developments were welcome. He wondered, however, whether the application of additional revenue measures could have resulted in at least maintaining the revenue ratio at its 1980/81 level. In any event, the authorities' stated willingness to take further fiscal measures should present policies prove inadequate in containing the deficit was welcome.

There seemed to be no provision in the program for compensating the shortfall in the rate of growth of credit to the private sector during the period up to September 1981, Mr. Schneider observed. Might that omission not hinder the expansion of the private sector, which could normally have been expected to follow the exchange rate adjustment of September 1981? The adjustment in interest rates should halt the process of disintermediation and encourage the formation of domestic bank assets. It would be useful if the first review of the Kenyan economy could describe the effects of that adjustment, so that the Executive Board could judge more accurately the possible need of further adjustments of interest rates.

The authorities were moving in the right direction with regard to their external policies, Mr. Schneider considered. The exchange rate adjustment of September 1981 seemed to have been effective; it would be useful to observe the behavior of the real effective exchange rate over a longer period in order to see to what degree export profitability had actually been restored. Could the staff say what export effects were forecast? Presumably the export compensation scheme would need to continue so as to balance the protection afforded by the new import tariffs. Although raising tariffs was a more appropriate tool for controlling imports than imposing qualitative restrictions, the authorities would have to guard against overprotecting the domestic market, thereby diverting resources away from the export sector. That area should be closely monitored in cooperation with the World Bank, which could follow progress within the framework of the structural adjustment loan. Incidentally, he wondered to what degree tariff increases had already been accounted for in the revenue projections in the budget.

The Kenyan authorities seemed to be progressing along the road to recovery, Mr. Schneider concluded. He was gratified that the authorities had expressed their willingness to take additional measures to monitor the economic situation more closely.

Mr. de Vries commented that there seemed to be three groups of countries with Fund programs: first, countries where long-term problems were being handled with some determination--for example, India, Thailand, Turkey, and perhaps Sri Lanka; second, countries where programs had failed and where cooperation with the Fund was no longer close; and third, a large intermediate group where the authorities were taking short-term remedial measures with more or less success. Kenya seemed to be typical of that third group of countries. The Kenyan authorities had taken important steps in making adjustments to exchange rates, interest rates, import liberalization, and budget policy--particularly in the introduction of a monitoring and reporting system. The measures taken were sufficient to justify approval of the requested stand-by arrangement. However, a great number of long-term problems in Kenya remained unsolved. For example, after large increases in 1980/1981, wage levels had been frozen--an action which, against the background of a 10 per cent inflation rate, was bound to build up tension and create problems for the future. Despite the measures that had been taken, the current budget was still worse than had been anticipated and the projected deficit for 1981/1982 was larger than the deficit projected for 1980/1981. In short, even though commendable measures had been taken, there was clearly a need for additional action with regard to the budget.

Some previous speakers had questioned whether a current account deficit equivalent to 8 per cent of GDP would be sustainable, Mr. de Vries recalled. He feared that improvements in the current account situation might have been caused by the cautious import licensing policy, which might be only short-term in nature, and would not address the fundamental problems. Despite recent liberalization measures, the import system was still extremely complicated; it would be useful if some quantification of the system in value terms could be made. The existence of the import licensing system was evidence that the exchange rate was not at an appropriate level. The same could be said for the export subsidy scheme, which did not seem to be helping exports greatly and which a number of Executive Directors believed ought to be abolished. The need for changes to the exchange rate and to the overall exchange system over the longer term should be considered by the authorities.

Interest rates in Kenya had been raised, but he wondered how widely the higher interest rates would be applied, Mr. de Vries said. Monetary policy as a whole still seemed more expansive than had been hoped two years before. With regard to the phasing of disbursements under the stand-by arrangement, he agreed with previous speakers that it would be wrong to accept the principle that disbursements due under a lapsed arrangement should be made available at the beginning of a replacement arrangement. In Kenya's case, however, he could go along with the front-loading. He was rather more concerned with the final disbursement due in November 1982, because it was not clear at the outset what performance criteria would have to be met to justify it. Agreements on performance criteria affecting fiscal and budgetary policies would have to be reached before that time. In fact, he hoped that before that date a new program would be presented to the Executive Board, which would deal in a firmer way and in a longer-term perspective with the long-term, fundamental problems facing the economy.

At the conclusion of EBM/81/118 the Chairman had said that the underlying weaknesses in Kenya's external accounts were mainly the result of excessive protection, insufficient export incentives, and past expansionary fiscal policies, Mr. de Vries recalled. The Chairman had gone on to state that there were three areas--the government budget, the control of foreign exchange, and the exchange rate--that needed careful examination before a new program would be submitted. All of those areas had now been examined and measures had been taken of a short-term remedial nature. However, longer-term policies were essential if more fundamental problems were to be tackled and a sustainable balance of payments position achieved.

Mr. Sigurdsson expressed his approval of the two proposed decisions. The proposed stand-by arrangement was intended to replace the two-year stand-by arrangement that had been approved in 1980, but under which Kenya could no longer draw because of a failure to meet important performance criteria in the summer of 1981, as a result mainly of public expenditure overruns. It was important, therefore, to understand clearly the reasons for the past failure of fiscal policy and the prospects for improved fiscal performance under the new program. It was equally important to look at the proposed new program as a whole, and to judge the likelihood of its success in bringing the balance of payments toward a sustainable position.

According to the staff, the deterioration in the budget situation in FY 1980/81 had been due entirely to a sharp increase in expenditures, Mr. Sigurdsson noted. That increase could be accounted for in part by unrealistically low expenditure projections and in part by factors beyond the control of the authorities. He would appreciate some elaboration by the staff on those views. What factors had been beyond the control of the authorities? Could they be regarded as temporary in nature or would they re-emerge in 1982? Had the staff been assured that the new expenditure projections, on which the proposed program was based, were more realistic than those presented in 1980? The failure to meet the program targets in 1981 was particularly serious; according to Table 2 of EBS/81/241, the 1 per cent rise in public sector revenue in 1981 would be reversed in 1982. Could the staff give further details on those estimates? Fiscal problems for 1982 would certainly be easier to deal with if public revenues were to remain at 1981 levels in relation to GDP. It might have been helpful if the staff could have weighed the relative importance of internal and external factors in explaining the setbacks experienced by the Kenyan economy since October 1980. He would be particularly interested to hear further details on the impact of the relaxation of import restrictions and on the sluggish export performance.

Like Mr. Taylor and Mr. Erb, he had some concern about the front-loaded nature of the proposed stand-by arrangement, Mr. Sigurdsson remarked. Had the possibility been discussed of linking disbursements more closely with program reviews? Such an approach might have been worth considering given the importance of the fiscal measures that remained to be formulated and implemented. Could the staff comment on why two reviews of the arrangement had been scheduled over the coming 12 months?

He had been interested to note the introduction of a quantified undertaking for trade liberalization as a performance criterion, Mr. Sigurdsson said. The authorities had stated their intention to move 20 per cent of the restricted items (340 items in total) from the restricted to the relatively free import categories. Such an innovation was welcome, although it remained to be seen what impact the liberalization would have on the economy. He would have welcomed more information, perhaps in tabular form, explaining the extent of the intended liberalization. He would also have welcomed some explanation from the staff on the definitions it had used in setting the performance criteria for credit expansion set out in Table 3. Why were the Eurocurrency drawings that had taken place before June 30, 1981 included in the ceilings of the 1980/81 program, but not in the ceilings of the 1981/82 program?

In looking at the substance of the program, it was encouraging to note the resolute measures that the Kenyan authorities had already taken and intended to take in the field of exchange and trade policies, Mr. Sigurdsson observed. The recent devaluation of the shilling would clearly be advantageous for the competitiveness of Kenyan exports. The staff had estimated that the effective change in the real exchange rate would be about 15 per cent during 1981; could it be somewhat more explicit on the adequacy of the present exchange rate and Kenya's exchange system in the context of the present program, and the objective of moving the balance of payments toward a sustainable position over the medium term? A more explicit target for the balance of payments might have been helpful in the stand-by arrangement.

He welcomed the authorities' intention to review the need for the export compensation scheme, Mr. Sigurdsson said. He would be interested to know how well the scheme had served its purpose and whether the authorities still considered it necessary in view of the important exchange rate actions taken during 1981. It would have been helpful if the staff paper could have contained more detailed information on the rates of export subsidy under the scheme at present, and quantitative estimates of its coverage and the authorities' intentions in that regard.

The simplification of the licensing system and the gradual replacement of quantitative restrictions by tariffs and prices was welcome, Mr. Sigurdsson observed. He would have been interested to have seen a better quantitative description of tariffs. The staff had explained that tariffs had been increased for 1,700 out of 2,700 import items, but it had not said by how much, or how important tariff revenues were for the Treasury. It would be useful to take those questions up during the review of import policy that was anticipated prior to the third drawing. It was important to keep in mind the longer-term intention of the authorities to reduce tariffs and replace them by general taxes.

The authorities' fiscal policy and public sector policies on pay and employment were praiseworthy, Mr. Sigurdsson considered. It remained to be seen, however, whether the ambitious goal of restraining expenditure by almost 3 per cent of GDP could be achieved. The review of fiscal policy, which was a performance criterion for the second drawing, was of particular importance. The authorities, with technical assistance from the Fund and elsewhere, had put in place important expenditure control mechanisms, which he hoped would work well. It would be interesting to know whether there was any new information on the implementation of the fiscal adjustment program, which in many ways assumed a central place in the stand-by arrangement. He would also like to know whether revenues were slackening in relation to GDP and, if so, why.

It was encouraging to note the resolution with which interest rate policy had been approached by the authorities, Mr. Sigurdsson said. The fact that real rates of return could now be obtained on monetary assets should help to bring about a better balance in the economy, both internally and externally. To help judge the efficacy of interest rate policy, it would be helpful to know how interest income and payments were treated under Kenyan tax laws.

In many ways Kenya's proposed program was promising, Mr. Sigurdsson concluded. Imbalances in the economy were being dealt with on a broad front, and the authorities had shown resolution in taking action on a wide range of economic policies. Important adjustment measures had already been taken in the field of exchange and trade policies and interest rate policy. Some of the program's elements were, however, still only in the form of good intentions; for example, in the field of fiscal policy. However, even in that field some encouraging signs could be seen, as the staff representative's opening comments had made clear. On the whole, Kenya's program ought to have a reasonable chance of success in reducing the balance of payments deficit, slowing down inflation, and thus improving the basis for future economic growth.

Miss Le Lorier expressed her support for the proposed stand-by arrangement, the basic objectives of which seemed entirely appropriate. She had been struck by the fact that imports were expected to increase by only 1 per cent in 1982 following a decrease of 6.5 per cent in 1981. She wondered whether the import liberalization process might not encourage a faster rate of growth of imports than expected. It had, after all, been deemed necessary to raise a Eurocurrency loan in order to provide a safety margin as the more open import system came into effect. Some staff comments on that would be welcome.

The staff seemed to have abandoned the practice of defining ceilings in terms of bands with lower and upper limits, Miss Le Lorier remarked. Although that practice had arisen following difficulties in some cases of obtaining sufficient data to specify precise performance criteria, it had some general advantages, particularly when attaining the lower limit triggered an early dialogue between the Fund and the authorities. Might it not have been useful to have used the band concept for Kenya as well as other countries, keeping in mind of course that the upper limit should be consistent with the pace of adjustment considered necessary?

The target for the fiscal deficit in 1981/82 as a percentage of GDP had been revised upward from the previous program to 7.5 per cent, Miss Le Lorier noted. Since the deficit had reached 10.6 per cent of GDP in 1980/81, retaining the earlier target of 5.5 per cent would not have been realistic. However, in 1979/80 the central government deficit had been equivalent to 8 per cent of GDP, and it might have been tempting in theory to set a target rather less ambitious than 7.5 per cent for 1981/82. Perhaps the staff could explain how the targets had been set. Presumably it was always a matter of judgment to assess whether the pace of adjustment should be tightened or lengthened in response to external shocks or internal slippages. It would be interesting to know what criteria were used in determining the pace of adjustment in Kenya.

She did not share the concerns expressed by some speakers with regard to the front-loaded nature of the disbursements, Miss Le Lorier stated. Making a large part of total resources available at the beginning of the program was not the result of the failure of the previous program, but a recognition of the significant adjustment efforts being made by the authorities, which required a timely and adequate amount of Fund financial support. In Kenya, the initial purchase of SDR 60 million was intended to provide sufficient foreign exchange to support the trade liberalization effort. Front-loading should not be ruled out simply because the new program replaced a previous one. Front-loading should be granted whenever the circumstances facing the country and the adjustment measures to be undertaken made it seem appropriate.

Mr. Narasimham expressed his support for the two proposed decisions. The staff papers described clearly the economic circumstances that had led to the cancellation of the previous stand-by arrangement and its replacement by the proposed program before the Executive Board. The Kenyan authorities had implemented a number of positive decisions over the past few months, and the new stand-by arrangement was likely to be more effective than its predecessor. Like Miss Le Lorier he could go along with the proposed phasing.

Since fiscal policy and performance had led to problems earlier, it was appropriate that the emphasis in the new program should be on means of improving fiscal performance, Mr. Narasimham remarked. He complimented the authorities for instituting a system of monitoring expenditures but he was somewhat concerned that similar attention had not been given to means of improving resource mobilization and revenues. Could the staff comment on how elastic domestic resource mobilization was in relation to GDP growth?

The staff had explained that in nominal terms development expenditure in 1981/82 at K Sh 6.1 billion would be marginally less than expenditure of K Sh 6.25 billion in 1980/81, Mr. Narasimham noted. Recurring expenditure, however, was expected to be somewhat higher in real terms. While in the short term some cuts might be necessary, he hoped that it would be possible for Kenya to return to increasing development expenditures in the framework of an appropriate long-term adjustment program. In considering the economy in the period beyond the present program, it would be interesting to know more about the proposed structural adjustment loan from the World Bank . He wondered to what extent the staffs of the World Bank and the Fund had been collaborating in Kenya. Many of Kenya's present external prolems were related to energy, nd he would be interested in the staff's comments on what plans the authorities had for energy conservation and for the development of domestic energy substitutes.

In discussing interest rate policy, the staff had referred to the increase in bank interest rates as a means of helping to arrest the disintermediation into nonbank financial intermediaries, Mr. Narasimham noted. While understanding the measure from the viewpoint of efficiency of monetary policy, he wondered whether the authorities had not been trying to promote savings. If so, did it matter much whether the savings were mobilized in banking institutions or in nonbanking financial institutions, particularly if the two types of institutions were governed broadly by the same regulations and deployed their resources according to the same national economic priorities. In short, he was not convinced that an increase in bank interest rates was necessary merely to stop the disintermediation into nonbank financial intermediaries. The staff had also made some references to the need to adjustment interest rates in Kenya to improve the capital account of the balance of payments. However, in an economy such as that of Kenya, where there were few short-term capital movements, he wondered whether the interest rate differential between Kenya and other countries would have a meaningful effect on short-term capital movements, and in what way it would affect the external account.

Mr. Kabbaj expressed support for the proposed decision and for the Kenyan authorities' program for 1981/82. The program accompanying the former two-year stand-by arrangement had not led to the results that the Fund and the authorities had expected, largely because of exogenous factors beyond the control of the authorities--such as the drought and a deterioration in the terms of trade, but also because of some hesitant financial policy. Regional disturbances had resulted in an escalation of defense and internal security expenditures and, thus, in a substantial widening of the overall budget deficit, which had risen to 10.6 per cent of GDP instead of the 6 per cent targeted in the two-year stand-by arrangement. Expenditures had also been swollen by the absence of an efficient system of expenditure controls.

Although the performance under the previous program had been unsatisfactory, Mr. Kabbaj continued, the authorities had expressed their willingness to pursue corrective actions in cooperation with the Fund, and had adopted a concise program aimed at reducing domestic and external imbalances through a set of courageous measures, a part of which had already been implemented. The 15 per cent depreciation of the exchange rate in terms of the SDR and the simplification of the import licensing system should have a favorable impact on the trade balance in 1981/82. He welcomed the more cautious fiscal policy, and particularly the proposed monitoring system aimed at reducing the volume of expenditures mainly through a more restrained employment and wage policy. The authorities should also be commended for their monetary policy and the resulting positive real interest rates, and for the substantial price increases agreed at both producer and consumer levels.

Could the staff say what impact the increase in financing through the banking system would have on the stabilization program, and what measures the authorities intended to adopt in that area, Mr. Kabbaj inquired? Could it also say what percentage of total imports would be shifted from restricted to free categories of imports before the end of 1981/82?

Mr. Buira said that it was evident that the Kenyan authorities were determined to improve the present financial and economic situation of their country. Like many developing countries, Kenya had been faced with a weak balance of payments and slow economic growth, which, to a large extent, reflected factors beyond the authorities' control--such as the worsening of the terms of trade following the energy price increases, and the two years of severe drought. The proposed program seemed adequate to address Kenya's problems, and should result in an improvement in growth performance and in the balance of payments over the medium term. The authorities' commitment to adjustment was made clear in the significant policy measures that had already been put into place, notably the reforms of the exchange and trade system that would do much to improve the allocation of resources. Like Miss Le Lorier, he saw the particular phasing of disbursements under the stand-by arrangement as an essential support for the substantial liberalization in the trade system. Considering the low level of Kenya's reserves, the program could not be successful without significant front-loading.

The level of interest rates had been raised significantly over the past 18 months and they were now positive in real terms, Mr. Buira continued. The recent price adjustments, including those for petroleum products, would help to improve the allocation of resources. It should not be forgotten that however determined the authorities' strategy might be, it could be pushed off track if the demand for Kenya's exports remained low following a failure of the industrial countries to climb out of the present recession.

Kenya had faced a growing fiscal disequilibrium in budgetary policies in 1980/81 and had failed to meet the targets of its previous Fund-supported program, Mr. Buira remarked. It would not be easy to correct the budgetary imbalance implicit in the present program in view of the mixed record of expenditure control and of the serious problems faced in the past. He had been impressed, however, by the new system of monitoring government revenues and expenditures, and the improved expenditure control that would facilitate the authorities' efforts to meet their budgetary objectives. The seriousness of their commitment in that area was underlined by the fact that contingency measures were already being prepared and would be implemented if budgetary policy threatened to go off track. It was heartening to note that early results in the current fiscal year indicated that budgetary policy was progressing satisfactorily. He attached special importance to the first Executive Board review of the Kenyan program in or before April 1982, which would allow the authorities and the Fund to review progress made in implementing the financial program. He believed that the program contained more than sufficient safeguards to guarantee that budgetary policy would evolve according to expectations.

Looking ahead, Mr. Buira continued, some of Kenya's problems were so deep that it might be necessary to follow the present program with another. He could fully support both Kenya's request for a stand-by arrangement and the proposed decision regarding the exchange restrictions.

Mr. Joyce said that he could support the proposed program and the extension of the approval of exchange restrictions. The program constituted a resonable attempt to begin the process of getting the Kenyan economy back on track. He was happy to note the new determination of the authorities and their commitment to introduce the measures necessary to achieve success. He particularly welcomed the steps they had already taken; they had devalued the exchange rate, raised interest rates, and taken steps to move away from a quantitative control on imports to a more tariff-oriented system. The authorities had also announced increases in producer prices and in some consumer prices, and had instituted a new expenditure monitoring arrangement. The success of all those measures would be crucial to the outcome of the overall program.

He shared the concern of some other speakers about the significant front-loading of disbursements within the arrangement, Mr. Joyce said. He acknowledged that front-loading could sometimes be appropriate, but he would like to know why such a large proportion of the total resources available to Kenya could be drawn immediately upon approval rather than, say, after the first review in April 1982. It had been argued that the front-loading was necessary in order to facilitate the implementation of the import liberalization program. However, he had understood that that purpose would be met by the recent Eurocurrency borrowing. He would appreciate some additional information on that point.

Welcome as the exchange rate changes had been, Mr. Joyce continued, he wondered whether they were adequate and, if not, how promptly the authorities would devalue again. He wondered how rapidly the effects of the exchange rate depreciation would be felt on exports. Might they be felt more rapidly in the nontraditional export sector than in the traditional sector? Unfortunately, export prospects for Kenya depended heavily upon a forecast increase in coffee prices and in the volume of coffee exports.

The increase in interest rates had been a significant step, particularly given the past views of the authorities on the need to maintain low interest rates, above all in the agricultural sector, Mr. Joyce observed. Could the staff say whether all interest rates were now positive, and whether any understandings had been reached concerning future flexibility in that area. As to fiscal policy, the target of reducing the budget deficit to 7.5 per cent of GDP over the coming year was ambitious, particularly since reliance was being placed almost exclusively on a reduction of expenditures and, therefore, upon the adequacy of the new expenditure control mechanism. He welcomed the authorities' commitment to take further action on fiscal policy should that prove necessary, and noted that the staff had discussed relevant measures with the authorities. Could the staff reveal what further measures were likely to be taken? Would they be concentrated on the expenditure side? Or would new measures be designed to raise additional revenues?

The proposed program seemed an appropriate means of resolving some of the short-term problems that Kenya faced, Mr. Joyce commented. However, it was the country's medium-term and long-term problems that gave the most cause for concern. The authorities should consider how sustainable the projected balance of payments deficit would be at the end of the program, and should recognize the need to overcome the economy's vulnerability arising from its high dependence upon certain traditional exports. It would have been helpful to the Executive Board, as it considered long-term questions, if more information could have been provided on the investment program. He hoped that at the first review of the stand-by arrangement Executive Directors would be able to discuss prospects for the postprogram period and what measures could be taken to improve them.

Mr. Nana-Sinkam expressed his support for the proposed program. Both the staff and Mr. Kiingi had suggested that inflation at 10 per cent was too high. In his view, the authorities should not consider that rate exceptionally high, particularly when it was compared with inflation rates in other countries in Africa. Obviously that did not mean that efforts should not be taken to bring the rate down, but merely that the authorities should feel pleased at the progress that they had already made.

The main problem facing the authorities was one of controlling expenditures, Mr. Nana-Sinkam noted. He hoped that increased expenditures over the past few years had not been for equipment; if that were the case, there were likely to be recurrent expenditures in the future that would have a large impact on the budget. It was also of concern that the increasing budget deficit had occurred at a time when development expenditures had been falling, and he hoped that they would increase soon.

A number of factors underlying Kenya's recent problems had been beyond the control of the country's authorities, Mr. Nana-Sinkam considered. There had been a deterioration in the terms of trade following increases in prices of food and oil imports, and there had been significant wage increases, offset in part by increasing prices to producers, and in some cases to consumers. If the present program were properly implemented, it would go a long way to help solve the major difficulties facing the authorities. He was glad that many measures had already been implemented and that the authorities were showing serious determination to strengthen the country's economy.

He could go along with the element of front-loading in the program, particularly since the authorities had already taken many measures before coming to the Fund for assistance, Mr. Nana-Sinkam said. The major part of the available resources would be needed at the time when the program measures were being implemented. In particular, foreign exchange was required to implement the import liberalization scheme. He had been happy to note that the Kenyan program would be reviewed on two occasions during the course of the year. It was possible that the failure of some stabilization programs in the African countries had resulted from delays in reviewing progress that was being made. If a program was reviewed only eight months or one year after its inception, it might then be too late to recommend policy changes. He realized that more frequent reviews implied a possible need for more staff--a problem that would have to be discussed when the Fund's administrative budget was reviewed.

Could the staff explain what impact the recent devaluation had had in the financial and budget fields? Mr. Nana-Sinkam inquired. He had been surprised to note that, despite the devaluation, there had only been a very small reduction in imports and that there had been no reduction in export subsidies. It was difficult to see, therefore, what purpose the devaluation had served. In conclusion, the objective of reducing the budget deficit from over 10 per cent to 7.5 per cent represented a great challenge to the authorities; he hoped that they would be successful in achieving it. He welcomed the authorities' assurance that they would take further measures should their present policies prove inadequate. In his view, the proposed stand-by program offered promise for the future.

Mr. Caranicas commented that approving the proposed stand-by arrangement would be equivalent to reopening the previous arrangement that had been interrupted because of nonobservance of two performance criteria. During the first year of the past stand-by arrangement, the budget deficit had risen from 8 per cent of GDP to 10.6 per cent instead of declining to 6 per cent as had been planned. Moreover, the current account deficit of the balance of payments had deteriorated more extensively than envisaged. In addition, net bank lending to the public sector had grown by 83 per cent instead of an envisaged 38 per cent. The main reasons for those developments had been the further worsening of Kenya's terms of trade, the drought conditions that had compelled the Government to import grains, the inordinately large wage increases in the public sector, the substantial increases in defense spending, the slow pace of opening up the economy, the unrealistic exchange rate policy, and the lack of control in some government spending agencies.

In support of its new program, the authorities had already devalued the shilling, had imposed a wage freeze on government employees, had raised interest rates substantially, and had liberalized the trade sector, Mr. Caranicas noted. According to the staff, the principal reason for the unexpectedly large budget deficit in 1980/81 had been substantial expenditure overruns partly due to inefficient expenditure control. While he welcomed the planned reduction of the budget deficit to 7.5 per cent of GDP, he was somewhat concerned that total government expenditure was growing rather faster than expected. The latest information given by the staff representative at the beginning of the meeting had been reassuring on that question, but he urged the authorities to increase their vigilance. It would be interesting to know how appropriate the present income tax system was, and what the likely effect of the liberalization of imports would be on tariff revenues. The seasonal pattern of tax collection at the moment did not seem consistent with a smooth conduct of monetary policy. He welcomed the decision to make the liberalization of imports a performance criterion under the stand-by arrangement. Any comments by the staff on the adequacy of the present exchange rate of the shilling, since its latest devaluation would be useful. Another question on which staff views might be helpful concerned the credit ceilings. What elements would the staff be taking into consideration in the coming months as they looked for an understanding with the Kenyan authorities on ceilings relating to total domestic bank credit and to net bank credit to the Government?

In hearing about the measures that had been taken to increase producer prices in Kenya, he had wondered about the future of agricultural exports, Mr. Caranicas said. It was well known that Kenya had great agricultural potential and could grow crops in both tropical and temperate zones. Perhaps greater emphasis should be given to agricultural development, not only as a means of boosting exports, but also as a means of helping to solve the problems caused by the influx of rural dwellers into the urban areas. The export markets of the countries in the former East African Community were important to Kenya, and he wondered what the prospects were for sending an increasing share of Kenya's exports to them, particularly in view of the recent decline in nontraditional exports and of the devaluation. The Kenyan authorities had in the past stated their intention of taking export-oriented measures, were they the measures referred to by Mr. Kiingi in his statement? The Executive Board should undertake a thorough analysis of Kenya's exports and imports at the time of the second review of the stand-by arrangement. He hoped that the authorities would be able to achieve significant success under the present stand-by arrangement by the time of the first review. Finally, he supported both proposed decisions.

Mr. Winkelmann recalled that the previous two-year stand-by arrangement had gone off track and had been canceled. The proposed new stand-by arrangement fitted into the authorities' overall development program and represented some shift in their policies. Kenya's main problems were structural in nature. After more than ten years of reasonable growth rates, the terms of trade had shifted against Kenya, and the future had become less promising as external problems were exacerbated by domestic problems, such as the continuing high rate of population growth. Fortunately, however, the authorities seemed to be taking a vigorous approach to their problems and for that reason he could support the request for a stand-by arrangement. In fact, the program proposed by the authorities would address some of the structural problems; in particular, it was designed to promote exports and liberalize imports.

He was pleased that, unusually, two reviews were planned during the course of the arrangement, Mr. Winkelmann said. Such reviews would help both the authorities and the Fund to monitor the progress that was being made. The authorities had already taken one large step to bring the economy back on course by devaluing the shilling. Perhaps the authorities had been overcautious, however, in failing to reduce export subsidies at the time of the devaluation. Reducing or doing away with the subsidies would have strengthened the economy by reducing pressures on the government budget. The decision to liberalize the import system by moving away from a quantitative to a tariff system was certainly a step in the right direction, and would lead to a better allocation of resources. The authorities planned to use the first drawing under the stand-by arrangement to facilitate the implementation of import liberalization. However, since the level of imports was not envisaged to increase over the coming year, he wondered why such a large proportion of the available resources should be open for drawing at the outset of the program.

He hoped that the authorities would be able to meet their fiscal objectives, Mr. Winkelmann continued. If the budget deficit widened, the authorities would be forced to resort to additional bank financing, and the program would come off track once again. Could the staff say whether the authorities could stay within their limits on borrowing from banks and borrowing from abroad, but still receive financing from nonbanking institutions that might borrow on foreign markets? With regard to the nonbanking institutions, he wondered whether the authorities had to pay higher interest rates to them than to the banks. If that were the case, did the nonbanking institutions attract more money from within the country or from abroad?

It seemed that the authorities' estimates for grants in the balance of payments statistics were rather high, Mr. Winkelmann commented. If, as seemed quite likely, grants did not reach the level envisaged, how far could they be compensated by private investment flows? It seemed that the climate for such flows might be more attractive as the authorities liberalized the economy.

It was not yet clear whether the price increases in Kenya over the past quarter of 1981 had been sufficient, or whether further incentives for increased profit in certain sectors of the economy might be necessary, Mr. Winkelmann observed. Debt service was still relatively low in relation to exports and was sustainable, but might become a problem in the future if the authorities continued to increase their reliance on external financing. The overall rate of economic growth was expected to decline and domestic expenditure for the development program would not increase in nominal terms in the coming year. Such a decrease in real terms would increase pressures for increases in development expenditure in the future. Should the authorities decide to finance those needs from external sources, debt servicing problems could be exacerbated. It was obviously necessary for the overall situation to be closely monitored.

The staff had mentioned the problem of an insufficient domestic savings rate, Mr. Winkelmann noted. That problem should be eased by the higher interest rates in the banking sector and by the reduction in the budget deficit. On the whole, the program was pointing the economy in the right direction. It was particularly encouraging that the authorities were so willing to discuss the country's problems with the staff and had committed themselves to taking action should developments with the budget deficit or the exchange rate seem to require it. The authorities obviously seemed determined to bring a better balance to the economy in the hope of building long-term economic strength.

Mr. El-Khouri expressed his support for both proposed decisions. The Kenyan authorities had taken a number of important and courageous measures, for which they deserved commendation. With regard to the phasing of disbursements, he believed that front-loading should be discussed on the merits of each stand-by arrangement and not be subject to a general rule. The first question that needed to be asked was whether a country had an urgent need for foreign exchange. If that were the case, there was clearly some justification for front-loading. Another element in the decision, however, was the relative weight of the adjustment measures that had already been undertaken vis-à-vis those that would be taken in the future. In Kenya's case the impact of the import liberalization measures already taken had to be weighed against that of the measures to be taken before June 1982. Did the measures taken in November 1981 warrant a rapid inflow of foreign exchange resources from the Fund?

Kenya's export compensation scheme had been introduced in 1975 and intensified in 1979, Mr. El-Khouri recalled. Both in 1980 and after the recent devaluation the authorities had stated their intention of reviewing the scheme. The general consensus in the Executive Board seemed to be that the scheme was inefficient, and he wondered how the authorities themselves viewed it; some comments from the staff would be appreciated. He also wondered whether the staff could give further details on the type of fiscal measures that the authorities had said they were ready to take in the future should their present policies prove inadequate.

His main question to the staff concerned the credit ceilings, Mr. El-Khouri continued. According to Table 3 on page 8 of EBS/81/241, net bank credit to the Government would be allowed to expand during the seven-month period between June 1981 and the end of January 1982 by about K Sh 2.4 billion. That expansion seemed to be far greater than comparable periods in the past. In Table 5 on page 11 of the same paper it was evident that according to the program, net bank credit to the Government between June 1981 and December 1981 was to rise by only K Sh 1.3 billion. Did that mean that the credit would expand by over K Sh 1 billion in January 1982?

Mr. Legarda said that he supported both proposed decisions. After the sharp deterioration in Kenya's budgetary position in 1980/81, due in part to inadequate expenditure control in the balance of payments, the authorities had taken a number of measures to correct the underlying imbalances, including a depreciation of the Kenya shilling, an upward adjustment of domestic interest rates, and a courageous reduction in government expenditures in the 1981/82 budget. He welcomed all of those policy changes.

The authorities had promised that 20 per cent of all import items in the restricted categories would be shifted to the category of free imports before June 30, 1982, Mr. Legarda noted. That plan appeared consistent with the medium-term balance of payments strategy that was oriented to a more open trade system, which would eliminate the biases in the present system that tended to slow down exports. Much remained to be done, but the first measures taken had been decisive, specific, and courageous. The fact that so many measures had already been taken and that there was an urgent need for foreign exchange justified the front-loading of disbursements. In that context, he agreed with Miss Le Lorier and Mr. Buira. With regard to interest rates, he agreed with Mr. Narasimham; there was no particular merit in distinguishing between savings in banks and in nonbanks. There was no convincing evidence that short-term foreign exchange flows were going to be affected by interest rate changes; nevertheless, the changes that had been made were welcome. He could not go along with some Directors, who had argued that interest rates should be positive in all categories. He agreed with Mr. Nana-Sinkam that an inflation rate of 10 per cent could not be considered excessively high; many developed countries would like to bring their inflation rates to that level.

Kenya's debt service ratio seemed sustainable, Mr. Legarda continued. In fact, it was neither on the high side nor on the low side and reflected Kenya's position in what Mr. de Vries had described as the middle group of countries receiving Fund assistance. In some senses, there had been an air of unreality in some of the present discussion. Some speakers seemed to consider that the Kenyan authorities were in complete control of all that happened in their country's economy. The remarks made by some Executive Directors that the Kenyan authorities should better regulate their "boom and bust" cycles and should implement more long-term programs should perhaps be more properly addressed to the larger economies' influence on world trade. If the Kenyan authorities' responses were more short term in nature, it was surely because the challenges the country faced were often short term, unpredictable, and sporadic. While the country was being forced to reduce its development spending, it was difficult for it to undertake long-term adjustment. While there was obviously room for deficiencies in demand management to be made up, some supply-oriented adjustment would also be necessary to address long-term problems. In looking at Kenya's future, he wondered what percentage of the world market Kenya held for its main export crops of tea and coffee. Could the staff give some price trends for those commodities? What were the projections for future prices? What taxes were placed on tea and coffee in the importing countries? In simple terms, how could the difference be explained between the price for coffee received by the producer and the price paid for coffee by a consumer in a different country?

Mr. Kharmawan remarked that the proposed stand-by arrangement with Kenya was different in some respects from most other arrangements. The arrangement had been designed to replace a previous two year stand-by arrangement that had lapsed. He believed that it was appropriate that the new arrangement should be for one year only, but hoped that after the period, should the need still be there, a further one-year arrangement could be agreed. It seemed likely that over the medium term, there might well be a need for continuing external assistance from the Fund.

One unusual characteristic about the stand-by arrangement was the provision of two reviews during a 12-month period, Mr. Kharmawan remarked. Could the staff explain why it had considered two reviews necessary? Did not the performance criteria provide the Fund with sufficient guarantees? If those criteria were not met, the country would not be able to make further drawings. Another new feature was the inclusion of a performance criterion related to import liberalization. Could the staff explain its reasons for devising such a criterion? While he supported freeing imports from restrictions and licensing, the performance criterion in the program seemed to call for a move away from import substitution to exports. If that were the case, for what reason was such an objective being pursued? It seemed that the level of imports in 1981 would have decreased and that they would only increase by a marginal amount over 1982. However, he believed that generally imports were liberalized so that their volume would increase for the benefit of economic growth. In that connection, he shared Mr. Narasimham's concern about the lack of growth. Why was the staff anxious that imports should be liberalized, if there was no reflection of the liberalization in the import figures? Lack of import growth gave grounds for concern, because all developing countries needed imports in order to promote economic growth. In devising a performance criterion related to import liberalization, had the staff envisaged that it would strengthen the balance of payments performance, or the country's reserve position? If that were the case might it not have been better to have resorted to a performance criterion relating to the balance of payments test? He hoped that the performance criterion accepted by Kenya would not be used as a precedent for other countries coming to the Fund.

Did the inclusion of two review clauses display some lack of confidence in the commitments made by the authorities? Mr. Kharmawan inquired. If that were the case, might it not have been more appropriate to have insisted on additional preconditions rather than two review clauses? Finally, he could support both proposed decisions.

The staff representative from the African Department recalled that several Executive Directors had referred to Kenya's unsatisfactory fiscal performance over the past year and had wondered whether the improvements forecast for the coming year would be realized. The Kenyan authorities had been shocked at the results of their fiscal policy in 1980/81 and had promptly reacted on several fronts. They had requested technical assistance from the Fund in building up a monitoring system that could identify main expenditure and revenue trends on a monthly basis. Three or four highly qualified accountants in the Treasury had been given the sole responsibility of overseeing the monitoring procedure and had been asked to report directly to the Permanent Secretary and to the Minister of Finance. Those accountants had monthly meetings with the Chief Accountants of all the spending ministries, reviewing the figures as they became available. If the need arose to reconsider policy on expenditure plans and targets, the question was then taken up directly by the Minister of Finance. The system had worked well, primarily because the authorities were committed to it as an essential feature of their fiscal policy. The Permanent Secretary of the Ministry of Finance had stated that he wished the system to continue and to be improved in conjunction with further technical assistance from the Fund. It was expected that a Fund technical assistance mission would go to Kenya in March or April 1982.

The staff had confidence in the effectiveness of the monitoring system, the staff representative stated. It was encouraging to note that government revenues for July-December 1981 had been about 13 per cent higher than in the corresponding period of the previous year. Progress was also being made on the expenditure side. The spending ministries had been instructed to limit spending to the appropriation set out in the budget and had been told that any excess expenditures could only be made after careful scrutiny by the Vice President. The President of the country had often stated in public speeches that expenditure limits would have to be respected, and had given his personal support to the monitoring system.

The authorities had shelved a number of expenditure projects, had cut back on others, and had stretched others over a longer time period, the staff representative continued. The staff had made detailed projections of expenditure and revenue trends for the year as a whole in order to be able to evaluate the monthly figures. The staff had also studied revenue and expenditure flows by season in previous years and had mapped out likely revenue and expenditure patterns for the year ahead.

The staff had identified a number of measures that the authorities could take should revenue performance prove inadequate over the coming year, the staff representative acknowledged. He would be hesitant, however, to disclose their exact nature, because the authorities felt such questions to be extremely sensitive in nature. He could reveal, however, that they were prepared to review the export compensation scheme, which a number of speakers had criticized during the present discussion. The staff had indicated to the authorities its opinion that the abolition of the scheme could do much to strengthen the budget and other areas of the Kenyan economy. The staff had also discussed with the authorities three or four revenue measures that could be implemented in the event that the fiscal accounts got off track. The authorities had committed themselves to take such measures by the end of February 1982, should they find that the fiscal accounts were not developing as projected. As to the elasticity of revenue in relation to GNP, two Fund technical assistance missions had visited Kenya to discuss modifications and improvements to the tax system. Some but not all of the recommendations had been taken; for example, there were still some measures that could be introduced in order to raise the rather low elasticity of the tax system.

The ratio of revenue to GNP would increase slightly in 1981 and then decline somewhat in 1982, the staff representative commented. The rise in 1981 could be explained by the revenue measures taken in the budget in June 1981, and primarily by the increases in tariffs. The staff estimated that import tariffs constituted about 40 per cent of total revenue. The little change in value of imports forecast for 1982 explained the lower revenue/GDP ratio for that year. The staff felt that expenditure projections for 1981/82 were more realistic than the initial projections for 1981. Obviously, the only way to make a thoroughly accurate assessment would be to assess each component of the budget, which of course the staff had not attempted to do. Many of the external factors that had caused the budget overruns in 1981 would not be repeated. The importation of food, particularly maize, and the salary increases of 25-30 per cent would not recur during 1982. The large adjustment in 1981 had been designed not only to allow public sector salaries to recover previous real levels, but also to establish adequate levels of salaries for the public sector, with no need for salary adjustments during 1982 or 1983. Another cause of expenditure overruns during 1981 had been high military expenditure. The increase in military spending for 1982 would be much more modest; it had been carefully scrutinized and was unlikely to be exceeded.

The shilling had been devalued in nominal terms by 20 per cent in 1981, the staff representative indicated. Taking trade weights and deflated differential inflation rates into account, the real depreciation was equivalent to about 15 per cent. That figure coincided with a recommendation made by the staff at the conclusion of the study made in 1980, at the request of the Kenyan authorities, of what the needed adjustment should be. At present the exchange rate seemed adequate, but as the import system was further liberalized, the exchange rate would have to be looked at again and perhaps modified. The staff believed that the Export Compensation Scheme should be abolished, regardless of the exchange rate level. The Export Compensation Scheme, which had been in place for a number of years, had been modified in 1980 when the premium paid to exporters who benefited from it had been increased from 10 per cent to 20 per cent. The scheme covered nontraditional exports, which composed 15-20 per cent of total exports. If the scheme were to be abolished, an export incentive would be removed from some exporters only, as there were signs that it was not as widely used as the authorities had wanted it to be. It was used by some large firms, which knew how to handle the bureaucracy and take advantage of it. The abolition of the scheme would, therefore, affect a number of large exporters, but would not adversely affect the medium-sized exporters or potential exporters that were not benefiting from the scheme at the moment. For that reason, even without an Export Compensation Scheme Kenya's exchange rate could be considered adequate for the moment.

Continuing, the staff representative explained that the staff had discussed possible alternative exchange systems, such as floating the currency or adjusting it with a moving peg. Although the authorities saw some advantage in such other systems, a reform of the present system would require changes in the central bank law and some other institutional changes. However, the authorities were committed to review the adequacy of the exchange rate and to change it by discrete steps if necessary, and they would perhaps make a more radical reform of the exchange system in the future.

The current account deficit projected for 1982 would be equivalent to about 8 per cent of GNP, compared to 10 per cent in 1981 and 13 per cent in 1980, the staff representative noted. It was difficult to project the current account deficit for 1982, particularly because of the introduction of the new import licensing system. The outcome would depend on how liberally imports were treated, how the system was managed, and how the flow of imports was affected. Looking at the deficit as a percentage of GDP over the period 1971 to 1979, and excluding the two years--1977 and 1978--when the country had benefited from the coffee boom, the average deficit had been equivalent to about 6.5 per cent of GDP, which could be taken as an indicator of a sustainable deficit. As to which deficit level the country could finance over the coming years, given the present state of capital flows, the staff's view was that, should a new stand-by agreement be arranged for Kenya, efforts should be made to reduce the deficit to between 6 per cent and 7 per cent of GDP. At present, Kenya benefited greatly from capital inflows and enjoyed a good credit rating, and the authorities found no difficulty raising loans abroad as evidenced by the recent successful conclusion of the Eurocurrency loan negotiation. Nevertheless, it would be safer to err on the side of caution and to aim for a slightly lower deficit in the current account.

At the moment, the debt service ratio was not particularly high compared to most other developing countries, the staff representative remarked. It was likely to rise, however, following the recent borrowing operations. The staff did not have very detailed information on Kenya's debt situation, but some calculations, done mainly by the World Bank, showed that the debt service ratio would rise until 1985 and peak around that period at a level of some 19 per cent, and then come down thereafter. Projections of the debt service ratio would obviously depend on what assumptions were made about future borrowing.

The Executive Directors adjourned their discussion of Kenya's request for a stand-by arrangement and an extension of approval of exchange restrictions until the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/82/1 (1/6/82) and EBM/82/2 (1/8/82).

2. EXECUTIVE BOARD COMMITTEES

The Executive Board approves the proposal set forth in EBD/82/1 (1/5/82).

Adopted January 7, 1982

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 81/106 and 81/107 are approved. (EBD/81/334, 12/29/81)

Adopted January 6, 1982

4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/82/1 (1/6/82) is approved.

APPROVED: June 14, 1982

LEO VAN HOUTVEN
Secretary