FOR
AGENDA

EBS/82/91

CONFIDENTIAL

May 11, 1982

To: Members of the Executive Board

From: The Acting Secretary

Subject: Kenya - Review of Stand-By Arrangement

Attached for consideration by the Executive Directors is a paper on a review of the stand-by arrangement for Kenya. A draft decision appears on page 19.

This subject, together with Kenya's request for a purchase under the compensatory financing of fluctuations in the cost of cereal imports (EBS/82/84, 5/11/82), is proposed to be scheduled for discussion on Wednesday, June 9, 1982.

Att: (1)

Issued in Helsinki and Washington, D.C.

INTERNATIONAL MONETARY FUND

KENYA

Review of Stand-By Arrangement

Prepared by the African Department

(In consultation with the Exchange and Trade Relations,
Fiscal Affairs, Legal, and Treasurer's Departments)

Approved by J.B. Zulu and S. Kanesa-Thasan

May 11, 1982

I. Introduction

On January 8, 1982 the Executive Board approved a stand-by arrangement (EBS/81/241, Supplement 2, 1/12/82) in an amount equivalent to SDR 151.5 million, representing 146.4 per cent of Kenya's quota of SDR 103.5 million. Of the total, SDR 54.7 million (52.8 per cent of quota) was to be provided from ordinary resources and SDR 96.8 million (93.6 per cent of quota) from supplementary financing. The schedule of purchases and repurchases under the stand-by arrangement is shown in Table 1.

The program stipulated that a review for the purpose of reaching understandings on fiscal, import, exchange rate, and interest rate policies was to be held before the second purchase under the arrangement could be made; at the same time credit ceilings for the end of June 1982 would be set. To that effect, a staff mission visited Nairobi during February 26-March 9, 1982. The staff team comprised Messrs. Karlstroem (head-AFR), J. Simpson (AFR), L. Doe (FAD), Ms. S. Eken (ETR), and Mrs. D.J. Heflin (secretary-AFR). The policy review was completed by a second staff visit to Nairobi during April 5-7, comprising Messrs. B. Karlstroem, J. Simpson, and L. Doe.

The Kenyan authorities will shortly request a purchase under the CFF equivalent to SDR 60.4 million (58.3 per cent of quota) relating to an excess in cereal import costs and a shortfall in merchandise exports estimated for calendar year 1981. The CFF paper (EBS/82/84, 5/11/82) will be presented to the Executive Board, concurrently with this paper.

II. Recent Economic Developments

Real GDP growth in 1981 has been officially estimated at 4 per cent, on the strength of a return of favorable weather conditions after a prolonged period of drought (Table 2).

Table 1. Kenya: Schedule of Purchases and Repurchases Under Current Stand-By Arrangement, and Fund Holdings of Kenya shillings, 1982 1/

(In millions of SDRs)

	Phasing of purchases	Scheduled repurchases	Fund holdings (At end of period)	
			Total	Per cent of quota
1982				
January	60.0	0.6	267.7	252.8
February	--	--	267.7	252.8
March	--	--	267.7	252.8
April	--	--	267.7	252.8
May	--	--	267.7	252.8
June	30.0	--	297.7	287.6
July	--	0.6	297.1	287.1
August	30.0	--	327.1	316.0
September	--	--	327.1	316.0
October	--	--	327.1	316.0
November	31.5	--	358.6	346.5
December	--	--	358.6	346.5

Sources: Phasing of the stand-by arrangement (EBS/81/241); and data provided by the Treasurer's Department.

1/ Excluding oil facility and compensatory financing facility.

Table 2. Kenya: Selected Economic and Financial Indicators, 1981-82

	1981 Program	1981 Estimate	1982 Program	1982 Projection
	(Annual per cent changes, unless otherwise specified)			
National income and prices				
GDP at constant prices	4.2	4.2	4.0	4.2
GDP deflator	12.0	12.0	11.4	15.4
Consumer prices	10.0	20.0	8.0	14.0
External sector (on the basis of SDRs)				
Exports, f.o.b.	-11.0	-7.0	17.1	11.3
Imports, c.i.f.	-6.5	-7.2	1.1	0.4
Non-oil imports, c.i.f.	3.7	-11.0	5.5	2.1
Export volume	-1.1	-10.0	6.7	6.0
Import volume	-14.2	-16.0	-4.7	-3.0
Terms of trade (deterioration -)	-7.5	-7.0	1.8	1.0
Nominal effective exchange rate (depreciation -)	—	-18.0	—	...
Real effective exchange rate (depreciation -)	—	-14.0	—	...
Government budget 1/				
Revenue and grants	18.2 2/	22.1	13.0	10.1
Total expenditure	24.0 2/	26.6	5.9	4.9
Money and credit 1/				
Domestic credit 3/	22.7 2/	24.2	19.9	25.1
Government 3/	37.5 2/	83.4	34.0	50.2
Private sector	15.2 2/	9.5	15.3	15.3
Money and quasi-money (M_2)	7.0 2/	7.3	11.0	7.5
Velocity (GDP relative to M_2) 4/	3.20 2/	3.23	3.45	3.68
Interest rate (annual rate, one year savings deposit) 4/	... 5/	10.00 6/	10.00	...
	(In per cent of GDP)			
Central government current account surplus	4.7 2/	2.9	3.5	4.0
Central government overall budget deficit	6.0 2/	10.6	7.5	7.8
Domestic bank financing	2.2 2/	4.3	0.7	1.9
Foreign financing	2.8 2/	4.9	5.3	3.1
Gross domestic investment	23.0	25.1	25.0	24.7
Gross domestic savings	12.5	16.2	16.2	19.1
Current account deficit 7/	10.0	9.8*	8.0	7.7
External debt	34.9	40.0	43.7	37.6
inclusive of use of Fund credit:				
External debt	36.7	41.8	45.5	39.4
Debt service ratio 8/	13.0	13.0	15.0	14.9
Interest payments 8/	5.5	5.5	6.1	7.9
	(In millions of SDRs, unless otherwise specified)			
Overall balance of payments 9/	-273.0**	-198.0**	32.0	-169.0**
Gross official reserves (months of imports)	1.2	1.4	2.0	1.5
External payments arrears	—	—	—	—

1/ Fiscal year ending June 30.
2/ Refers to stand-by program approved on October 15, 1980 and canceled on January 7, 1982.
3/ The definition of net domestic bank credit for purposes of the ceiling differs from that of the monetary survey in that the former includes the domestic currency counterpart of the Eurocurrency drawing. Likewise, the ceiling on net bank credit to the Government includes the domestic currency counterpart of the Eurocurrency drawing, and deposits from the "General Account" of the Cereals and Sugar Finance Corporation held with the Treasury.
4/ Level in per cent.
5/ The program did not specifically indicate level, only upward direction.
6/ Rate introduced in September 1981.
7/ Asterisk * reflects severe constraint on foreign exchange availability.
8/ In per cent of exports of goods and services.
9/ Double asterisk ** reflects severe constraint on foreign exchange availability.

The rate of inflation measured by the consumer price index, 1/ which had gradually decelerated during most of 1981, picked up again after September due to the devaluation of the Kenya shilling and the fuel price adjustment. Close to the end of the year the consumer price index rose further as a result of large--but necessary--upward adjustments in the (controlled) retail prices of several foodstuffs (up to 30 per cent). Thus, while the increase of the average index for the whole year 1981 was 12 per cent, the year-on-year increase for the average of the last quarter was 14 per cent.

The financial position of the Central Government deteriorated appreciably in FY 1980/81 (July-June), when the overall deficit reached 10.6 per cent of GDP (K Sh 4.5 million) compared with a program target of 6 per cent of GDP and up from 8 per cent of GDP in 1979/80. This outcome was due to an unexpectedly large increase in current as well as development expenditure (27 per cent) as compared with a programmed increase of 24 per cent. Despite higher foreign financing of the larger overall deficit, financing from the banking system reached about K Sh 1.6 billion in 1980/81 compared with less than K Sh 200 million in the previous fiscal year. The main factors behind the rapid increase in expenditure were larger-than-expected supplementary appropriations to finance a 23-30 per cent wage increase granted in October 1980, higher security and development outlays, and expenditures associated with the hosting of the OAU Conference. In addition, extrabudgetary expenditure was undertaken, reflecting weak expenditure controls.

In the current fiscal year, however, the Government has pursued a fiscal policy directed toward restraint. Total expenditure for the first seven months of FY 1981/82 was largely on target while recurrent revenue was ahead of target. As a result, performance criteria relating to domestic bank credit for January 1982 were met, with total domestic credit slightly lower than the ceiling and actual net bank credit to Government being considerably below the ceiling (Table 3). Furthermore, in the 12-month period ending January 1982 the distribution of credit between private and public sectors improved substantially (Table 4). Thus, the contribution of the rise in net bank credit to Government to the growth of the money stock declined from 12 per cent in the year ending June 1981 to 10 per cent in the year ending January 1982; in contrast, the contribution of the growth of bank credit to private sector to the growth of the money stock rose from only 7 per cent in the year ending June 1981 to 11 per cent in the year ending in January 1982. The growth of broad money was 10 per cent in the year ending January 1982, both figures significantly below the growth of nominal GDP. As a result of the relative decline in liquidity in the economy, the velocity of money in 1981 rose to a level closer to long-term trends (Chart 1).

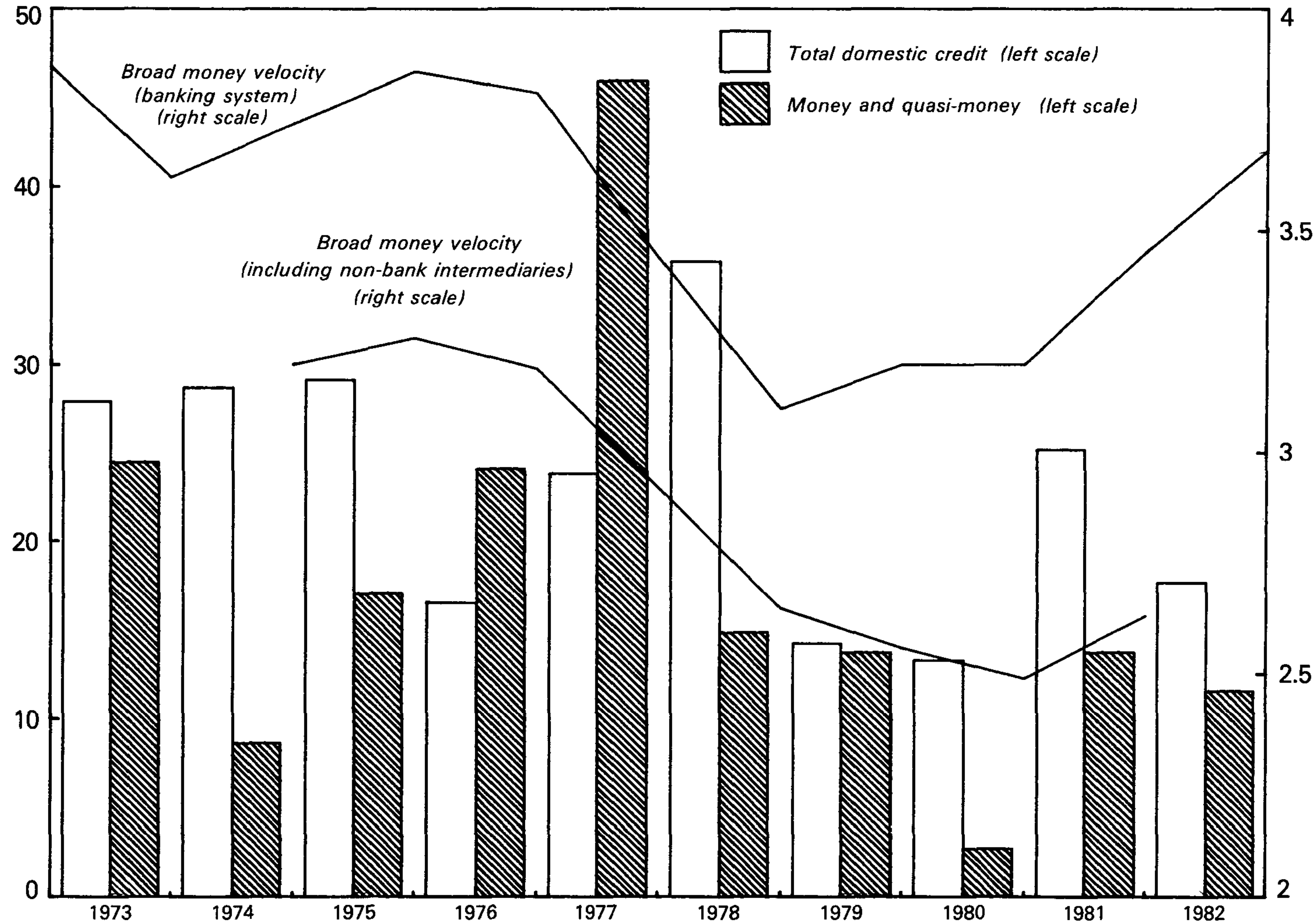
1/ Composite index with the following weights: lower income earners 78 per cent, middle 19 per cent, and upper 3 per cent.

CHART 1

KENYA

BROAD MONEY VELOCITY AND MONEY AND CREDIT GROWTH

(In per cent)



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

Table 3. Kenya: Quantitative Performance Criteria

(In millions of Kenya shillings)

	June 1981	1981/82 Program Jan. 1982	June 1982 1/
Total domestic bank credit 2/3/			
Ceiling		20,800	21,284
Actual	17,016	20,551	
Net bank credit to Government 2/ 3/			
Ceiling		6,550	6,241
Actual	4,153	5,707	
New external borrowing contracted or guaranteed by the Government of 1-12 years' maturity (cumulative)			
Ceiling 4/		160	160
Actual 4/	--	145	

Sources: Letter of Intent and Policy Memorandum, December 3, 1981; and Letter of Intent, May , 1982.

1/ A performance criterion, not stated in the Table, refers to transfer of 20 per cent of all import items now subject to quantitative restrictions to the free-import schedules by end-June 1982.

2/ For an exact definition of net domestic bank credit and net bank credit to Government, see EBS/80/125, pp. 25-27.

3/ Defined to include deposits from the "General Account" of the Cereals and Sugar Finance Corporation held with the Treasury, use of the local currency counterpart of Euro-currency drawings and use of the local currency counterpart of IMF purchases.

4/ Ceilings for 1981/82 in millions of U.S. dollars.

Table 4. Kenya: Monetary Survey, 1980-82

(In millions of Kenya shillings)

	1980	1981			1982		
	Dec.	Jan.	June	Dec.	Jan.	June	Dec.
Net foreign assets	2,154	2,286	1,266	514	-80	-765	-1,458
Net domestic credit	15,706	16,003	17,017	19,668	19,526	20,245	23,150
Government (net)	3,451	3,837	4,532	6,178	5,441	5,560	6,000
Public entities	498	464	460	465	508	820	650
Private sector	11,757	11,702	12,025	13,025	13,577	13,865	16,500
Other items (net)	1,188	1,869	1,111	1,229	1,417	1,025	1,000
Money and quasi-money	16,672	16,420	17,172	18,953	18,029	18,455	20,692
(12-month growth rate)	2.7	1.3	7.3	13.7	9.8	7.5	9.2
Memorandum items:							
Total domestic credit 1/	16,444	16,738	17,751	20,693	20,551	21,284	...
Net bank credit to Government 1/	3,935	4,473	4,888	6,716	5,707	6,241	...

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

1/ See footnote 3 on page 6.

According to revised estimates, the current account deficit of the balance of payments declined from SDR 712 million (13.2 per cent of GDP) in 1980 to SDR 612 million (10.8 per cent of GDP) in 1981 (Table 5). This improvement, resulting mainly from substantial reduction in the value of imports, occurred despite a further deterioration in the terms of trade. The decline in import volume (16 per cent) reflected substantially lower government imports and a decline in import demand as domestic stocks were reduced (Table 6). The volume of merchandise exports also declined (by 10 per cent), reflecting a sharply lower volume of petroleum exports and a decline or stagnation in tea and other exports. The terms of trade turned further against Kenya, with a 3 per cent increase in export prices against an 11 per cent rise in import prices. The capital account showed a positive balance of SDR 414 million in 1981, about SDR 148 million less than the previous year. Although there was a general decline in all categories of capital inflows, the main factors behind the overall decline were lower disbursement of public long-term capital, a sharp drop in import credits, and the absence of drawings from the structural adjustment loan, which had bolstered capital inflows in 1980. As a result of the above developments, the overall balance of payments deficit reached SDR 198 million in 1981, of which SDR 23 million was financed by net purchases from the Fund. Gross official reserves declined by SDR 176 million to about SDR 215 million at the end of 1981, equivalent to six weeks of imports.

The Government's energy conservation policy met with considerable success in 1981, partly as a result of the substitution of hydroelectricity for thermal power, made possible by the abundant rainfall during part of the year, but largely because domestic prices of fuel were allowed to reflect devaluation adjustments and other import and transformation costs. Preliminary estimates indicate that domestic consumption of petroleum products has been reduced by as much as 10 per cent, with most of the reduction being attributable to the drop in fuel usage for thermal electricity. The domestic retail price of petroleum products was increased twice in 1981, by 10 per cent in May and by 19 per cent in October, the latter adjustment following the September 21 devaluation of the Kenya shilling.

III. Review of the 1981/82 Program

The main objective of the program is the strengthening of the balance of payments through the removal of external constraints on economic growth, the restoration of domestic financial stability, and the shift of real resources to the international tradeable goods sector. In order to attain these objectives the Government has taken a number of policy measures in the fields of exchange rate and interest rates policies, they have simplified and begun to liberalize the import system, and they are implementing monetary and fiscal policies directed toward restraint.

Table 5. Kenya: Balance of Payments, 1979-82

(In millions of SDRs)

	1979	1980	1981 Estimate	1982 Program	1982 Revised projections
Trade balance	-589	-1049	-972	-899	-878
Exports	(788)	(958)	(891)	(999)	(992)
Imports	(-1,377)	(-2,007)	(-1,863)	(-1,898)	(-1,870)
Services (net)	143	230	240	336	274
Transfers (net)	77	107	120	130	134
Current account balance	-369	-712	-612	-433	-470
Public long-term capital (net)	139	160	122	140	95
Private long-term capital (net) 1/	167	147	118	141	124
Other capital (net) 2/	132	125	77	--	--
Exceptional financing	76	123	90	184	82
SAL loans	(--)	(56)	(--)	(112)	(70)
Eurocurrency loan	(76)	(68)	(65)	(45)	(-22)
Other concessionary loans	(--)	(--)	(25)	(28)	(34)
SDR allocation	7	7	7	--	--
Overall balance	152	-150	-198	32	-169
Increase in official NFA (-)	-152	150	198	-32	169
Change in gross reserves	-211	111	176	-167	-26
Use of Fund credit	56	44	23	135	195
Other liabilities	3	-5	-1	--	--
Memorandum items:					
Gross reserves end of period					
In millions of SDRs	493.6	391.7	215.4	382.4	241.4
In months of imports	4.3	2.3	1.4	2.4	1.5
Current account/GDP	7.8	13.2	10.8	8.0	8.0
Conversion rates (KSh per SDR)					
Period average	9.66	9.66	10.55	11.95	11.95
End of period	9.66	9.66	11.95	11.95	11.95

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

1/ Includes parastatals.
2/ Includes errors and omissions and valuation adjustments.

Table 6. Kenya: Exports, f.o.b. and Imports, c.i.f., 1980-82 1/

(Value in millions of SDRs; price, volume and terms of trade changes in per cent)

	1980	1981	1982 Program	1982 Revised proj.
Value				
Exports	958	891	999	992
Coffee	(224)	(208)	(235)	(250)
Tea	(120)	(114)	(141)	(129)
Petroleum and by-products	(222)	(223)	(240)	(220)
Other	(392)	(346)	(383)	(393)
Imports	2,007	1,863	1,898	1,870
Mineral fuels	(563)	(578)	(603)	(558)
Other	(1,444)	(1,285)	(1,295)	(1,312)
Prices				
Exports		3	7	5
Coffee		(-13)	(7)	(12)
Tea		(-6)	(6)	(3)
Petroleum and by-products		(21)	(4)	(-1)
Other		(5)	(5)	(6)
Imports		11	6	4
Mineral fuels		(21)	(4)	(-1)
Other		(7)	(7)	(6)
Volume				
Exports		-10	9	6
Coffee		(7)	(10)	(7)
Tea		(1)	(10)	(10)
Petroleum and by-products		(-17)	(4)	(--)
Other		(-16)	(5)	(7)
Imports		-16	-5	-3
Mineral fuels		(-15)	(--)	(-2)
Other		(-17)	(-6)	(-4)
Terms of trade		-7	2	1

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

1/ Both export and import data on a balance of payments basis.

1. External policies

An active exchange rate policy and the reform of the import system are key policies in the Government's medium-term strategy of strengthening export incentives and opening the domestic economy to greater foreign competition.

a. Exchange rate policy

The Government's aim of promoting export-oriented output and competitiveness in the domestic manufacturing sector was furthered in 1981 through two successive devaluations of the Kenya shilling in February and September, amounting to about 20 per cent in terms of the SDR. This brought export prices and costs of imported inputs in domestic currency to more realistic levels. Following these adjustments, the real effective exchange rate for the Kenya shilling at the end 1981 was 6 per cent below its value at the beginning of 1976 (Chart 2). 1/ However, as a result of Kenya's high rate of inflation vis-à-vis those of trading partners, the real exchange rate appreciated somewhat during the first quarter of 1982. The Government intends to keep the exchange rate under continuous surveillance, particularly at a time when the inflation rate in Kenya has accelerated.

b. Import policy

The gradual elimination of excessive protection enjoyed by large sectors of the economy was initiated in 1980 with the elimination of "letters of no objection." Later, with the publication of the 1981/82 budget, import tariffs were raised on over 1,400 items. Following this, the import system was further rationalized and streamlined with the introduction in November 1981 of new import schedules which classify all imports into three groups (Schedules 1, 2A, and 2B) on the basis of priority. 2/

1/ First quarter of 1976 was taken as the base period because the shilling was depreciated by 10.8 per cent against the SDR in October 1975 as part of a medium-term program of structural economic reforms.

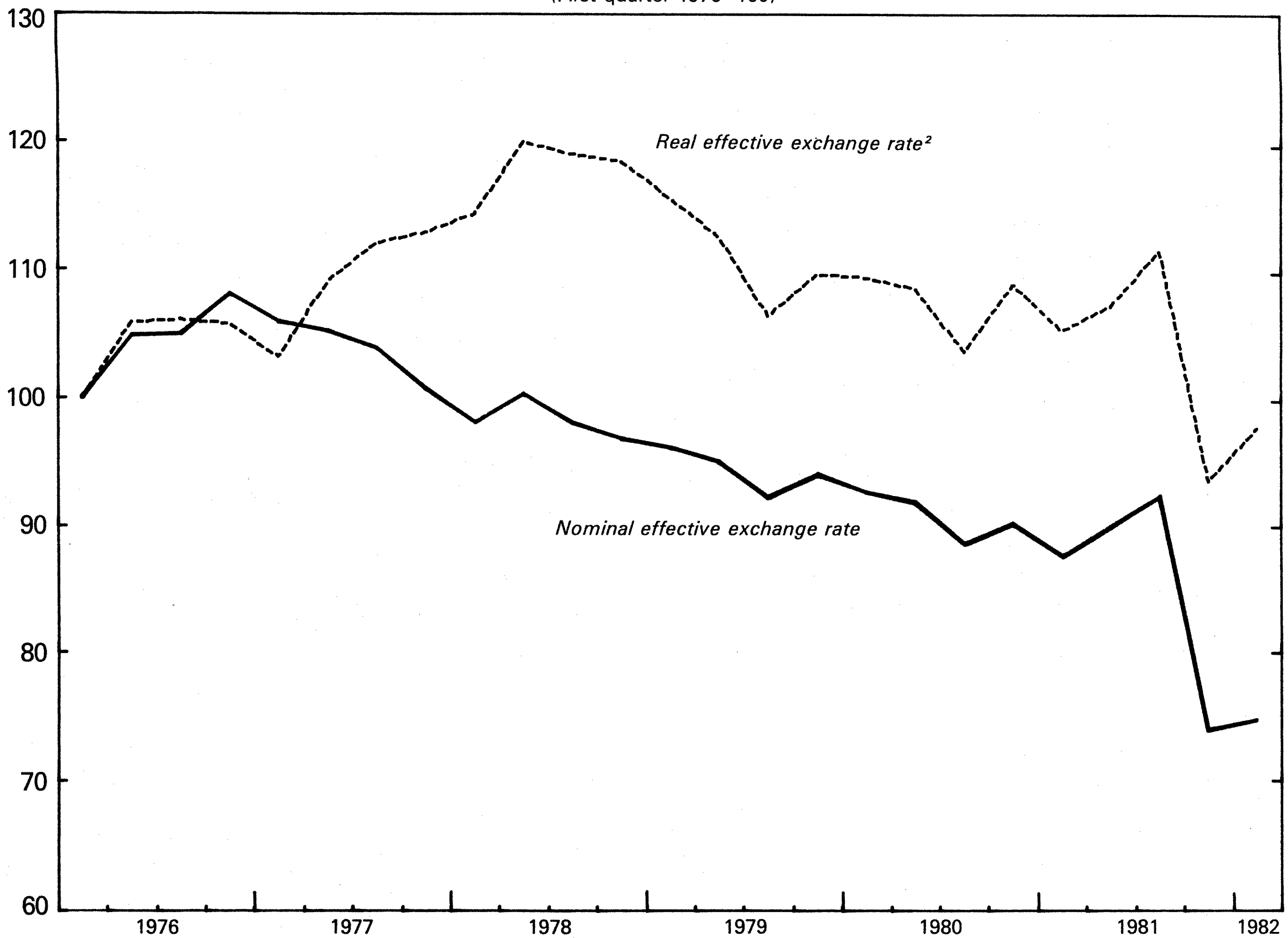
2/ Schedule 1 contains high-priority items, namely, raw materials, capital goods, spare parts, medicines, and agricultural equipment. Schedule 2A is subdivided into 2A special, which includes high-priority items such as grains, petroleum products and nonluxury consumer goods whose importation requires authorization by a state agency, and 2A ordinary, which comprises nonluxury consumer goods. Importation of items in Schedule 2A is limited to importers who have been granted foreign exchange quotas. Schedule 2B contains items that are domestically produced or whose substitutes are available from domestic industry, and luxury consumer goods. The importers' quotas for Schedule 2B are item specific. For items in Schedule 1 and Schedule 2A special, licenses are being issued automatically.

CHART 2

KENYA

NOMINAL AND REAL EFFECTIVE EXCHANGE RATES[1]

(First quarter 1976=100)



Sources: Data provided by the Kenyan authorities; and staff estimates.
[1]Trade-weighted quarterly averages.
[2]Nominal effective exchange rate adjusted by relative CPI.

The new import policy is characterized by a rationalization and simplification of the discretionary and inefficient system that existed before. 1/ During January-February 1982, 96 per cent of the total licenses issued were for goods under Schedules 1 and 2A special. Under Schedule 2A ordinary foreign exchange has been allocated only for imports of raw materials. The importation of goods other than raw materials under Schedule 2A ordinary and goods under Schedule 2B have been authorized for specific projects, with priority given to agricultural and export-oriented projects. No specific quotas were assigned during those two months to goods under Schedule 2B. Imports under Schedule 1 have been processed without delays,and on average the time lag between the issuance of licenses and allocation of foreign exchange is about one week.

The SDR value of total licenses issued during the 12 months ending in February 1982 was about 11 per cent higher than that of licenses issued during the same period in the previous year. In view of the shortage of foreign exchange, the Central Bank has temporarily taken a more cautious attitude toward import allocations. Thus, the total foreign exchange allocation for January-June 1982 is 2.5 per cent higher in terms of SDRs than the allocation corresponding to January-June 1981. The authorities hope to increase the level of allocation in the second half of 1982.

The authorities are firmly committed to move 20 per cent of import items now subject to quantitative restrictions to Schedule 1 by end-June 1982, and to date some 240 items have already been identified. The final list will be announced with the 1982/83 budget. In the discussions with the staff the Kenyan officials also indicated that the items to be shifted would be significant in terms of actual or potential value of imports.

c. Balance of payments outlook

The balance of payments outlook for 1982 is for a narrowing of the current account deficit to 8 per cent of GDP as stipulated in the program from

1/ The new system is now being administered by three committees: Ministers Import Committee (MIC), Officials Import Committee (OIC) and the Import Quota Allocation Committee (IQAC). Every six months the Ministry of Planning, the Ministry of Finance, and the Central Bank prepare projections of foreign exchange receipts as well as demand for imports under each schedule. These are presented to the OIC, which then makes recommendations to the MIC on global quotas. Based on import demand estimates the MIC allocates foreign exchange by schedule. Day-to-day work on import policy is being done by the IQAC, which meets every week to allocate quotas to individual importers according to established priorities. The IQAC also monitors the issuance of licenses and compares them to original quotas for various categories of imports. For monitoring purposes the Ministry of Commerce and the Central Bank report weekly the licenses issued and allocations of foreign exchange, respectively.

from about 11 per cent of GDP in 1981. The value of exports is estimated at SDR 992 million, about 11 per cent higher than in 1981, reflecting higher export prices and further volume increases in coffee and tea exports. Higher volumes are also projected for nontraditional exports, partly due to the beneficial effects of the devaluation of the Kenya shilling in 1981. Imports are expected to remain constant in SDR terms but to decline by about 3 per cent in volume mainly as a result of lower government imports, and also reflecting the higher cost of imports in domestic currency resulting from tariff increases and exchange rate adjustments. In 1982 the terms of trade are expected to improve slightly for the first time since 1977, reflecting mainly gains in coffee and tea prices. Net capital inflows are now projected at about SDR 301 (as apposed to SDR 465 million in the program) reflecting, in part, lower levels of inflows of public and private (including parastatal) capital. Program projections were higher because they included another Eurocurrency loan which was eventually not contracted, and the the second SAL from the IBRD, initially projected at US$130 million and now revised downward to US$80 million. The resulting overall balance of payments deficit will be SDR 169 million, in contrast with an SDR 32 million surplus projected earlier.

The debt service payments on medium- and long-term loans in 1982 are projected at about SDR 249.6 million, or equivalent to 12.7 per cent of exports of goods and services. Including service charges and repurchases to the Fund, the debt service ratio is projected at 14.9 per cent (Table 7). Although debt service payments are expected to rise in absolute terms in the next few years, they will nevertheless remain manageable. Contracts of new loans on commercial terms amounted to US$144.5 million as of the end of February 1981; this compares with the program's ceiling of US$160 million.

2. Fiscal policy

The main fiscal objective was the reduction of the overall deficit from an estimated 10.6 per cent of GDP in FY 1980/81 to 7.4 1/ per cent in FY 1981/82 (Table 8). The fiscal adjustment was almost entirely dependent on restraints in expenditure growth, with the ratio of total expenditure to GDP declining from 43.4 per cent in FY 1980/81 to 39.6 per cent in FY 1981/82; total revenue and grants were expected to remain at about the same proportion of GDP (32-33 per cent).

On the basis of preliminary data for the first eight months of 1981/82, total expenditure increased roughly in line with projections contained in the stand-by arrangement. Much of the success met by the Kenyan authorities in controlling budgetary expenditure was due to the improved monitoring and control procedures put into place in FY 1981/82. In this respect the

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1/ On the basis of initial GDP projections the fiscal deficit was projected at 7.5 per cent of GDP.

Table 7. Kenya: Debt Service Payments, 1982-87

(In millions of U.S. dollars)

	Medium- and long-term debt 1/			Fund 2/			Total debt service payments	Debt service ratio 3/
	Interest	Principal	Total	Charges	Principal	Total		
1982	130.5	119.1	249.6	25.0	19.4	44.4	294.0	14.9
1983	131.4	125.7	257.1	33.4	49.4	82.8	339.9	15.1
1984	130.0	139.5	269.5	30.1	66.7	96.8	366.3	14.6
1985	125.3	171.0	296.3	25.7	56.5	82.2	378.5	13.7
1986	116.0	167.2	283.1	17.0	42.7	59.7	342.8	11.3
1987	104.9	167.8	272.7	7.4	27.1	34.5	307.2	9.2

Sources: Data provided by the Kenyan authorities; World Bank; IMF Treasurer's Department; and staff estimates.

1/ Preliminary World Bank projections based on debt outstanding, including undisbursed, as of December 31, 1981.
2/ Converted at an exchange rate of SDR 1 = US$1.15.
3/ As a percentage of exports of goods and services.

Fund-sponsored fiscal reporting system, with monthly data on revenue collections on a cash basis and on expenditure checks issued, has been very useful for setting quarterly fiscal targets. Meanwhile, recurrent revenue collections for the same period (July-February) turned out to be slightly better than projected, with collections on income and sales tax substantially higher than anticipated (22 per cent and 7 per cent higher, respectively), those of customs and excise taxes (6 per cent below target), and other revenue on target. In contrast, drawings of foreign grants and loans lagged behind projections by an estimated K Sh 680 million. The low level of foreign assistance was partly explained by deficiencies and delays in the process of claiming reimbursement and partly attributable to delays in negotiations with the IBRD including one involving a second structural adjustment loan.

The outlook for the entire FY 1981/82 indicates that the program's fiscal objectives should be approximately achieved. Prospects for recurrent revenue for the remainder of the fiscal year are broadly in line with the program's targets. In an effort to ensure that actual revenue collections meet targeted levels, on April 28 the Kenyan authorities raised excise tax rates on beer and cigarettes; the measure is expected to yield about K Sh 50 million during the remainder of the present fiscal year and K Sh 400 million annually thereafter. With extra effort to speed up reimbursement claim procedures, the shortfall in foreign assistance for the year as a whole should be relatively limited in the amount of K Sh 831 million. Further reductions in development expenditure due to the slowing down of the rate of implementation of some projects, are expected to further offset the effect of the foreign assistance shortfall on the overall deficit. No new development projects are to be started unless foreign financing is fully secured; this is in order to discourage the undertaking of projects against token appropriations. 1/ Moreover, ministries are required not to undertake new development-related expenditure without prior Treasury approval.

Additional pressure on the fiscal sector, not foreseen in the budget has developed from the need to finance a buildup to normal levels of cereal stocks by the Cereals and Sugar Finance Corporation (CSFC). 2/ A good harvest--after a few years of drought--has resulted in an unusually large stock financing need, which in the past has been obtained from the Treasury. Efforts will be made to obtain a maximum amount of financing from nonbank sources through sales of CSFC promissory notes at interest rates significantly higher than those presently paid by the institution. Given the magnitude of the required financing, it may become necessary for

1/ These provisions have no budgetary appropriation other than a token K Sh 200, but enable the corresponding ministry to incur an unspecified amount of expenditure, which correspondingly increases the initial budgetary appropriations.

2/ The CSFC provides the financial resources to the National Cereals and Produce Board (NCPB) which markets the crops.

the CSFC to seek government financing to cover the purely seasonal element of the CSFC lending. The overall credit ceiling for June 1982 has been adjusted to take into account this possibility. However, repayment of government lending, prior to September 1982, would be explicitly assumed in setting the credit ceiling for September 1982.

3. Monetary and credit policies

a. Credit and monetary policies

The restoration of a more balanced growth in bank credit between the private sector and the Central Government was furthered through the Kenyan authorities' efforts to elicit increased financing of the budget from nonbank sources. Through an increase in Treasury bill rates and strict enforcement of liquid asset requirements for nonbank institutions, holdings of Treasury bills by nonbanks rose by K Sh 700 million between June 1981 and January 1982, and further to K Sh 1.3 billion by the end of March 1982. With the amount of outstanding Treasury bills not varying significantly during the second half of 1981 and the first quarter of 1982, the increase in holdings by nonbank financial intermediaries was accompanied by a decline in commercial bank holdings. An increased borrowing by the Government from the nonbank intermediaries is a natural consequence of the rapid growth of these institutions. On the basis of a sample of 15 nonbank intermediaries, comprising savings and loan associations, building societies, hire-purchase societies, and other credit institutions, the share of nonbank credit to the private sector in total credit increased from one fifth in 1978 to one third in 1981. During the same period the share of nonbank intermediary liabilities to the private sector in total private financial assets rose from 16 per cent to 23 per cent.

The program anticipates an increase in total domestic credit of 25 per per cent during FY 1981/82. Net bank credit to Government is expected to increase from K Sh 5,707 million at the end of January 1982 to K Sh 6,241 million, by end-June. If an advance to cover a delay in the drawing of the second SAL is excluded, net credit to Government would have declined in line with the normal seasonal pattern of government borrowing, reflecting, inter alia, seasonally large revenue flows toward the end of the fiscal year. In fact, the rate of growth in total domestic credit would have otherwise declined from 24 per cent in the year ending January 1982 to 21 per cent by the end of FY 1981/82. The increase in net bank credit to Government will be accompanied by an increase in credit to the rest of the public sector and to the private sector, mainly as a result of seasonal financing needs of the Cereals and Sugar Finance Corporation. Taking into account balance of payments projections and the expected credit growth, broad money is projected to increase by 7.5 per cent in the year ending June 1982.

b. Interest rates

In contrast with past policy of keeping interest rates stable, the objective of the Central Bank starting in June 1980 has been to eliminate the negative real interest rates previously prevailing. Following the sharp increase in oil prices in 1973-74, inflation in Kenya showed a double-digit rate through 1978, against which interest rates were negative in real terms (Chart 3). The rate of increase in consumer prices abated in 1979 as a result of a decline in domestic demand and moderation in import prices, but surged again in early 1980 owing to bad weather and poor supply conditions. In June that year the Central Bank adjusted interest rates upward between 0.73 and 1.5 percentage points, bringing maximum deposit and lending rates to 7 and 11 per cent, respectively. After the first quarter of 1981 inflation again picked up. This time the Central Bank increased all rates by a total of 2 percentage points in June 1981. In September 1981, maximum lending and deposit rates were once again increased, by 1 and 2 percentage points, respectively, resulting in positive real interest rates quoted on loans by both the commercial banks and the nonbank financial institutions. As a result of increases in administered consumer and producer prices during December 1981, domestic inflation accelerated to 14 per cent in the last quarter of the year, a rate roughly parallel to the maximum lending rate. Taking into account the adjustments made during the last two years, maximum deposit rates quoted by commercial banks have almost doubled--from a level of 5 7/8 in June 1980 to the present 11 per cent. It is estimated that actual maximum rates charged by commercial banks increased during the same period by over 50 per cent.

Until 1981 rates paid on Treasury bills were stable and quite low. During the coffee boom period of 1977-78 Treasury bill rates were as low as 2 per cent, due to excess liquidity in the economy; later they rebounded to over 6 per cent in 1978-79 reflecting increasing financial needs of the Government. The fiscal situation strengthened in fiscal year 1979/80, and Treasury bill rates declined to less than 5 per cent. Since mid-1981, inflation and the increase in interest rates quoted by commercial banks forced the Government to adjust Treasury bill rates upward in order to compete for domestic financial savings. The average Treasury bill rate for January-March 1982 was about 12 per cent, or three times the level of two years earlier.

Although regulated by the Central Bank, deposit and lending rates charged by nonbank financial intermediaries have de facto been traditionally higher than those quoted by commercial banks. Since September 1981, however, the same maximum lending rates are applicable to both bank and nonbank financial institutions.

IV. Staff Appraisal and Proposed Decision

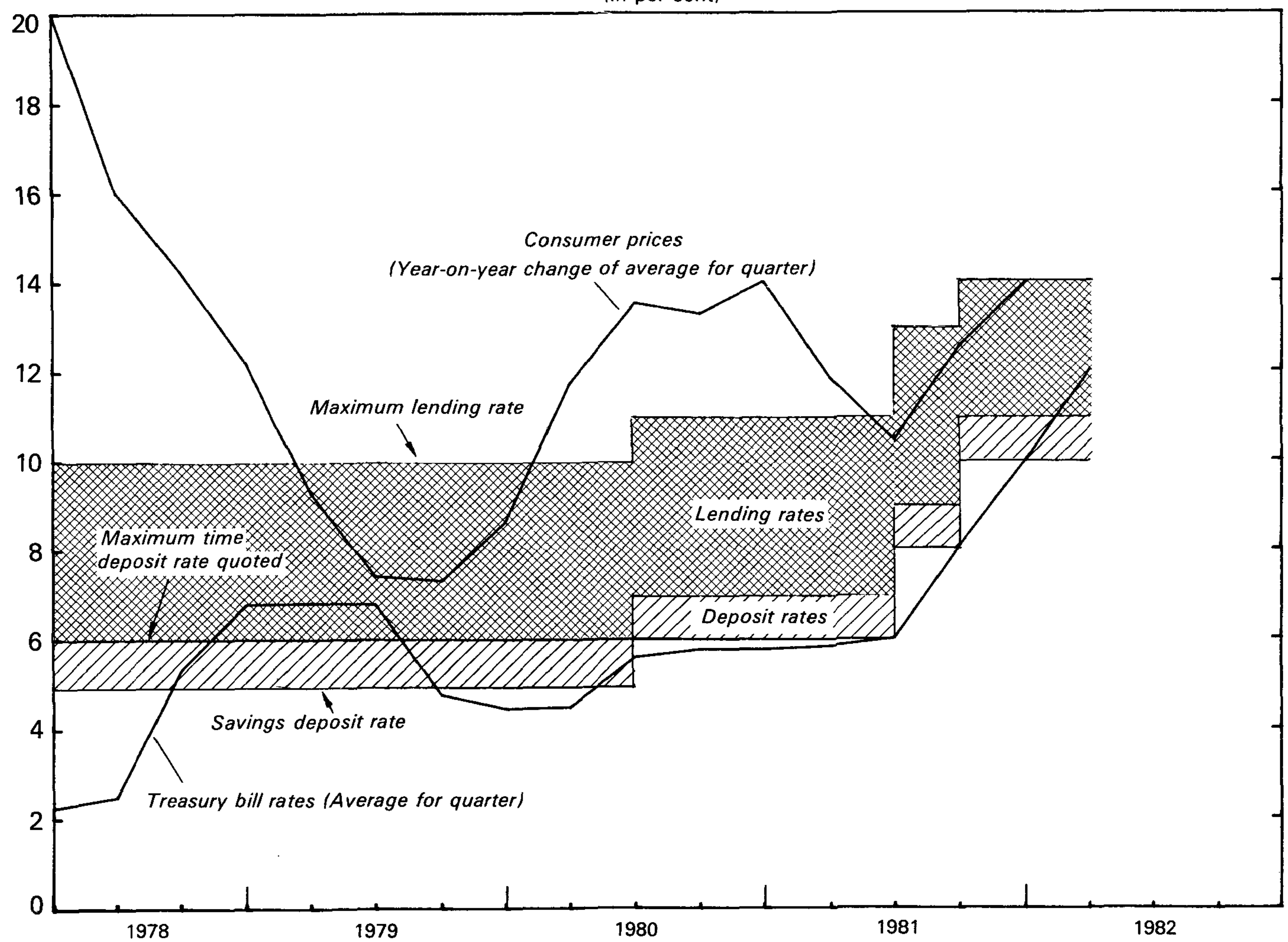
In order to remove the external constraint on economic growth and restore domestic financial stability, a number of policy measures have been taken over the past year. The shilling has been devalued by about 20 per cent vis-à-vis the SDR, interest rates have been raised significantly, and a potentially far-reaching import reform has been initiated.

CHART 3

KENYA

INTEREST RATES[1] AND MOVEMENTS IN CONSUMER PRICES, 1978-82

(In per cent)



Sources: Data provided by the Kenyan authorities.

[1] Quoted by Commercial Banks.

To complement these measures and ensure that real resources are effectively shifted to the internationally tradeable goods sector, a fiscal policy directed toward restraint is being pursued, and the growth in credit is directed primarily to the private sector, while the growth in money supply is being contained substantially below the growth in nominal output.

The review with the Kenyan authorities has touched on all these aspects of policy with the purpose of assessing whether further actions are necessary to achieve the program targets.

The present level of the exchange rate appears to the staff to provide adequate incentives for exporters; and import prices, affected also by the tariff increases last year, have risen sharply, thus aiding the transition of the import policy from one of quantitative restrictions to one where prices rather than controls regulate the flow of imports. In the future, the adequacy of the exchange rate will need to be assessed in the context of the liberalization of import policy, and a flexible exchange rate policy will be a necessary part of the policy strategy.

With the publication of new import schedules in November 1981, the import system has been rationalized and the scope for discretionary decisions has been substantially reduced. The flow of imports has remained high despite low exchange reserves. The staff was assured that a further 20 per cent of all import items now under quotas will be moved to the unrestricted schedule at the time of the budget in mid-June. Moreover, the items to be shifted would be meaningful in the sense of comprising a significant proportion of the value of total imports. The next review mission, tentatively scheduled for June 1982, will be in a position to analyze and assess this further step toward a freer import system. It is clear that the pace of the import reform will depend to a large extent on the availability of foreign exchange. In this context, the support from the Fund, under both the stand-by arrangement and the CFF, as well as that from the IBRD under the forthcoming second structural adjustment loan, are vital in sustaining progress in this area. Beyond the immediate future, however, Kenya needs to generate more foreign exchange through an accelerated export expansion to pursue successfully a long-run policy aimed at more rapid and balanced growth.

In the area of public finances substantial progress has been achieved in the current fiscal year. In particular, the monitoring and control of public expenditure have improved significantly, in part with the help of technical assistance provided by the Fund. Development expenditures in real terms are expected to be 10-15 per cent lower than in 1980/81. This is partly the result of shortfalls and delays in the implementation of projects, but partly also the effect of more stringent controls. Recurrent expenditure and revenues are developing roughly as planned. Revenue will be boosted by the recent increase in excise tax rates on beer and cigarettes, a measure that should be welcomed. Foreign grants and loans are expected to be substantially lower than expected in the program, but this shortfall will be offset by lower development expenditure and a larger financing of the budget deficit from nonbank sources. The staff feels that the significant increase in the Treasury bill rate since January 1982 was justified and will help place more government debt with nonbank financial institutions.

An unexpectedly large harvest has caused some unanticipated strains on the budget and the financial system, namely to finance the stock accumulation of wheat and other cereals. In the staff judgement, a minor adjustment in the fiscal target and the indicative credit ceilings set out in the program for June 1982, in order to provide some bridging finance for the purely temporary part of the stockbuilding would be justified. Even after this small adjustment the fiscal deficit in 1981/82 would be reduced substantially from that in the preceding year--11 per cent of GDP to 7.8 per cent of GDP.

Credit expansion (including the counterpart of the Eurocurrency loan) in 1981/82 is estimated at 25 per cent, or somewhat higher than the estimated growth in nominal output. Taking into account the projected overall deficit in the balance of payments, the program now foresees a growth in money supply of 7.5 per cent in the course of FY 1981/82. This would raise the velocity of money back to a level close to the long-term average (abstracting from the abnormal years in the late 1970s when the coffee boom led to sharp deviations in money/GDP relationship).

In light of trends in domestic and foreign financial markets, the staff feels that the interest rate structure, especially after the increase in Treasury bill yields early this year, is adequate for the time being. The rate of inflation is now higher than had been anticipated, largely as a result of the devaluations last year and of the increase in December in certain administered prices. The rate of inflation is likely to slow down in the course of 1982. However, should that not occur and should the balance of payments remain weak, there may be a need to consider a further upward adjustment in interest rates later in the year.

The current account deficit in the balance of payments is being reduced in 1982 in line with the program target (to 8 per cent of GDP from 11 per cent in 1981). Net capital inflows for 1982 have been revised downward, mainly because another Eurocurrency loan was not contracted (as had been anticipated) and because projected drawings in 1982 under the SAL have been revised downward from US$130 million to US$80 million. In view of recent trends in autonomous capital inflows, the staff feels that there will be a need for some further reduction in the current account deficit over the next few years in order to create a viable overall balance of payments position.

The Eurocurrency loan negotiated and drawn by the Kenyan Government is in the amount of US$115 million. This, together with a few smaller external commercial loans, is below the ceiling on external borrowing provided for in the program. The Government is very reluctant to increase its foreign commercial debt and does not intend to raise any further loans during the program period. It considers the present level of debt service payments as manageable but would like to keep any further increase to a minimum. The staff agrees with these views.

The following draft decision is proposed for adoption by the Executive Board:

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

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

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

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

Relations with the Fund 1/

Status:	Article XIV
Date of membership:	February 3, 1964
Quota:	SDR 103.5 million
Fund holdings of currency:	SDR 334.69 million (323.37 per cent of quota)
Of which: oil facility	SDR 4.07 million (3.93 per cent of quota)
compensatory facility	SDR 69.0 million (66.7 per cent of quota)
extended facility	SDR 4.49 million (4.34 per cent of quota)
supplementary financing facility	SDR 78.46 million (75.81 per cent of quota)
Holdings of SDRs:	SDR 8.2 million, or 22.2 per cent of net cumulative allocation (SDR 36.99 million)
Trust Fund loan disbursements (first and second periods):	SDR 46.91 million
Direct distribution of profits from gold sales (July 1, 1976-July 31, 1980):	US$7.61 million
Gold distribution:	41,079.961 fine ounces (four distributions)
Exchange arrangement:	Pegged to the SDR at K Sh 11.95 = SDR 1 (since September 21, 1981)
Intervention currency and rate for the U.S. dollar:	U.S. dollar; K Sh 10.58 = US$1

1/ As of April 30, 1982.

CONFIDENTIAL

May , 1982

Dear Mr. de Larosière:

1. In the letter to you dated December 3, 1981 we requested a stand-by arrangement for a period of one year for an amount equivalent to SDR 151.5 million, in support of the policies adopted by the Kenya Government within its financial program. The stand-by arrangement, approved by the Executive Board on January 8, 1982, set performance criteria for January 31, 1982 with respect to total domestic credit of the banking system and net bank credit to the Government. In addition, we indicated in our letter that we would review with the Fund exchange rate, interest rate, fiscal, and import reform policies and would reach understandings with the Fund in these areas. The arrangement also called for the establishment, at the time of the review, of credit ceilings for end-June 1982.

2. The performance criteria for January 1982 have been observed and we propose to reach understandings on exchange rate, interest rate, and fiscal and import reform policies that are described in this letter, and to set credit ceilings for end-June 1982. The description of these proposed understandings is accompanied by a review of recent policy developments, and of policies that we intend to pursue for 1982.

3. After the two devaluations in 1981, resulting altogether in a depreciation in terms of the SDR of 20 per cent, the Kenya shilling has become significantly more competitive. The present exchange rate provides, in our view, adequate incentive to exporters and, together with tariff modifications, allows for a realistic pricing of imports. 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.

4. Interest rates quoted by commercial banks and rediscount rates have been raised in the last two years, the last adjustment taking place on September 21, 1981. In January 1982 the interest rate on Treasury bills was increased substantially in order to maximize sales of government debt to the nonbank sector. The effective yield was raised from 10 per cent to 13.5 per cent. In our view, the overall level of domestic interest rates appears to be adequate at the present time, but we will continue to keep our interest rate policy under careful review.

5. In the area of fiscal policy substantial progress has been made along the lines spelled out in the stand-by arrangement, especially with respect to the monitoring and control of public expenditures. As of end-February 1982 total expenditures were increasing roughly in line with the program targets. Strong efforts are being made not to exceed the budget limits and, in fact, we foresee a shortfall in development expenditure for the year as a whole, largely as a result of intensified scrutiny of spending commitments. Domestic tax revenue has been running above the projected level, and to prevent slippages during the remainder of the fiscal year some excise tax rates were increased late in April. However, to be on the safe side, we are inclined not to expect an "overperformance" on the revenue side for the year as a whole. If this proves to be an excessively cautious projection, there will be a safety margin in terms of the fiscal target and the credit ceilings. Three unexpected developments have complicated fiscal management in 1981/82. First, there has been a substantial shortfall in foreign grants and loans during the first seven

months of fiscal year 1981/82. Second, the rebuilding of cereal stocks by the National Cereals and Produce Board (NCPB) financed by the Cereals and Sugar Finance Corporation (CSFC) to a normal level after several years of drought and stock depletion may entail some financing from the Treasury. Third, there has been an unexpected delay in the disbursement of a second structural adjustment loan (SAL) by the IBRD until after the end of FY 1981/82. In order to contain the budget deficit and limit the Government's recourse to bank financing, we are trying to finance the major part of the cereal stock building from private financial institutions. Moreover, we have now put a freeze on all new development programs which do not have external funding secured. We are also making extra efforts to speed up the process of claiming foreign grants and loans.

6. In view of the unexpected developments mentioned above, minor adjustments of the indicative targets included in the original program will be necessary. These adjustments will reflect firstly the purely seasonal and thus short-term component of the stock financing. We calculate that this part of the CSFC financing amounts to K Sh 220 million, and we firmly expect that this amount, initially financed from the budget, will be repaid to the Treasury by end-September 1982. Secondly, in order to take into account the delay in disbursing the SAL by the IBRD, it will be necessary to resort to temporary financing from the local banking system in the amount of K Sh 675 million. We firmly expect that this disbursement will be made in August; the proceeds of this disbursement will be used to reduce the Government's borrowing from the banking system. Thus, as a result of the above adjustments, the fiscal deficit for 1981/82 will be K Sh 4,172 million, or 7.8 per cent of the revised nominal GDP. Net

credit by the banking system to the Government will be limited to K Sh 6,241 million at end-June 1982, and total domestic credit of the banking system will be limited to K Sh 21,284 million at end-June 1982. This entails a growth in total domestic credit (including the use of the Eurocurrency loan) of 25.1 per cent and a growth in total money supply of 7.5 per cent over the 1981/82 fiscal year. The growth in nominal GDP for the fiscal year is estimated at 18.6 per cent.

7. The Government's import policy, as indicated in the policy memorandum of December 3, 1981 is being implemented on the basis of the new import schedule introduced in November 1981. The new import policy entails a rationalization and clarification of the import system. Within the limitations of the foreign exchange availability, it has been implemented in a liberal way as indicated by the significant increase in the value of imports. The value of import licenses processed by the Central Bank in the six months September 1981 to February 1982 was no less than 33 per cent higher (in SDR terms) than the corresponding value in the preceding year. The Government will announce, at the time of the budget in June 1982, the shifting of 20 per cent of all restricted import items to Schedule 1, where import permissions are freely granted. Preparatory work for this policy action is already at an advanced stage. Although the speed of the liberalization process is obviously constrained by the shortage of foreign exchange, policy intentions in this area remain unchanged. In this context, the expected availability of assistance from the IMF is of vital importance.

8. The Government believes that the policies set forth in this letter show that the program is being carried out as intended. We would like to assure you that we will take any further measures that may become appropriate for this purpose.

Yours sincerely,

/s/

D. Ndegwa
Governor of the Central Bank of Kenya

/s/

A. Magugu
Minister of Finance