

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

EBS/81/241
Supplement 2

CONFIDENTIAL

January 12, 1982

To: Members of the Executive Board
From: The Secretary
Subject: Kenya - Stand-By Arrangement

Attached for the records of the Executive Directors is the text of the stand-by arrangement for Kenya agreed at Executive Board Meeting 82/3, January 8, 1982.

Att: (1)

Kenya--Stand-By Arrangement

Attached hereto is a letter, with attached annex, dated December 3, 1981 from the Minister of Finance, requesting a stand-by arrangement and setting forth the objectives and policies which the Government of Kenya intends to pursue. To support these objectives and policies, the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For a period of one year from January 8, 1982 Kenya will have the right to make purchases from the Fund in an amount equivalent to SDR 151.5 million, subject to paragraphs 2, 3, 4, and 5 below without further review by the Fund.
2. Purchases under this arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 60 million until April 2, 1982, SDR 90 million until August 2, 1982, and SDR 120 million until November 2, 1982. None of these limits shall apply to a purchase under the stand-by arrangement that would not increase the Fund's holdings of Kenya's currency beyond 25 per cent of quota or increase the Fund's holdings of that currency resulting from purchases of supplementary financing or borrowed resources beyond 12.5 per cent of quota.
3. Purchases under this arrangement shall be made from ordinary resources until total purchases under this arrangement reach the equivalent of SDR 8,011,626, then from ordinary resources, and with supplementary financing in the ratio of 1 to 1.2 until purchases under this arrangement reach the equivalent of SDR 110,648,266, and then with supplementary financing.
4. Kenya shall not make purchases under this arrangement that would increase the Fund's holdings of its currency in the credit tranches beyond 25 per cent of quota, or increase the Fund holdings of that currency resulting from purchases of supplementary financing beyond 12.5 per cent of quota:
 - (a) during any period in which the data at the end of the preceding period indicate that the limit on total domestic credit of the banking system or the limit on net credit from the banking system to the Government, both described in paragraph 7 of the Policy Memorandum, are not observed; or
 - (b) during any period after April 1, 1982 or August 1, 1982, as appropriate, in which suitable performance criteria have not been established in consultation with the Fund as contemplated by the last three sentences of paragraph 4 of the letter of December 3, 1981, or after such performance criteria have been established, while they are not being observed; or
 - (c) during any period after June 30, 1982 in which the import policy measures referred to in the second from last sentence of paragraph 5 of the Policy Memorandum concerning the transfer of import items to Schedule 1 are not in effect; or

- (d) during the entire period of this stand-by arrangement, if Kenya
 - (i) fails to observe the limit on the contracting of public or publicly guaranteed external debt on commercial terms, described in paragraph 9 of the Policy Memorandum, or
 - (ii) imposes or intensifies restrictions on payments and transfers for current international transactions, or
 - (iii) introduces or modifies multiple currency practices, or
 - (iv) concludes bilateral payments agreements which are inconsistent with Article VIII, or
 - (v) imposes or intensifies import restrictions for balance of payments reasons.

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

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

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

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

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

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

9. During the period of the arrangement Kenya shall remain in close consultation with the Fund. These consultations, including those pursuant to the provisions of paragraph 5 of the attached letter, may include correspondence and visits of officials of the Fund to Kenya or of representatives of Kenya to the Fund. Kenya shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Kenya in achieving the objectives and policies set forth in the attached letter.

10. In accordance with paragraph 5 of the attached letter Kenya will consult with the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria in paragraph 4 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Kenya has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Kenya's balance of payments policies.

CONFIDENTIAL

December 3, 1981

Dear Mr. de Larosière:

1. Attached is a memorandum setting forth the major elements of Kenya's economic and financial policies which cover the period July 1, 1981 to September 30, 1982.

2. To assist in financing the projected external deficit over the program period, and in support of our stabilization and structural adjustment policies as set out in the attached memorandum, the Government of Kenya requests from the International Monetary Fund a new stand-by arrangement in support of a program starting July 1, 1981, for an amount equivalent to SDR 151.1 million. In this connection we also request cancellation of the stand-by arrangement approved by the Fund on October 15, 1980.

3. The main policy objectives under the new program are to contain the balance of payments deficit, to restore a balanced sectoral growth in the economy, and to promote domestic savings. To achieve these objectives, the Government is tightening its fiscal policy stance and has adjusted the exchange rate for the second time this year, while liberalizing existing import policies; in addition, the interest rate level has again been adjusted, following similar action in June 1981. These policies are described in the attached memorandum.

4. The Government of Kenya proposes to reach understandings with the International Monetary Fund on (a) ceilings relating to total domestic bank credit; (b) ceilings relating to net bank credit to the Government; (c) a ceiling on public and publicly guaranteed external borrowing on commercial terms of maturity of 1 to 12 years; and (d) import policy, as set out in the attached memorandum. Developments in the areas of fiscal policy, import reform, exchange rate, and interest rate policies will be reviewed prior to April 1, 1982, and the Government of Kenya will reach understanding with the Fund in these areas. At that time, credit ceilings for June 1982 will be established. A further review of import policy will be held before August 1, 1982 and understandings reached on progress in this area. At that time, credit ceilings for September 1982 will be established.

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

Yours sincerely,

/s/

D. Ndegwa
Governor of the Central
Bank of Kenya

/s/

Mwai Kibaki
Vice President and
Minister of Finance

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

CONFIDENTIAL

December 3, 1981

Memorandum of the Government of Kenya on its
Economic and Financial Policies

(1) In 1980 the Government of Kenya launched a medium-term program designed to correct emerging structural imbalances and to re-establish a higher growth rate with financial stability. The Government also proposed to use monetary and fiscal policies to control aggregate demand and to limit in the short run balance of payments deficits to manageable levels. The Fund supported the objectives of this program through a two-year stand-by arrangement approved on October 15, 1980 covering fiscal years 1980/81 and 1981/82.

(2) In 1980/81 Kenya faced difficulties in meeting its medium- and short-term objectives; many of the difficulties were beyond the country's control. Apart from weak demand abroad for Kenya's exports, Kenya's terms of trade deteriorated further and severe drought conditions weakened the productive sectors and required substantial imports of foodstuffs. With the return of more normal weather conditions, the outlook for agricultural production and growth now looks more favorable. In addition, fiscal developments in 1980/81 deviated significantly from the targets set forth in the program for that year. However, measures are now being implemented to correct the fiscal imbalance. These measures, together with actions on the exchange rate, on interest rates, and on import policy (all detailed below), provide the policy basis for the new stand-by arrangement.

(3) The Government's medium-term development program presented in 1980 included structural reforms to make the economy more outward looking and competitive. Toward this end, the Government undertook to strengthen export incentives and to open the domestic economy to greater foreign competition. Of major importance in achieving these objectives was the improvement of export incentives and a reform of the import system. The latter involved the gradual substitution of quantitative restrictions with tariffs, the reduction of the excessive protection enjoyed by certain sectors of the economy, and the adoption of a tariff policy which would reduce industries' intensive reliance on imported raw materials.

(4) To encourage exports and to limit the growth of imports, the exchange rate for the Kenya shilling was adjusted effective September 21, 1981, by 15 per cent in foreign currency terms from K Sh 1 = SDR 0.0985 to K Sh 1 = SDR 0.0837. This measure was in addition to the adjustment of about 5 per cent which occurred in February 1981. After the latest exchange rate measure, the Government will review the need for the continuation of the export compensation scheme. In addition, the Government will review the producer prices for the major food commodities in order to ensure that their relative prices do not decline vis-à-vis those for export commodities. The Government will keep the exchange rate under

continuous surveillance taking into account Kenya's balance of payments situation as well as movements in key international currencies.

(5) The last two budgets announced major adjustments in import tariffs involving 1,700 items (60 per cent of total); in the 1980/81 budget, the letters of no objection were removed and a 10 per cent import surcharge was introduced. However, further work in this area was delayed when it was realized that a complete review of the import system, which after many years of ad hoc changes had grown administratively complex, was needed. Work was immediately begun in preparing a new and comprehensive set of import schedules to permit a classification of imports according to priority. Such classification was needed in order to remove quantitative restrictions and bans, replacing them with appropriate tariffs. Because of its comprehensive nature, this task faced many difficulties and delays, but now the new import schedules have been published. An acute shortage of foreign exchange has made it difficult to implement an automatic processing of licenses. However, since November 10, 1981, imports into Kenya are being regulated on the basis of the new import schedules. The new schedules classify imports by priority, according to the following principles:

Schedule 1 includes items of high priority, namely raw materials, capital goods, spare parts, medicines, and agricultural equipment. The purpose is to give these goods automatic licensing by the Ministry of Commerce and to provide them with foreign exchange by the Central Bank without delay.

Schedule 2a includes two types of goods: high priority items which require prior approval of other government agencies, such as grains and petroleum products, and nonluxury consumer goods which are subject to quotas. The high priority items are freely importable as items in Schedule 1, once authorization by the regulatory agency has been received. The remaining items are subject to quotas, but once an importer obtains a quota for 2a items, he can import any item or combination of items within the schedule up to the limit of his quota.

Schedule 2b comprises those goods which are produced domestically or for which there are adequate domestic substitutes, and luxury items. All of these items have a low priority and are subject to quotas, equal to the average value of these imports in 1979-80.

It is the Government's objective to move an increasing number of goods to the less restrictive schedules after they have been subjected to appropriate tariff rate adjustments. The Government intends, by the end of June 1982, to switch into Schedule 1, 20 per cent of all items now subject to quantitative restrictions after further tariff adjustments have been introduced. In the following two years, items will be switched at a more rapid pace. In order to fully implement the Government's industrial policy in the medium term, the level of tariff protection will subsequently be lowered.

(6) In 1980/81 the budgetary outturn deviated markedly from the Government's objective to limit the overall deficit to 5-6 per cent of GDP, in part through factors beyond its control. The overall deficit amounted to about 11 per cent of GDP. In addition, unpaid vouchers amounting to K Sh 0.4 billion were accumulated during the year. Because of the larger overall deficit the Government exceeded the ceilings on net bank credit to the Government and net domestic credit at the end of June 1981, even though the previous ceilings had been observed. The Government intends to regain full control of its expenditure programs, to reduce the overall budgetary deficit in 1981/82 substantially to K Sh 3.9 billion, estimated as equivalent to 7.5 per cent of GDP, and to reduce significantly unpaid vouchers. The Government intends to finance the resulting overall deficit with a higher proportion of foreign borrowing on concessional terms and nonbank domestic resources than in the previous fiscal year. As a result, bank and Eurocurrency financing of the budget will be limited to K Sh 1.4 billion compared to K Sh 2.3 billion in 1980/81. The increased import duties and the other revenue measures adopted with the 1981/82 budget are expected to yield a net increase in revenue of K Sh 0.4 billion, while the recent devaluation of the Kenya shilling is estimated to yield additional revenues, mainly import duties, amounting to K Sh 0.7 billion. Taking into account these measures and the normal growth in revenues, the Government expects total revenues and grants to reach K Sh 16.8 billion in 1981/82, an increase of 13 per cent over the previous year. On the expenditure side, the Government has instituted severe economy measures which are expected to substantially reduce the ratio of total government expenditure to GDP. Recurrent expenditure (net of debt amortization), after allowing for the effects of the devaluation, is estimated at K Sh 14.2 billion, representing an increase of about 10 per cent, compared to an increase of 21 per cent in 1980/81. The Government does not intend to grant salary increases to civil servants in 1981/82 beyond the normal within grade increments. The reduced rate of increase in recurrent expenditure also reflects the Government's decision to contain total expenditures, specifically to curtail drastically foreign travel, purchases of new and replacement vehicles, and to limit increases in the number of civil servants. To achieve the latter, the Government intends to streamline functions within the civil service, with a large proportion of staff requirements being met from redeployment of existing staff and increases in productivity. A circular has been issued to spending ministries instructing them not to fill vacant posts without prior approval of the Directorate of Personnel Management and the Treasury. Such approval will only be granted on a restricted basis to fill necessary posts. Development expenditure is programmed at K Sh 6.2 billion, about the same level in nominal terms as in 1980/81. Projects amounting to K Sh 104 million included in the 1981/82 development budget have been cut, and a list of projects which could be rephased from the second half of FY 1981/82 into FY 1982/83 has been identified. These projects will be rephased if development expenditure during the first half of FY 1981/82 exceeds targeted levels. To ensure that the targeted level of development expenditure is not exceeded, all expenditure against "token provisions" requiring full domestic financing contained in the 1981/82 budget

has been frozen. To further ensure that the targeted overall deficit is not exceeded, the Government has strengthened expenditure controls and, with Fund technical assistance, is introducing a reporting system which will enable budgetary performance to be monitored on a monthly basis. Moreover, if the above policies are insufficient to limit the overall deficit to the targeted level, the Government is prepared to take additional measures before the end of February 1982. A list of contingency measures has been drawn up by the Government. Accordingly, we intend to limit the projected government deficit for the period July 1981 to December 1981 to K Sh 3,330 million. We will reach understandings with the Fund prior to April 1, 1982 on whether further measures would need to be undertaken to bring the projected government deficit for the fiscal year ending June 30, 1982 to K Sh 3,952 million. The projected government deficit referred to in the preceding sentence is consistent with projected total net government expenditure in accordance with the following projections: for the period to end-December 1981, K Sh 9,763 million; for the fiscal year ending June 30, 1982, K Sh 20,064 million. The budget deficit for the first quarter of fiscal year 1982/83 will be determined at the time of the program review to be held before August 1, 1982; during fiscal year 1982/83 the Government intends to further reduce the overall deficit in terms of GDP.

(7) Because of the objective with respect to the budget, the banking system will be better able to finance private sector activity. In 1981/82 private sector credit will be allowed to grow by 15.3 per cent compared to 9.5 per cent in 1980/81. Taking into account planned government borrowing, overall credit will grow by 13.6 per cent compared with 19.1 per cent in the previous year. Thus, total domestic bank credit which was K Sh 17.0 billion at the end of June 1981 will not be allowed to exceed K Sh 20.8 billion, including any further Eurocurrency borrowing after June 30, 1981, on January 31, 1982. Net bank credit to the Government, net of the deposits of the Cereals and Sugar Finance Corporation (CSFC) with the Treasury, and including any further use of Eurocurrency borrowing after June 30, 1981, which was K Sh 4.2 billion on June 30, 1981, will not be allowed to exceed K Sh 6.6 billion on January 31, 1982. In view of the rate of inflation which Kenya has suffered in the recent past, interest rates have been negative in real terms for some time. Consequently, there has been a disincentive for financial savings and a flow of funds toward financial institutions outside the commercial banks. In the 1981/82 budget, the Government announced a 2 per cent increase in both deposit and lending rates, and on September 21, 1981, commercial bank lending rates were raised by a further one percentage point to a maximum of 14 per cent, while deposit rates in the commercial banks were raised by two percentage points to a maximum of 11 per cent. The Government intends to keep interest rates under continuous review.

(8) In calendar year 1981, the current account deficit of the balance of payments is expected to narrow slightly to about 10 per cent of GDP compared to 13 per cent in 1980. Although exports are estimated to be

slightly reduced during the year due to lower export prices and a fall in petroleum exports, a substantial reduction in the growth of imports is projected, partly reflecting a smaller volume of crude oil imports. Moreover, an important increase in tourism earnings is projected. For 1981 the overall external deficit, excluding the drawing on a Eurocurrency loan, is estimated at SDR 273 million. As a result of the policy measures outlined in this note, it is expected that the current account deficit will be reduced to about 8 per cent in 1982, with a further adjustment expected in 1983.

(9) In 1981 Kenya's debt service ratio is estimated at 13.0 per cent and it is expected to rise slightly in the following two years, but will remain at a manageable level. Consequently, the Government of Kenya feels that there is sufficient room to maneuver with respect to additional foreign borrowing in order to allow the attainment of balance of payments equilibrium within the next two or three years, the needed period for the Government's medium-term structural policies to take hold. However, recognizing the need for prudent action in this area, the Government intends to limit the contracting of public and publicly guaranteed external borrowing on commercial terms in the maturity range of 1-12 years to US\$160 million during the 15 months ending in September 1982.