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CONFIDENTIAL

October 16, 1989

To: Members of the Executive Board

From: The Secretary

Subject: Kenya - Midterm Review of the First Annual Arrangement Under the Enhanced Structural Adjustment Facility

Attached for consideration by the Executive Directors is the staff report for the midterm review under the first annual arrangement under the enhanced structural adjustment facility for Kenya, which will be brought to the agenda for discussion on a date to be announced. A draft decision appears on page 26.

Mr. Heller (ext. 8353) or Ms. Calika (ext. 6948) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

KENYA

Staff Report for the Midterm Review of the First Annual Arrangement Under the Enhanced Structural Adjustment Facility

Prepared by the African Department and the Exchange and Trade Relations Department

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

Approved by Mamoudou Touré and A. Basu

October 13, 1989

I. Introduction

On May 15, 1989, the Fund approved for Kenya a three-year arrangement under the enhanced structural adjustment facility (ESAF), in support of an economic and financial program covering the calendar years 1989-91, and the first annual arrangement thereunder, in support of the program for 1989 (EBS/89/84, 4/27/89). Total access under the ESAF arrangement, which replaced Kenya's arrangement under the structural adjustment facility (SAF) and the 18-month stand-by arrangement (canceled at the request of the authorities), is equivalent to SDR 241.4 million (170 percent of Kenya's quota), with annual access amounting to SDR 80.5 million (56.7 percent of quota) under each of the three annual arrangements. The first semiannual disbursement equivalent to SDR 40.2 million was made on May 31, 1989, and the second semiannual disbursement will be available after October 31, 1989, subject to compliance with the end-September 1989 performance criteria and completion of the midterm review.

The discussions on the midterm review of the first annual arrangement under the ESAF were conducted by a staff mission that visited Nairobi during August 28-September 11, 1989. 1/ In the attached letter to the Managing Director from the Vice President and Minister for Finance and the Governor of the Central Bank dated September 26, 1989 (Appendix I), the authorities review progress in policy implementation

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1/ The mission comprised Mr. P.S. Heller (head-AFR), Ms. J. Horne (FAD), Ms. N. Calika (AFR), Mr. R. Feldman (ETR), Mr. J. Hiwatashi (AFR), and Mrs. L. Duffield-Sorkowitz (secretary-ETR). Mr. E.L. Bornemann (AFR) joined the mission during the second week. Mr. T. Allen from the World Bank mission in Nairobi participated in some of the discussions.

under the first annual ESAF arrangement and economic and financial developments through September 1989, and describe the policies that they intend to pursue for the remainder of the year.

As of September 30, 1989 total Fund credit outstanding to Kenya was equivalent to SDR 305.7 million, or 215.3 percent of quota (Table 1). Taking account of scheduled repurchases and the prospective second semiannual disbursement under the ESAF, total outstanding Fund credit at end-December 1989 would amount to SDR 314.5 million, or 221.5 percent of quota. By end-December 1991, when all the disbursements under the three-year ESAF arrangement would have taken place, total outstanding Fund credit would amount to SDR 370.1 million, or 260.6 percent of quota.

Summaries of Kenya's relations with the Fund and the World Bank Group are presented in Appendices II and III, respectively.

II. Background

In the face of deteriorating financial and economic conditions, in late 1987 Kenya adopted a major stabilization and structural adjustment program. The program, which was supported by an 18-month stand-by arrangement and arrangements under the SAF (both of which became effective on February 1, 1988), aimed at maintaining the real growth rate, containing the rate of inflation, and reducing the current account deficit to a sustainable level. To attain these objectives, the Kenyan Government adopted a tight fiscal and monetary stance and initiated a flexible exchange rate policy, as well as a phased introduction of structural reforms in agriculture, industry, the financial sector, public enterprises, and government expenditure policy. The major elements of the adjustment program were successfully implemented during 1988 and, as a consequence, the objectives of the program with regard to growth, financial stability, and the external sector were to a large extent achieved (Table 2). 1/

In early 1989 the Kenyan authorities requested support under arrangements under the ESAF for their 1989-91 program, which was designed to broaden and reinforce the adjustment process. 2/ The program aims to achieve a real GDP growth rate higher than the population growth rate, to reduce the rate of inflation to the average of Kenya's main trading partners, to curtail substantially the external current account deficit, and to build up Kenya's net official inter-

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1/ For details see Staff Report for the 1989 Article IV Consultation and Request for Arrangements Under the Enhanced Structural Adjustment Facility (EBS/89/84, 4/27/89).

2/ For details see EBS/89/84 (4/27/89) and Enhanced Structural Adjustment Facility Policy Framework Paper for 1989-91 (EBD/89/123, 4/26/89).

Table 1. Kenya: Use of Fund Credit, September 1989-December 1991

	Outstanding Sept. 30, 1989	1989 Oct.-Dec.	1990 Jan.-March	1990 April-June	1990 July-Sept.	1990 Oct.-Dec.	1991 Jan.-March	1991 April-June	1991 July-Sept.	1991 Oct.-Dec.
					(In millions of SDRs)					
Total transactions (net)		8.82	-19.25	15.12	28.61	-20.26	35.48	-8.29	31.56	-7.38
Transactions under tranche policies (net)		-26.67	-14.51	-20.38	-6.89	-15.52	-4.76	-8.29	-8.67	-7.38
Repurchases		26.67	14.51	20.38	6.89	15.52	4.76	8.29	8.67	7.38
Ordinary resources		(5.33)	(5.33)	(3.46)	(2.13)	(2.13)	(—)	(1.96)	(3.91)	(3.91)
Borrowed resources		(21.34)	(9.19)	(16.91)	(4.76)	(13.39)	(4.76)	(6.34)	(4.76)	(3.46)
Transactions under special facilities (net)		-4.74	-4.74	-4.74	-4.74	-4.74	—	—	—	—
CFF (net)		(-4.74)	(-4.74)	(-4.74)	(-4.74)	(-4.74)	(—)	(—)	(—)	(—)
ESAF loans		40.23	—	40.23	40.23	—	40.23	—	40.23	—
Total Fund credit outstanding 1/	305.65	314.48	295.23	310.35	338.96	318.70	354.18	345.89	377.45	370.07
Under tranche policies	(173.33)	(146.66)	(132.15)	(111.77)	(104.88)	(89.36)	(84.60)	(76.31)	(67.64)	(60.27)
Under special facilities	(63.69)	(58.95)	(54.21)	(49.48)	(44.74)	(40.00)	(40.00)	(40.00)	(40.00)	(40.00)
Under SAF	(28.40)	(28.40)	(28.40)	(28.40)	(28.40)	(28.40)	(28.40)	(28.40)	(28.40)	(28.40)
Under ESAF 1/	(40.23)	(80.47)	(80.47)	(120.70)	(160.93)	(160.93)	(201.17)	(201.17)	(241.40)	(241.40)
					(As percent of quota)					
Total Fund credit outstanding 1/	215.25	221.46	207.91	218.56	238.70	224.44	249.42	243.58	265.81	260.62
Under tranche policies	(122.07)	(103.28)	(93.06)	(78.71)	(73.86)	(62.93)	(59.58)	(53.74)	(47.63)	(42.44)
Under special facilities	(44.85)	(41.51)	(38.18)	(34.85)	(31.51)	(28.17)	(28.17)	(28.17)	(28.17)	(28.17)
Under SAF	(20.00)	(20.00)	(20.00)	(20.00)	(20.00)	(20.00)	(20.00)	(20.00)	(20.00)	(20.00)
Under ESAF 1/	(28.33)	(56.67)	(56.67)	(85.00)	(113.33)	(113.33)	(141.67)	(141.67)	(170.00)	(170.00)

Sources: IMF, Treasurer's Department; and staff estimates.

1/ Includes use of ESAF Trust resources.

Table 2. Kenya: Selected Economic and Financial Indicators, 1985-90 1/

	1985	1986	1987	1988	1989 Program 2/	1989 Projection	1990 Program 2/	1990 Revised program
	(Annual percent changes, unless otherwise specified)							
National income and prices								
GDP at constant prices	4.9	5.5	4.8	5.2	5.1	4.9	5.2	5.2
GDP deflator	9.3	9.3	6.1	9.7	7.2	8.2	6.5	6.5
Consumer prices	10.5	4.3	6.6	10.4	8.0	8.8	7.5	7.5
External sector (on the basis of SDRs)								
Exports, f.o.b.	-8.0	7.5	-29.7	7.8	8.8	4.0	5.5	13.0
Imports, c.i.f.	-4.4	-0.8	1.5	6.9	4.1	7.6	4.7	4.2
Non-oil imports, c.i.f.	-6.3	18.7	0.7	13.1	2.8	6.0	4.4	3.4
Export volume	4.2	15.2	-3.5	5.5	5.7	6.4	4.5	7.9
Import volume	-7.5	17.4	5.0	12.3	—	1.3	1.8	0.7
Terms of trade (deterioration -)	-16.4	12.0	-17.5	3.5	-1.1	-8.0	-1.9	1.3
Nominal effective exchange rate (depreciation -) 3/	-16.9	-6.7	-15.8	-7.3	...	-6.6	...	...
Real effective exchange rate (depreciation -) 3/	-11.9	-4.4	-13.0	-2.2	...	-4.9	...	...
Government budget 4/								
Revenue and grants	15.0	16.7	20.3	16.5	13.8	18.3	12.5	11.7
Total expenditure	15.7	24.5	0.2	20.0	12.6	18.8	10.5	9.8
Money and credit								
Domestic credit	12.5	29.0	20.5	7.2	10.3	10.3	8.3	5.3
Government	10.2	53.7	29.7	-6.7	13.3	17.4	1.6	-6.6
Other sectors	13.6	17.7	14.9	16.7	8.7	6.4	12.1	12.4
Money and quasi-money (M2)	10.2	27.6	12.4	8.3	11.6	11.6	12.0	8.4
Velocity (GDP relative to M2) 5/	3.5	3.2	3.2	3.5	3.4	3.5	3.4	3.6
Interest rate (annual rate) 5/								
Savings deposit (minimum)	11.0	11.0	11.0	10.0	...	12.5	...	...
Average time deposit	11.5	11.5	9.8	12.4	...	...	...	...
Maximum lending rate	14.0	14.0	14.0	15.0	...	18.0	...	...
	(In percent of GDP)							
Government budget 4/								
Revenue and grants	23.4	23.9	25.1	25.5	26.6	26.7	26.9	26.8
Total expenditure	29.5	32.1	28.0	29.3	30.8	30.9	30.6	30.5
Overall deficit 6/								
Including grants	5.4	7.6	4.0	3.9	4.2	4.2	3.7	3.7
Excluding grants	6.4	8.9	6.1	6.1	6.7	6.8	6.3	6.4
Domestic bank financing	1.8	4.8	-0.1	0.1	0.6	0.6	0.4	0.4
Nonbank financing	4.5	2.4	3.0	0.9	0.5	0.5	0.6	0.6
Foreign financing	-0.9	0.4	1.1	2.8	2.5	3.1	2.0	1.7
Financing gap	—	—	—	—	0.6	—	0.7	0.9
Gross domestic investment	25.8	18.8	24.8	25.6	24.3	25.7	24.7	25.7
Gross domestic savings	24.8	18.9	19.7	20.5	20.1	20.1	20.9	21.4
External current account deficit								
Including grants	1.5	0.5	6.3	5.3	4.0	5.5	3.7	4.1
Excluding grants	3.3	2.5	8.1	8.3	7.0	8.8	6.6	7.4
External debt								
External debt inclusive of Fund credit	51	54	56	59	58	58	62	64
Debt service ratio 7/	29	29	34	29	30	31	28	28
Interest payments 7/	11	11	12	12	11	11	10	10
	(In millions of SDRs, unless otherwise specified)							
Overall balance of payments	-91	76	-76	-43	8	57	-38	-47
Additional financing requirement	—	—	—	—	50	—	83	93
Gross official reserves (months of imports) 8/	3.4	3.7	2.1	2.1	2.3	2.2	2.6	2.5
External payments arrears	—	—	—	—	—	—	—	—

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

1/ The data reflects revised GDP figures starting with 1985. The revisions had the impact of changing nominal GDP at market prices by +1.6 percent in 1985, +0.2 percent in 1986, -0.8 percent in 1987, +1.9 percent in 1988, and +2.6 percent each in 1989 and 1990.
2/ As shown in EBS/89/84.
3/ December-to-December variations; for 1989, December 1988 to August 1989 variation.
4/ Fiscal year beginning July 1.
5/ Level in percent.
6/ Figures do not add up because of adjustment to cash basis.
7/ In percent of exports of goods, nonfactor services, and private transfers.
8/ In months of nongovernment imports.

national reserves. To attain these targets, the program for 1989-91 stresses further tightening of the fiscal stance, tackling structural issues related to the budget, implementing a financial sector restructuring program and key reforms in the trade and industrial sectors, and pursuing flexible exchange and interest rate policies, as well as other market-oriented domestic policies. The reforms in the financial and industrial sectors are also being supported by the IDA through sector adjustment credits 1/ and by cofinancing by other multilateral and bilateral donors.

Within the context of the program's overall medium-term objectives, the first annual program under the ESAF targeted a rate of growth of 5.1 percent in real GDP, deceleration in the rate of inflation to 8 percent (from 10.4 percent in 1988), a reduction in the external current account deficit (including official transfers) to 4.0 percent (from 4.5 percent in 1988), and a buildup of SDR 58 million in net official international reserves.

III. Program Implementation in 1988/89

In 1989 considerable progress has been made in implementing the program, which remains essentially on track. The quantitative and structural benchmarks for June 1989 were observed, in some cases by a wide margin (Table 3).

After a rise of 5.2 percent in real terms in 1988, owing primarily to favorable weather conditions and the impact of the agricultural structural measures implemented over the last few years, the real GDP growth rate in 1989 is expected to decelerate slightly, reflecting less favorable weather conditions at the beginning of 1989, lower-than-anticipated coffee production, and higher oil prices. During the first half of 1989 the inflation rate exceeded 10 percent, considerably above the target of 8 percent for end-1989, owing to increases in producer and consumer prices early in the year and a somewhat-greater-than-expected growth in broad money.

The overall budget deficit on a cash basis in 1988/89 (July/June), at 3.9 percent of GDP, was well below the 4.5 percent target (4.4 percent in terms of revised GDP) 2/ originally programmed (Table 4).

1/ The Industrial Sector Adjustment Credit (ISAC) was approved by the World Bank in mid-1988 for US$112 million, and the Financial Sector Adjustment Credit (FSAC) and Financial Sector Technical Credit (FSTC) were approved in mid-1989 for US$125 million.

2/ The Kenyan authorities have revised their GDP figures for the past several years. As a consequence, the current GDP figure for 1988/89 is 2.3 percent higher than initially estimated. In the remainder of this paper, program targets in terms of GDP are (unless stated otherwise) those presented in EBS/89/84 and do not reflect the revised GDP figures.

Table 3. Kenya: Performance Under the First Annual Arrangement Under the Enhanced Structural Adjustment Facility

	1989 June
	(In millions of Kenya shillings)
Quantitative benchmarks	
Total domestic credit 1/	
Ceiling	55,044
Actual	52,422
Net bank credit to the Government 2/	
Ceiling	15,620
Banking system	(19,321)
CSFC	(-3,701)
Actual	13,670
Banking system	(17,510)
CSFC	(-3,840)
	(In millions of U.S. dollars)
New nonconcessional external loans contracted or guaranteed by the Government 3/ (cumulative per calendar year)	
a. 1-12 years' maturity	
Ceiling	100.0
Actual	56.4
b. Short-term credits of less than one year's maturity 4/	
Ceiling	--
Actual	--
Minimum cumulative increase in net official international reserves from end-December 1988 5/	(In millions of SDRs)
Benchmark	42
Actual	80
Structural benchmarks	Status
Implement the import liberalization program and provide on monthly basis, data on import license applications, approvals, and corresponding foreign exchange allocation by end-September 1989.	Done
Adopt fiscal measures, including user charges in health, education, and other sectors beginning July 1989.	On target
Confine the growth of the Government's personnel wage bill to 7.5 percent beginning July 1989.	On target
Maintain positive real interest rates throughout 1989.	On target

Sources: Memorandum of economic and financial policies attached to the letter of April 18, 1989; letter of intent dated September 26, 1989; and data provided by the Central Bank of Kenya and the Ministry of Finance.

1/ Total domestic credit of the banking system is the sum of net credit to the Government, other public sector credit, and private sector credit. It includes bank credit utilized by the Cereals and Sugar Finance Corporation (CSFC).

2/ Net credit to the Government is net credit to the Government from the banking sector. The ceiling excludes the operations of the CSFC.

3/ In conformity with existing regulations, no public enterprise will borrow on nonconcessional terms without government guarantee.

4/ Other than related to imports.

5/ Net official international reserves are defined as the Central Bank of Kenya's net foreign reserve assets (SDRs, gold, and foreign exchange holdings) minus its short-term deposit liabilities to foreigners; plus the Central Government's net foreign reserve assets (excluding those related to Fund transactions); plus Kenya's reserve position in the Fund; minus Kenya's net use of Fund credit.

Table 4. Kenya: Government Finances, 1986/87-1989/90

	1986/87	1987/88 Prelim. Actuals	1988/89 Program 1/	1988/89 Prelim. Actuals	1989/90 Program 1/	1989/90 Revised Program
	(In millions of Kenya shillings)					
Revenue and grants	29,614	35,637	41,816	41,506	47,591	49,118
Revenue	27,999	32,710	37,980	37,892	43,073	44,219
Grants	1,615	2,927	3,836	3,614	4,518	4,899
Expenditure and net lending	39,755	39,815	48,967	47,768	55,117	56,765
Recurrent expenditure	29,511	30,646 2/	37,040	36,426	41,588	42,719
Of which: wage bill	(9,874)	(11,508)	(12,632)	(13,352)	(13,579)	(14,353)
Development expenditure and net lending	10,244	9,169 2/	11,927	11,342	13,529	14,046
Overall deficit (treasury accounts)	-10,141	-4,178	-7,151	-6,262	-7,526	-7,647
Adjustment to cash basis 3/	716	-1,505 4/	—	-58 5/	—	—
Overall cash deficit	-9,425	-5,683	-7,151	-6,320	-7,526	-7,647
Financing	9,425	5,683	7,151	6,320	6,529	7,647
Foreign financing	542	1,522	3,893	4,567	4,560	5,626
Domestic financing	8,883	4,161	3,258	1,753	1,969	2,021
Of which: banking system and CSFC	(5,923)	(-78)	(2,200)	(219)	(1,074)	(1,102)
Financing gap	—	—	—	—	997	—
Overall cash deficit (excluding grants)	-11,040	-8,610	-10,987	-9,876	-12,044	-12,546
	(In percent of GDP)					
Memorandum items:						
Revenue and grants	23.9	25.1	26.2	25.5	26.6	26.7
Revenue	22.6	23.0	23.8	23.2	24.1	24.1
Grants	1.3	2.1	2.4	2.2	2.5	2.7
Expenditure and net lending	32.1	28.0	30.7	29.3	30.8	30.9
Recurrent expenditure	23.8	21.6	23.2	22.3	23.2	23.3
Of which: wage bill	(8.0)	(8.1)	(7.9)	(8.2)	(7.6)	(7.8)
Development expenditure and net lending	8.3	6.5	7.5	6.9	7.6	7.6
Overall cash deficit	-7.6	-4.0	-4.5	-3.9	-4.2	-4.2
Overall cash deficit (excluding grants)	-8.9	-6.1	-6.9	-6.1	-6.7	-6.8
Foreign financing	0.4	1.1	2.4	2.8	2.5	3.1
Domestic financing	7.2	2.9	2.0	1.1	1.1	1.1
Of which: banking system and CSFC	(4.8)	(-0.1)	(1.4)	(0.1)	(0.6)	(0.6)
Financing gap	—	—	—	—	0.6	—

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

1/ As presented in EBS/89/84 (4/27/89), as revised program.

2/ Excludes an estimated amount of K Sh 2,000 million in recurrent and development expenditures, for which the issue of checks had been delayed into 1988/89.

3/ The adjustment factor arises partly because financing data are derived from sources other than revenue and expenditure data. It also includes a float element resulting from differences between checks issued and checks cashed and statistical discrepancies.

4/ Includes the counterpart to the reduction in the check float of K Sh 1,700 million during 1987/88.

5/ Includes an estimated increase in the check float of K Sh 1,840 million during 1988/89.

Excluding grants, the deficit remained at its 1987/88 level of 6.1 percent of GDP, rather than the 6.9 percent originally targeted. The fiscal outcome reflected primarily a better-than-programmed performance of both recurrent and development outlays, with total expenditures remaining at K Sh 1.2 billion (0.7 percent of revised GDP) less than previously anticipated. The preliminary data indicate that while recurrent expenditure was about K Sh 600 million (0.4 percent of GDP) below its programmed level, the projected wage bill was higher by about K Sh 720 million (owing to more-than-anticipated wage increases), implying a growth of 16 percent, well above the projected growth of 9.8 percent. Total revenue was slightly below the program target, reflecting mainly lower-than-programmed receipts from import duties and from the sales tax on imports.

Financing of the deficit was largely from external and domestic nonbank sources. Net foreign financing amounted to K Sh 4.6 billion (2.8 percent of GDP), compared with K Sh 3.9 billion in the program, while the bulk of the K Sh 1.8 billion in domestic financing, in contrast to the program, was from nonbank sources. Net bank credit to the Government at end-June 1989 was about K Sh 400 million above its June 1988 level (1.0 percent of the beginning-of-period broad money stock), compared with the programmed increase of K Sh 2.2 billion (5.5 percent of beginning broad money) (Table 5). As a result, bank financing of the deficit (excluding the Cereals and Sugar Finance Corporation) was K Sh 2.0 billion (1.2 percent of GDP) below the end-June 1989 program benchmark. As in the previous fiscal year, this development was largely due to the authorities' postponement of cash payments toward year-end, as reflected in a buildup of K Sh 1.8 billion in the stock of unpresented checks at end-June 1989.

During 1988/89, total domestic credit rose by only 8.3 percent, in sharp contrast to the programmed 13.7 percent. As a consequence, total domestic credit at end-June 1989 was K Sh 2.6 billion below the programmed ceiling. During the fiscal year ended June 1989, net credit to the Government expanded by 2.3 percent compared with 12.8 percent in the program, and credit to the nongovernment sector rose by 11.6 percent instead of the targeted 14.2 percent. As a result, net domestic assets rose during the year by 1 percent less than the 15.2 percent in the program. Broad money, however, increased in 1988/89 by 17.8 percent, more than the 17.0 percent programmed, reflecting a higher-than-projected increase in net foreign assets.

In the external sector, the current account deficit in 1988 narrowed to 5.3 percent of GDP from 6.3 percent in the previous year, as the deterioration in the merchandise trade deficit was more than offset

Table 5. Kenya: Monetary Survey, June 1985–June 1990 1/

	1985		1986		1987		1988				1989					1990		
	June	Dec.	June	Dec.	June	Dec.	March	June	Sept.	Dec.	March	June		Sept.	Dec.	March	June	
	Actual										Actual	Prog. 2/	Actual	Program 2/		Prog. 3/	Prog. 2/	Prog. 3/
	(In millions of Kenya shillings)																	
Net foreign assets	-427	-1,759	-408	-255	-759	-2,367	-2,590	-3,143	-3,327	-3,627	-2,517	-2,921	-2,162	-3,132	-2,691	-1,181	-1,465	-1,464
Total domestic credit	28,113	31,600	34,259	40,775	43,916	49,114	48,063	48,401	49,337	52,666	51,636	55,044	52,422	56,897	58,080	57,371	59,432	57,712
Government (net)	8,108	9,954	10,728	15,301	17,109	19,846	17,717	17,121	16,889	18,512	17,775	19,321	17,510	21,891	21,741	20,241	21,165	19,382
Other	20,005	21,645	23,532	25,474	26,807	29,268	30,346	31,280	32,448	34,154	33,861	35,723	34,912	35,006	36,339	37,130	38,267	38,330
Other items (net)	-1,847	-1,438	-2,374	-4,289	-4,911	-6,013	-4,836	-5,469	-5,520	-4,944	-3,341	-5,579	-3,386	-5,583	-6,197	-5,563	-5,698	-5,510
Money and quasi-money	25,838	28,404	31,477	36,230	38,246	40,734	40,637	39,788	40,489	44,095	45,778	46,544	46,875	48,182	49,192	50,627	52,269	50,738
	(Annual change in percent)																	
Total domestic credit	12.3	12.5	21.9	29.0	28.2	20.5	11.2	10.2	2.7	7.2	7.4	13.7	8.3	15.3	10.3	11.1	...	10.1
Government (net)	12.7	10.2	32.3	53.7	59.5	29.7	6.0	0.1	-15.3	-6.7	0.3	12.8	2.3	29.6	17.4	13.9	...	10.7
Other	12.2	13.6	17.6	17.7	13.9	14.9	14.5	16.7	15.6	16.7	11.6	14.2	11.6	7.9	6.4	9.7	...	9.8
Money and quasi-money	11.7	10.2	21.8	27.6	21.5	12.4	7.3	4.0	2.2	8.3	12.7	17.0	17.8	19.0	11.6	10.6	...	8.2
Velocity	3.63	3.52	3.44	3.23	3.24	3.22	3.36	3.57	3.64	3.46	3.45	3.50	3.48	3.49	3.52	3.53	...	3.62

Sources: Central Bank of Kenya; and staff estimates.

1/ The claims of the National Bank of Kenya on the public entities and the private sector guaranteed by the Government are shown beginning in June 1988 as part of credit to the nongovernment sector. Before that date they were shown as part of credit to the Government. Beginning September 1989, net credit to Government includes K Sh 770 million debt of public enterprises that was assumed by the Government; previously this debt was classified under outstanding credit of the nongovernment sector.

2/ As presented in EBS/89/84 with the exceptions that the distribution of credit between the Government and the nongovernment sectors has been revised to reflect the change introduced in September 1989 described in footnote 1, and also the revised GDP figures.

3/ EBS/89/84 did not contain program figures for March 1990; the June 1990 figures reflect revised program targets.

by higher, mostly official, transfers (Table 6). 1/ Net services were essentially unchanged. The overall balance of payments deficit was about half the size of the previous year's deficit. Gross foreign reserves rose by SDR 20 million in 1988, while net international reserves fell by SDR 43 million; net credit from the Fund was SDR 64 million, which included a purchase in October 1988 equivalent to SDR 40 million under the compensatory financing provisions of the CCFF. 2/

During the first half of 1989, external sector policies were in line with the program. The exchange rate was flexibly managed, depreciating by 2.7 percent in real effective terms during this period, compared with 2.2 percent in calendar year 1988 (Chart 1). Official external borrowing on nonconcessional terms was reported to have been confined during the first half of 1989 to US$56.4 million for loans in the 1- to 12-year maturity range. The available trade data for the first half of the year suggest that the growth in receipts from tourism and "other exports," 3/ when compared with the same period in the previous year, has been strong; the growth in tea receipts has been more moderate and in coffee receipts, about flat. Non-oil import growth has also been strong.

Net official reserves during the first half of 1989 increased by SDR 80 million, in part reflecting SDR 50 million of external borrowing in April by the Coffee Board of Kenya; excluding this external borrowing, net official reserves increased by SDR 30 million, compared with a target of SDR 42 million. It should be noted that the Coffee Board borrowed to finance large inventories of coffee that had built up when export quotas were in effect and to facilitate payment to producers. This loan, which will be repaid in less than one year from when the funds were received, and with payments starting in October 1989, was not guaranteed by the Government; it was backed by collateral in the form of

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1/ The current account deficit for 1988 had been previously estimated to be SDR 283 million (or 4.5 percent of GDP in EBS/89/84), compared with most recent data showing a deficit of SDR 340 million. The merchandise trade deficit is now SDR 20 million larger than the earlier estimate, while net service receipts are SDR 31 million lower and mainly reflect revisions to investment income receipts, port earnings, and receipts from embassies and international organizations.

2/ The purchase was based on a net shortfall in merchandise exports and cereal imports for the year ended April 1988. CCFF, compensatory and contingency financing facility.

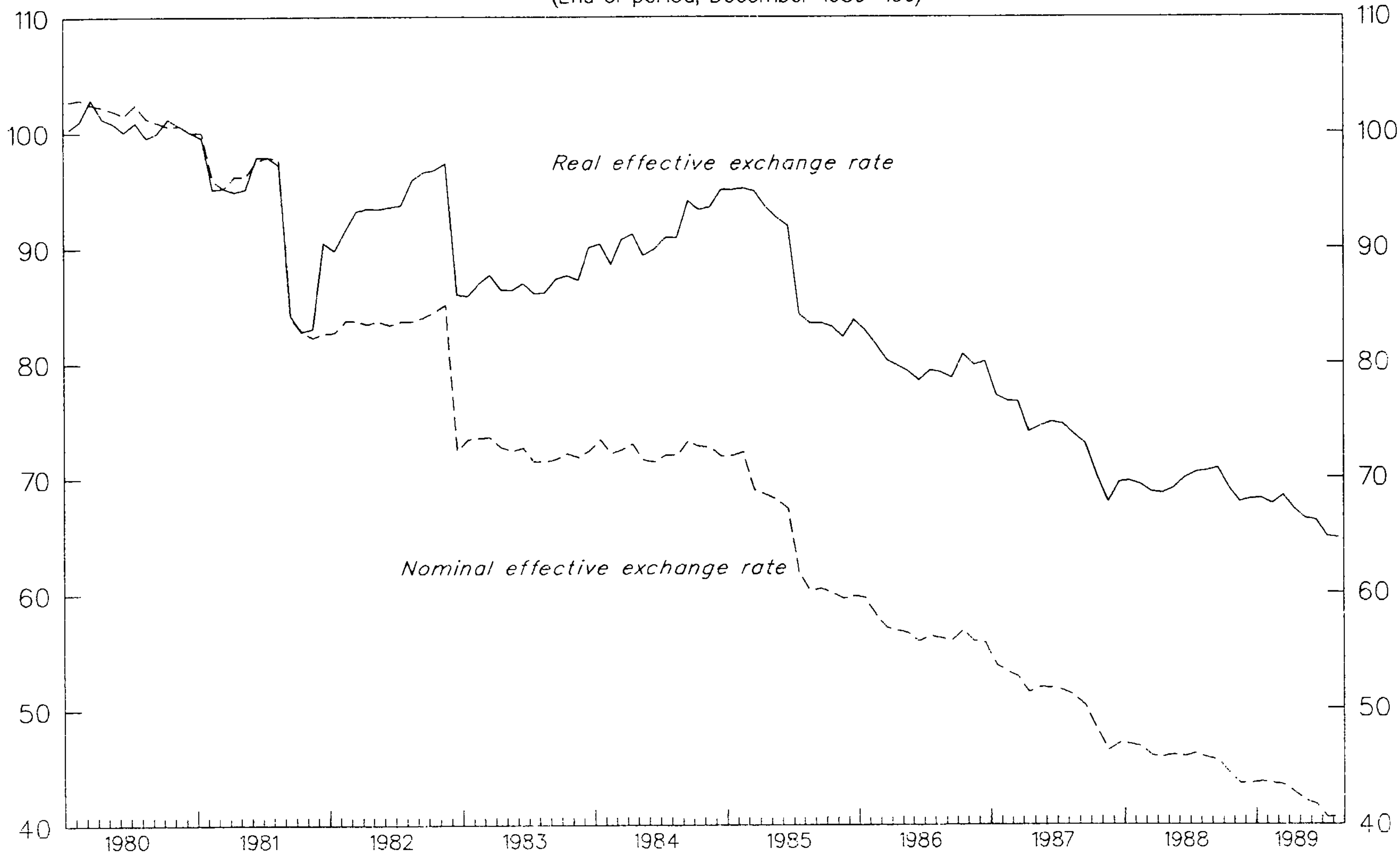
3/ Total export receipts excluding coffee, tea, and oil products.

CHART 1

KENYA

NOMINAL AND REAL EFFECTIVE EXCHANGE RATES, JANUARY 1980–AUGUST 1989

(End of period; December 1980=100)



Sources: IMF, Economic Information System; and data provided by Kenyan authorities.

Table 6. Kenya: Medium-Term Balance of Payments, 1985-90

	1985	1986	1987	1988	1989		1990	
					Prog. 1/	Rev.	Prog. 1/	Rev.
					(In millions of SDRs)			
Current account	-89	-29	-387	-340	31 2/	-78 2/	-236	-266
Exports, f.o.b.	928	998	702	757	825	787	870	889
Coffee	277	408	183	205	210	190	201	219
Tea	230	182	154	155	175	177	195	201
Oil products 3/	117	78	60	63	70	60	70	64
Other	305	330	307	334	370	370	405	407
Imports. c.i.f.	-1,447	-1,435	-1,457	-1,557	-1,601	-1,676	-1,676	-1,746
Government 4/	-92	-247	-282	-266	-238	-253	-230	-237
Oil	-454	-256	-270	-215	-260	-254	-276	-275
Other	-901	-932	-906	-1,075	-1,103	-1,169	-1,170	-1,234
Trade balance	-520	-438	-755	-800	-776	-889	-805	-857
Services (net)	242	232	202	203	272	244	321	302
Of which: Travel	230	240	256	276	301	297	331	327
Private transfers	80	50	56	66	63	69	68	77
Official transfers	108	127	110	191	473 5/	499 5/	180	212
Capital account	-2	106	311	297	27	135	198	219
Long term (net)	-77	109	185	234	12	92	178	227
Official	-55	73	192	249	2	82	158	207
Inflows 6/ 7/	(162)	(289)	(406)	(443)	(492)	(572)	(383)	(432)
Outflows	(-217)	(-217)	(-214)	(-194)	(-490) 8/	(-490) 8/	(-225)	(-225)
Private 9/	-22	36	-8	-15	10	10	20	20
Short term (net) 10/ 11/ 12/	75	-4	126	62	15	43	20	-8
Overall balance	-91	76	-76	-43	58	57	-38	-47
Financing	91	-76	76	43	-58	-57	38	47
Gross reserves	36	18	161	-20	-40	-40	-50	-50
IMF credit (net)	53	-90	-84	64	-18	-18	4	4
Other assets (net)	1	-5	—	-1	—	—	—	—
Additional financing requirements	—	—	—	—	—	—	83	93
Memorandum items:								
Gross reserves (end of period)	381	362	202	222	262	262	312	312
Gross reserves								
In months of nongovernment imports	3.4	3.7	2.1	2.1	2.3	2.2	2.6	2.5
In months of total imports	3.2	3.0	1.7	1.7	2.0	1.9	2.2	2.1
					(In percent of GDP)			
Current account deficit								
Including official transfers	1.5	0.5	6.3	5.3	4.0 2/	5.5 2/	3.7	4.1
Excluding official transfers	3.3	2.5	8.1	8.3	7.0	8.8	6.6	7.4
Net official capital inflows plus official transfers	0.9	3.2	4.9	6.9	6.7	8.8	5.4	6.5

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

1/ EBS/89/84 (4/27/89).

2/ Excluding the cancellation of Government debt owed to the Federal Republic of Germany as described in footnote 5 below, the projected current account in 1989 would be in deficit by SDR 254 million (4 percent of GDP, Program) and SDR 363 million (5.5 percent of GDP, Revised).

3/ Prior to 1987, customs data included bunkering fees collected on transit shipment destined to neighboring countries. The data for 1986 were adjusted, and the counterpart was included in errors and omissions. Data for earlier years are under revision.

4/ Beginning in 1986, data include special imports of defense-related equipment and civilian aircraft. They amounted to SDR 117 million in 1986, SDR 162 million in 1987, an estimated SDR 76 million in 1988, and are projected to amount to SDR 51 million in 1989 and SDR 50 million in 1990.

5/ Excluding in 1989 the cancellation announced on February 9, 1989 of DM 696 (SDR 285) million of amortization payments on Government debt owed to the Federal Republic of Germany, official transfers would be SDR 188 million (Program) and SDR 214 million (Revised).

6/ Includes loans financing imports of defense-related equipment described in footnote 4.

7/ Includes in 1987 and in 1988 counterpart (SDR 43 million in each year) for imports of defense-related equipment purchased in earlier years but shipped in those years. Includes IDA funds in 1989-90 under the Financial Sector Adjustment Credit.

8/ Including the counterpart for the cancellation of debt described in footnote 5.

9/ Series revised to reflect previously unincorporated data from the Central Bank.

10/ Includes in 1989 Eurodollar loan of $62 million contracted by the Coffee Board of Kenya.

11/ Takes into account in 1989-90 the amortization of the Eurodollar loan described in footnote 9.

12/ Includes errors and omissions and valuation adjustments (1985-88).

the Coffee Board's coffee stocks. 1/ Given the short-term nature of the coffee borrowing, it will have no permanent effect on the stock of debt after April 1990; the interest payments will amount to about 0.25 percent of the average annual current account receipts for 1988-89.

On the structural side, the authorities made significant progress in 1989 in implementing the program's measures. Producer prices were raised in February and July to enhance agricultural production. The organizational and financial restructuring of the National Cereals and Produce Board (NCPB) proceeded essentially as scheduled. New NCPB staff began to be recruited, training within the NCPB was strengthened, and a system of monitoring the availability and distribution of food grains was initiated. The financial restructuring of the NCPB was completed with the write-off of K Sh 5.3 billion in the 1988/89 budget and the conversion of the Cereals and Finance Corporation's outstanding loans to the NCPB into equity or irredeemable non-interest-bearing capital from the Government.

A number of fiscal structural reforms were announced at the presentation of the 1989/90 budget involving discretionary tax measures, user charges, and expenditure rationalization (see Section IV.3 below for details). Further steps were taken in 1989 to restructure public enterprises and to monitor and define their financial relations with the Central Government. In particular, the Government allowed Kenya Railways to begin operating on commercial principles, and continued its financial restructuring of both the Railways and the South Nyanza Sugar Company. The Government started monitoring the financial performance and flow of funds of ten nonfinancial public enterprises (selected on the basis of size and reliability of data) and initiated work with technical assistance from the United Nations Development Program (UNDP) to formulate a policy framework for public enterprises. Market rates of interest on direct loans from the Government to the public enterprises began to be charged. Moreover, work commenced on the systematic categorization of the Government's portfolio of loans to public

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1/ At the time of the formulation of the 1989 program, it had been indicated, for purposes of setting the quantitative benchmarks on net international reserves and the ceiling on nonconcessional external borrowing, that no public enterprise could borrow on nonconcessional terms without government guarantee. Although the Coffee Board had already just signed the loan agreement when the negotiations for the program were taking place at the Fund in April, the authorities present at the discussions were unaware of this occurrence. The authorities have subsequently explained that there are a few public enterprises which can borrow on commercial terms without government guarantee based on their own collateral (e.g., the Coffee Board, Kenya Post and Telecommunications Corporation, National Oil Company, and Kenya Pipeline Company); the authorities have recently assured the staff that there are no plans for such enterprises to borrow on this basis for the rest of 1989.

enterprises, with the intention of clarifying the Government's position as net creditor to public enterprises and strictly enforcing the collection of loans. A study of development finance institutions was completed in June 1989 and Cabinet approval was obtained on the principles and guidelines for the financial and organizational restructuring of such institutions.

The implementation of the industrial sector adjustment program, particularly the measures associated with the external sector, has continued in 1989. On the import side, the structural performance criterion relating to the implementation of the import liberalization program and the development of an effective system for monitoring its operations has been observed. In this regard, the import licensing system has been streamlined and the new monitoring system indicates that there has been a considerable shortening of the interval between the application for an import license and the acquisition of the corresponding foreign exchange. Furthermore, the quantitative restrictions on import items in Schedule IIIB were lifted in mid-1989 as planned (thereby raising the value of imports licensed without restrictions to about 94 percent of the value of total 1986/87 imports), and replaced by tariffs as the sole form of protection. The tariff categories for all import schedules were also rationalized in the process of reducing the number of these categories from 17 to 12. At the same time, the weighted average tariff for items in Schedules I, II, and IIIA combined were reduced as programmed. Although average tariffs were raised for items in Schedule IIIB, the actual increases, with only three exceptions, were smaller than those proposed by the recent study on tariff equivalents. Finally, the Government has investigated whether dumping has been a serious problem in Kenya and has concluded that anti-dumping legislation is not required.

In addition to the import measures cited above, which will help encourage investment and nontraditional exports, progress has also been made in 1989 in enhancing export prospects. Three additional manufacturing-in-bond facilities have been approved. A study was completed on export incentives for Kenyan industry. While the insufficient level of detail in the study precluded the immediate development of an action program for a medium-term export promotion scheme, the study did provide helpful comparative analysis along with policy guidelines and recommendations, and was very useful for garnering support for Kenya's outward-looking policies. On the investment side, important measures to strengthen the functioning of the investment approval process were taken. To help remove some bottlenecks, a high-level Cabinet Sub-Committee on Investment, headed by the Vice President, was established. The management of the Investment Promotion Center was strengthened, with the expectation of significantly reducing project approval delays, and investment guidelines were published in May 1989. In line with the objective of improving the efficiency and competitiveness of the industrial sector, in September 1989 the number of items under the Price Control (General) Order was reduced to 19 with the decontrol of the prices of animal feeds and animal salts.

In the context of the Government's financial sector adjustment program and in line with the policy of maintaining positive real interest rates, the minimum savings deposit rate for commercial banks was raised 2 percentage points in April, to 12 percent. Moreover, with a view to encouraging commercial banks to make longer-term loans and in pursuit of the eventual objective of market-determined interest rates, the maximum lending rate for loans with maturities greater than four years was raised by 3 percentage points to 18 percent. To help remove inefficiencies in the financial system, a revised Banking Bill was presented in mid-1989 to Parliament and subsequently passed. The Act strengthens the supervisory role of the Central Bank by allowing it to intervene in institutions--prior to insolvency--to restructure, effect mergers, or liquidate as appropriate. The Act also limits advances to insiders and redefines exposure and capital adequacy requirements. During 1989 the Central Bank strengthened its supervisory capability by developing standardized financial reporting formats, written examination and inspection procedures, and appropriate provisioning guidelines. The Bank also prepared restructuring programs for ten weak financial institutions. To facilitate the promotion, development, and regulation of the securities market, a bill to establish the Capital Markets Authority was presented to Parliament in mid-1989.

IV. Policies for the Remainder of 1989 and 1989/90

In addition to the assessment of economic and financial developments in 1988 and the first half of 1989, the midterm review discussions concentrated on the prospects for the remainder of 1989 and 1989/90, with special emphasis on the adequacy of policy implementation for achieving the growth, inflation, and balance of payments targets of the program. In view of the unexpectedly difficult external environment as well as the inflationary pressures early in 1989, the authorities have decided on the adoption of a more restrictive monetary and credit stance, including higher real interest rates, and an exchange rate policy that attempts to address the more difficult external situation.

1. Economic overview

In view of developments during the first half of 1989, real GDP growth in 1989 is estimated to be 4.9 percent, slightly less than the targeted 5.1 percent. This outcome, compared with the targeted growth for 1989, may be attributed primarily to the less favorable performance of the agricultural, transport, and trade sectors and the more favorable performance of the finance, building and construction, and ownership of dwellings sectors. The manufacturing and government sectors are expected to perform as initially envisaged.

The domestic resource balance, or savings-investment balance, is expected to deteriorate marginally in 1989. Total consumption (at current prices) is projected to increase slightly, from 79.5 percent of GDP in 1988 to 79.9 percent in 1989, reflecting an increase in private consumption. The domestic savings ratio will fall commensurately, largely owing to the projected decline in private savings, while government savings is expected to improve. The decline in private savings in 1989, due in part to the fall in real interest rates at the beginning of the year with the high inflation rate, is expected to be reversed, aided by the planned monetary policy measures in late 1989 and in early 1990. Gross investment relative to GDP is likely to increase slightly in 1989, in part because of the favorable impact of import liberalization on private investment.

The month-on-month inflation rate, which began to decelerate after May 1989 and was about 9 percent in August 1989, is anticipated to remain at about 9 percent at end-1989, compared with the targeted 8 percent. The expected slowdown in inflation during the second half of 1989 reflects in part the tighter monetary stance.

2. Balance of payments outlook and external policies

The external sector outlook for 1989 and 1990 appears less favorable than initially projected. 1/ For 1989, the current account deficit is now expected to widen slightly, from 5.3 percent of GDP in 1988 to 5.5 percent in 1989, rather than narrowing to 4.0 percent of GDP from 4.5 percent of GDP as envisaged in the program. External capital inflows, however, are likely to be substantially higher than originally projected, such that the programmed buildup in net official reserves of SDR 58 million by the end of 1989 is still expected.

The current account deterioration in 1989 is largely due to a higher trade deficit. The original program had assumed almost no change in SDR terms in the average export price of Kenyan coffee in 1989, whereas these coffee prices are currently expected to be 24 percent lower than in the previous year, reflecting the drop in world coffee prices in the wake of the collapse of the quota system under the International Coffee Agreement. Mostly because of this revision, 1989 coffee export receipts are now likely to be SDR 30 million below the level assumed in the program. Oil export projections have also been lowered to reflect reduced sales to neighboring countries. Imports are expected to be higher than previously envisaged, because of both higher government imports as well as the strong demand thus far in 1989 for nongovernment imports, which reflects in part a stronger-than-

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1/ Revised balance of payments projections, presented in Table 6, are based on discussions with the Kenyan authorities and broadly reflect the most recent commodity price projections from the Fund's Research Department at the time of the mission, but with coffee and tea prices at somewhat lower levels. Consistent with these latter projections--which have average coffee prices rising by about 20 percent by the fourth quarter of 1990 from their level in the third quarter of the previous year--there is to be a significant rebound from the prevailing low level of current coffee prices.

anticipated impact of import liberalization. Meanwhile, estimates of net service receipts have been reduced. This reduction results from the interest payments on the Coffee Board loan and lower airport services receipts following an increase in the minimum jet fuel price to a level above world prices. Receipts from tourism are expected to be only modestly lower than in the program, as recent incidents in the game parks appear not to have had much of an overall adverse effect on bookings.

The higher capital inflows in 1989 largely reflect developments under the ISAC as well as the Coffee Board borrowing discussed earlier. The second tranche of the ISAC from IDA is expected to be disbursed before the end of 1989, as scheduled. However, the amount of associated cofinancing, which already had accounted for a significant amount of programmed inflows, is now expected to be even higher than previously anticipated, because of both additional funds and some speeding up of disbursements. Under the FSAC from IDA, about SDR 50 million will be disbursed in 1989, in line with expectations.

The deterioration in the current account observed in 1989 should be reversed in 1990. A significant decline in the deficit to 4.1 percent of GDP is now projected for 1990, against the somewhat smaller deficit of 3.7 percent of GDP originally targeted. Coffee exports are projected to rebound in 1990 because of both higher prices, expected to increase by 5 percent in SDR terms in 1990 from the previous year's level, and higher volume; the anticipated 15 percent rise in volume reflects declining inventories, higher production, the Coffee Board's projected sales program, and the quality premium on Kenyan coffee. The value of coffee exports, as a result, is above the original projection. 1/ Tea exports will benefit from unexpectedly higher prices while the remaining categories of exports are little changed. On the import side, the growth in nongovernment, non-oil, imports is expected to decelerate from about 5 percent in real terms in 1989 to half that in 1990, in line with cautious macroeconomic policies and the assumed drawdown of imported inventories accumulated during the previous phases of the import liberalization program. With little change in import prices, the growth rate still implies that the value of these imports in 1990 will be about 5 percent higher than earlier projected. In the services account, tourism is expected to remain a buoyant source of foreign exchange earnings, although projected net services receipts have been scaled back.

With net capital inflows only somewhat higher than previously projected and insufficient to offset a wider-than-programmed current account deficit, current indications suggest that the financing gap for 1990 has grown moderately to SDR 93 million, taking into account the

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1/ Should coffee prices not rebound but remain at about their fourth quarter 1989 level, the value of coffee exports in 1990 would stay around its level in the previous year. Clearly, less robust export volume growth would also put pressure on the external position.

unchanged reserve target. There are reasonable prospects that the 1990 financing gap will be filled by cofinancing of the FSAC, IDA reflow funds, and additional aid inflows. Moreover, some official bilateral creditors are expected to write off their loans to Kenya.

To support Kenya's adjustment effort, a flexible exchange rate policy will continue to be pursued. This is particularly necessary in light of the unexpectedly less favorable external environment, the need to support the trade reforms being implemented, and the goal of expanding and diversifying the export base. In this regard, the real effective exchange rate was depreciated by an additional 2.2 percent in July and August, so that the depreciation in the first eight months of 1989 amounted to 4.9 percent. 1/

On the structural side, more detailed work has begun on assessing the impact on domestic industries of unrestricted import licensing, which will be ultimately directed toward the preparation of an action program for restructuring viable public enterprises adversely affected by liberalization. A proposal to study and recommend policies for restructuring the textile industry has been approved by IDA for funding through its Project Preparation Facility. As regards the export compensation scheme, the Government clearly recognizes the need to improve administrative arrangements to ensure prompt payment of export compensation; the aim is to reduce delays in obtaining compensation, with one month targeted as the maximum time for obtaining compensation. Further work on a comprehensive medium-term export promotion program is currently under way, with the expectation that a program for export processing zones will be formulated by June 1990. In this connection, an initial study has been commissioned to evaluate the enabling environment for an export processing zone near Mombasa, which should be completed before the end of the year. Another study, which is to be financed through the World Bank Special Project Preparation Facility and Special Project Facility, and which is to be commissioned by the end of the year for completion by mid-1990, will evaluate the enabling environment for an export processing zone near Nairobi; further detailed and technical work will be undertaken as needed.

3. Fiscal policy and structural reforms in the budget

In line with the medium-term fiscal and macroeconomic objectives, the fiscal program for 1989/90 provides for the containment of the overall cash deficit at 4.2 percent of GDP (6.8 percent excluding grants) and includes structural revenue and expenditure reforms. This program target, although representing an increase in the cash deficit of 0.3 percentage point above the estimated 1988/89 outcome, is to be held

1/ Calculations of the real effective exchange rate are based on data (on country coverage, price indices, exchange rates, etc.) agreed with the Kenyan authorities, and not the same as the data utilized in the Fund's Information Notice System.

close to the 4.2 percent budget deficit (4.1 percent in terms of revised GDP) originally targeted in order to accommodate the programmed inflow of concessional external resources amounting to 3.1 percent of GDP while maintaining the programmed domestic financing of the deficit. The 1989/90 budget, as presented to Parliament, also allows for the possible absorption of additional highly concessional external financing (equaling about 0.8 percent of GDP) of meritorious projects supportive of growth, should this not jeopardize the achievement of the macroeconomic targets.

To achieve the deficit target, total revenue and grants are programmed to increase to 26.7 percent of GDP in 1989/90, 1.2 percentage points above the 1988/89 level. Foreign grants are targeted to increase by about 0.5 percent of GDP. Total revenue in 1989/90 is projected to rise by 0.9 percentage point, to 24.1 percent of GDP. Targeted additional revenue from the introduction of user charges is anticipated to amount to about 0.4 percent of GDP, with the remaining receipts projected to come primarily from additional tax revenue from import duties and the sales tax on imports. As in the previous fiscal year, about 0.6 percent of GDP (K Sh 1.2 billion) is expected to be raised from new discretionary tax measures introduced in the 1989/90 budget. About K Sh 500 million, or 43 percent of this amount, is projected to come from the increase in the sales tax on beer introduced earlier in 1989 and the sales tax/value-added tax (VAT) reform. The raising of excise duties on cigarettes and tobacco in April 1989 is expected to bring in additional revenue of K Sh 300 million (26 percent), while changes in the existing tariff structure (to replace quantitative restrictions) are anticipated to yield K Sh 200 million (17 percent), with the remaining receipts coming from income tax and miscellaneous other measures. In particular, the introduction of a presumptive tax of 5 percent on the value of gross sales of agricultural produce is expected to yield revenue of about K Sh 812 million. Additional taxation measures include the lowering of the effective corporate tax rate and the top rate of personal income tax, a widening of personal income tax brackets, and an increase in income tax personal exemptions. The net effect on revenue from the new income tax measures and miscellaneous taxes is about K Sh 160 million (14 percent), allowing for a projected loss in receipts of about K Sh 510 million from the elimination of the export tax on coffee and tea.

On January 1, 1990, the manufacturing sales tax will be replaced by a VAT that retains the multiple rate structure, while a uniform 17 percent VAT will be levied on business services. The net receipts from the sales tax/VAT reform, allowing for reduced sales tax rates on some goods under the 1989/90 budget, should yield K Sh 180 million (0.1 percent of GDP) in 1989/90. Moreover, in line with the program's objective of financing a rising share of recurrent expenditures through user charges on health, education, and other public services, about K Sh 860 million will be raised from newly introduced charges. In the health sector, K Sh 228 million will be raised from the introduction of fees for hospital services in district and provincial hospitals, as well as at the Kenyatta National Hospital. In the education sector, higher fees for tuition and boarding at the universities, reduced allowances at the teacher training colleges, and the netting out of existing charges to parents from secondary school budgetary grants, will yield K Sh 564 million.

Government expenditure is targeted at 30.9 percent of GDP in 1989/90, close to the 30.8 percent originally programmed (30.0 percent in terms of revised GDP). The upward revision of expenditure in terms of revised GDP reflects primarily an increase in development spending that is higher than initially programmed as a result of the Appropriations-in-Aid (A-in-A) development grants of K Sh 764 million (0.4 percent of GDP), and an upward revision in some recurrent outlays, including external interest payments and personnel expenditures. Taking into account the lower-than-expected expenditure outturn for 1988/89 and the presently programmed outlays for 1989/90, the annual average total expenditure in terms of GDP for the two fiscal years is projected to be about 30 percent, as originally programmed.

An important element of the 1989/90 program is the introduction of a ceiling of 7.5 percent on the growth of the wage bill (total personal emoluments in all ministries, including the Ministry of Education) to help restrain total expenditures and to correct the imbalance between government wages and nonwage and maintenance outlays. The Government has introduced a number of measures to curtail growth in civil service employment, including: (1) the freezing of all posts that had been vacant for more than six months as of end-April 1989; (2) a ban on the further upgrading or creation of posts during 1989/90, except with specific authority from the Treasury; (3) the extension of control over recruitment at lower grade job levels; (4) the withdrawal of guaranteed government employment for trainees from government training institutions; and (5) a reduction in the number of untrained teachers employed without Government approval. The authorities believe that these measures should be sufficient to meet the program's target for the growth in the wage bill.

In conformity with the budget rationalization program, the 1989/90 budget limits capital expenditures to a small number of high priority projects and provides for real increases in operations and maintenance expenditures in priority sectors, including education, health, road maintenance, water supply, and agricultural services. A monthly monitoring system of wage bill developments and operations and maintenance outlays will be implemented in 1989. To increase the effectiveness of the process of government expenditure planning, the Government will prepare a public sector project list in December 1989, distinguishing ongoing from new projects and classifying projects according to budgetary subheads. Additionally, a public fixed investment program will also be formulated, embracing the capital expenditure of both the Central Government and selected nonfinancial public enterprises.

The program provides for an increase in external financing of 0.3 percentage point, to 3.1 percent of GDP in 1989/90, in line with Kenya's greater recourse to concessional external resources. Domestic financing of the deficit remains as programmed, at 1.1 percent of GDP, with the increase in bank credit limited to 0.6 percent so as to provide sufficient room for credit expansion to the private sector. In the event that net external financing (excluding A-in-A financing) or domestic nonbank financing of the deficit exceeds that programmed, the target for net credit to the Government during 1989/90 (as measured at the end of June 1990) will be adjusted downward by the amount of the excess (Table 7). The programmed financing of the 1989/90 cash deficit also excludes recourse to delayed payments by the Government, consistent with the program's aim of limiting the size of the float. The level of unpresented checks at the end of June 1990 will not exceed their end-June 1989 level of K Sh 2.9 billion.

In the medium term, the Government seeks to reduce the overall budgetary deficit to a level compatible with available foreign financing and noninflationary domestic financing. The Government aims at reducing the overall cash deficit from 4.2 percent of GDP in 1989/90 (6.8 percent excluding grants) to 3.7 percent of GDP in 1990/91 and 3.2 percent of GDP (5.8 percent excluding grants) in 1991/92. Attainment of these targets will require the implementation of structural measures to raise total revenue by 0.5 percentage point, to 24.6 percent of GDP by 1991/92, and to reduce the expenditure/GDP ratio by about 0.5 percentage point, to 30.4 percent of GDP in 1991/92. Moreover, by 1991/92, almost all additional domestic bank credit will be channeled to the private sector. Structural reforms in taxation policy will further broaden the tax base and increase the elasticity of the tax system, and will include the extension of the proposed manufacturing and business services VAT to the retail sector by 1991/92, the modernization and strengthening of tax administration in the revenue-collecting department, and improved tax policy formulation capabilities of the Treasury. An increasing share of recurrent costs will be financed by user charges for educational and medical services. On the expenditure side, the Government remains committed to reducing gradually the share of the budget claimed by personnel expenditure, through annual ceilings on the growth in the wage bill, while increasing real nonwage operating outlays in priority sectors. Beginning in the next annual budget and the 1990/91-1992/93 forward budget exercise, the Government will present an economic classification of expenditures and also distinguish between ongoing and new development projects.

4. Public enterprise reform

In the course of 1989/90, the Government intends to pursue further its efforts toward public enterprise reform, with the overall objective of increasing their efficiency and financial viability. The Government will continue the ongoing program of organizational reform of the NCPB and the financial restructuring of the Kenya Railways and the South Nyanza Sugar Company. The monitoring of the financial performance and

Table 7. Kenya: Performance Criteria and Benchmarks of the First Annual Arrangement Under the Enhanced Structural Adjustment Facility

	1989	1989		1990	
	June Actual	Sept. 1/	Dec. 2/	March 3/	June 3/
Quantitative Performance Criteria					
		(In millions of Kenya shillings)			
Total domestic credit 4/	52,422	56,897	58,080	57,371	57,712
Net bank credit to the Government 5/	13,670	17,420	17,270	15,631	14,772 6/
Banking system	(17,510)	(21,891)	(21,741)	(20,241)	(19,382)
CSFC	(-3,840)	(-3,701)	(-3,701)	(-3,840)	(-3,840)
Debt assumed from parastatals	(—)	(-770)	(-770)	(-770)	(-770)
		(In millions of U.S. dollars)			
New nonconcessional external loans contracted or guaranteed by the Government (cumulative per calendar year) 7/					
a. 1-12 years' maturity	56.4	100.0	100.0	...	...
b. Short-term credits of less than one year's maturity 8/	—	—	—	...	...
Quantitative Benchmark					
		(In millions of SDRs)			
Minimum cumulative increase in net official international reserves from end-December 1988 9/	80	37	58	...	...

Nonquantitative Performance Criteria

Review: A midterm review will be completed by end-October 1989 to assess implementation of structural measures, the 1989/90 budget, exchange and interest rate policies, the financing of the 1989 balance of payments, and the benchmarks and performance criteria during first half of 1989/90.

Trade and Payments Restrictions:
The Government of Kenya will continue to maintain a liberal exchange and trade system and will not introduce any new, or intensify existing, restrictions.

Structural Performance Criterion	Target Date
Implement the import liberalization program and provide on monthly basis data on import license applications, approvals, and corresponding foreign exchange allocation.	End-September 1989.
Structural Benchmarks	
Maintain positive real interest rates.	Throughout 1989.

Source: Memorandum attached to the letter of request of Kenyan authorities of April 18, 1989; and the letter of intent dated September 26, 1989.

1/ Performance criteria.
2/ Quantitative benchmarks.
3/ Indicative targets.
4/ Total domestic credit of the banking system is the sum of net credit to the Government, other public sector credit, and private sector credit. It includes bank credit utilized by the Cereals and Sugar Finance Corporation (CSFC).
5/ Net credit to the Government is net credit to the Government from the banking sector. The ceiling excludes the operations of the CSFC, and the amount of public enterprise debt assumed by the Government and reclassified from outstanding private sector credit.
6/ This target will be adjusted downward to the extent that net external financing of the deficit during the July 1989-June 1990 period, excluding A-in-A financing, exceeds K Sh 204 million, or to the extent that domestic nonbank financing exceeds K Sh 0.9 billion.
7/ In conformity with existing regulations, no public enterprise will borrow on nonconcessional terms without Government guarantee. For purposes of converting new nonconcessional external loans into U.S. dollars, the U.S. dollar exchange rates cabled to the Central Bank of Kenya from the Federal Reserve Bank of New York for January 3, 1989 will be used.
8/ Other than related to imports.
9/ Net official international reserves are defined as the Central Bank of Kenya's net foreign reserve assets (SDRs, gold, and foreign exchange holdings) minus its short-term deposit liabilities to foreigners; plus the Central Government's net foreign reserve assets (excluding those related to Fund transactions); plus Kenya's reserve position in the Fund; minus Kenya's net use of Fund credit.

flow of funds of selected nonfinancial public enterprises will be further expanded and refined in 1989/90. The draft policy framework paper on public enterprises should be completed by December 1989. Moreover, preliminary action in restructuring the Industrial Development Bank and the Industrial and Commercial Development Corporation is expected by the end of 1989; by June 1990 action is to be taken as to which subsidiaries of these institutions will be privatized, restructured, or liquidated. In the course of 1989/90, the Government will begin to address the need for a major re-equipping and organizational restructuring of Kenya Airways and its likely borrowing requirements over the course of the three-year program. The Government has indicated that it will seek the assistance of the Fund and the World Bank in evaluating the investment program of Kenya Airways and ensuring that the program can be undertaken within the framework of the macroeconomic program.

5. Monetary policy and financial sector reform

During the remainder of 1989 and the first half of 1990, monetary policy will seek to reduce inflationary pressures and support external adjustment. Total domestic bank credit is programmed to increase by 10.1 percent in 1989/90, with net credit to the Government expanding by 10.7 percent. 1/ This target for credit expansion is consistent with an expansion of 8.2 percent in broad money and an increase in velocity, from 3.48 at end-June 1989 to 3.62 at end-June 1990. This is a tighter monetary stance than in the original program, which targeted broad money to expand by more than 12 percent, and reflects concerns with inflationary pressures as well as the unexpectedly less favorable external current account positions for 1989 and 1990.

Financial sector reform will continue during the remainder of 1989. In line with the objective of achieving eventual market determination of interest rates and in view of inflationary pressures thus far during 1989, certain adjustments in the interest rate structure will be undertaken. By October 15, 1989, the minimum savings deposit rate for commercial banks will be raised from 12.0 percent to 12.5 percent, the commercial banks' maximum lending rate for maturities of three years or less will be raised to 15.5 percent from 15.0 percent, and those for more than three years will be raised to 18.0 percent. At the present time the 18.0 percent maximum lending rate applies only to maturities greater than four years. Moreover, should the inflation rate during the remainder of 1989 be higher than currently envisaged, additional interest rate action will be taken at the beginning of 1990.

1/ In the comparison of the program targets with the original program targets, account needs to be taken of the fact that in September 1989 the Government assumed K Sh 770 million of the liabilities of the public enterprises to the banking system. Until then the liabilities had been recorded as bank claims on the nongovernment sector.

During the last quarter of 1989, progress is expected in the introduction of monetary programming. Although the Monetary Policy Committee has been actively meeting and handling a variety of issues, the introduction of reserve money management and the active use of available monetary policy instruments have been somewhat delayed owing to unavoidable delays in securing technical assistance to the Central Bank. Fund technical assistance, in the form of an Advisor on Open Market Operations to the Central Bank, is expected to be available in October 1989. Regarding the development of the capital market, it is anticipated that the Capital Markets Authority will be established soon after Parliament approves its legislation.

V. Social Implications of Program

The potential social impact of the structural measures being implemented in Kenya in relation to most other African countries is relatively small since the economic distortions and imbalances in the country are comparatively much less. The adverse effects of some of the programmed measures are also being minimized in Kenya by their gradual application and by the Government's active efforts to ameliorate their impact. Thus, the introduction of higher fees at the university has been accompanied by a loan program through the commercial banks to assist needy students. The introduction of fees in the hospitals is being matched by an effort to raise the quality of care provided as well as a program to strengthen services at health centers and dispensaries, which provide much of the care for the most vulnerable groups. In 1989, the Government also established a Ministry of Reclamation and Development of Arid, Semi-Arid and Wasteland in order to help transform those areas from being recipients of welfare to being providers of employment, surplus food, and growth. Moreover, plans are under way for the Government to launch a Small-Scale Enterprise Program to help create additional jobs, particularly in the growing urban centers outside Nairobi.

VI. Staff Appraisal

Kenya's 1989 program, supported by the first annual arrangement under the ESAF, remains essentially on track. The quantitative and structural benchmarks for mid-1989 were all observed, in some cases with a wide margin. Moreover, the structural performance criterion relating to the implementation of the import liberalization program and import license monitoring system was met before the scheduled program date of end-September 1989. The program targets for real economic growth and international reserves are on the whole expected to be realized in 1989, but the targets for the current account deficit, owing mainly to unanticipated external developments, and for the inflation rate are likely to be exceeded.

In view of these developments, for the remainder of 1989 the authorities should maintain their present policy stance, which includes a tighter monetary and credit stance than originally programmed and the flexible management of the exchange rate. Moreover, even though the end-December credit benchmarks in the program remain as originally set, the authorities would be well advised to keep credit expansion below these benchmarks. In this connection, the authorities' plans to raise interest rates are to be commended, both in terms of the needed current monetary stance and in terms of the medium-term objectives of the program.

The cash budget deficit for 1988/89 was below the program target. As in the previous fiscal year, however, this outcome was achieved by the postponement of cash payments and by the buildup of unpresented checks at the end of the year. The authorities' commitment to confine the level of unpresented checks at the end of 1989/90 to their end-1988/89 level is welcomed. It is essential for the authorities to be vigilant in their efforts to attain the programmed fiscal deficit target and to maintain the pace of structural fiscal reforms during 1989/90. In this regard, the authorities will need to continue their commitment to reduce the growth in personnel expenditure to the 1989/90 program target through the implementation of measures recently introduced to limit government employment and the containment of average annual salary increases to within-grade increments.

Considerable progress has been made with the implementation of the import liberalization program. The staff also commends the authorities on the exchange rate policy followed thus far in 1989 and on their commitment to continue pursuing a flexible exchange rate policy that takes into account trade reform, external developments, and the need to encourage export diversification and expansion. Such a flexible approach to policy in general is particularly important in the light of the vulnerability of Kenya's balance of payments to adverse external developments, which has once again been demonstrated in 1989. The more immediate external prospects now look weaker than previously envisaged, and without appropriate policy adjustment so will the medium term. Thus, the authorities should stand ready to accelerate the pace of the depreciation of the real effective exchange rate during the remainder of 1989 and to take stronger corrective measures if the need arises. Moreover, the authorities should adhere firmly to their policy of borrowing from abroad on concessional terms, which is essential for the attainment of the program's projected decline in the debt service ratio. At the same time, the authorities' efforts to take corrective actions and strengthen the external position will need to be supported by adequate and timely external concessional assistance.

During 1989 the programmed structural measures have been implemented essentially as envisaged, and the authorities are encouraged to continue with their structural reform efforts in the remainder of the year. In this regard, the export compensation scheme needs to be improved and the development of a medium-term export promotion program needs to be hastened. Moreover, further progress should be achieved on the reforms scheduled in the public enterprise sector, the tax system, the financial sector, and price decontrol.

VII. Proposed Decision

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

The Fund determines that the midterm review specified in paragraph 2(c) of the first annual arrangement under the enhanced structural adjustment facility (EBS/89/84, Sup. 1, 5/26/89) has been completed.

September 26, 1989

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. Camdessus:

1. The Memorandum on Economic and Financial Policies, which accompanied our letter of April 18, 1989, outlined the structural adjustment program that the Kenyan Government intended to pursue during the three year period January 1989-December 1991, and presented in detail the objectives, policies, and measures for the first year of this program. In support of this program, on May 15, 1989 the Fund approved a three-year structural adjustment arrangement under the enhanced structural adjustment facility (ESAF) in an amount equivalent to SDR 241.4 million, 170 percent of Kenya's quota, and the first annual arrangement thereunder.

2. During the first half of 1989, considerable progress was made in program policy implementation and the program remains essentially on track. The program's fiscal target for 1988/89 (July-June) was achieved, restraint in overall credit policy was maintained, flexible exchange and interest rate policies were continued, and significant reforms were introduced under the financial sector restructuring and industrial sector adjustment programs. The program's quantitative benchmarks for end-June 1989 were observed and the structural benchmarks are being implemented as scheduled.

3. The overall economic growth target for 1989 has been reduced slightly from 5.1 percent to 4.9 percent. This reduction mainly reflects less favorable weather conditions at the beginning of 1989, lower than anticipated coffee production, and higher oil prices. The inflation rate during the first half of 1989 has remained relatively high; at the end of June 1989, the weighted month-on-month rate of inflation was 10.3 percent (viz., end-June 1989 relative to end-June, 1988). This development may be attributed to increases in producer and consumer prices in February and April, increased excise and sales tax rates brought forward from the 1989/90 budget to April 1989, and a somewhat greater-than-anticipated growth in broad money. While the inflation rate has begun to abate since the peak of 11.5 percent in May to 8.9 percent in August, the weighted month-on-month rate of inflation in 1989 is still estimated to be about 9 percent instead of the targeted 8 percent. In the external sector, net official reserves, excluding the external borrowing by the Coffee Board of Kenya, increased by SDR 30 million during the

first half of 1989, compared with the target of SDR 42 million, despite preliminary customs data which indicate strong import growth in the first five months of this year. The Coffee Board, which operates on a commercial basis, borrowed SDR 50 million in April 1989 to finance large inventories of coffee that had built up when export quotas were in effect and to facilitate payment to producers. This loan, which will be repaid in less than one year, was not guaranteed by the government, and was backed by collateral in the form of the Coffee Board's coffee stocks.

4. Based upon preliminary actual data, the 1988/89 fiscal program target of an overall cash deficit of 4.5 percent of GDP (6.9 percent excluding grants), was attained, with a cash deficit of 3.9 percent of GDP (6.1 percent excluding grants). Government revenues were K Sh 88 million below the program target, while total expenditure was K Sh 1.2 billion (0.7 percent of revised GDP) less than originally anticipated. External financing of the budget amounted to K Sh 4.6 billion (2.8 percent of GDP), compared with K Sh 3.9 billion in the program. The bulk of the K Sh 1.8 billion of domestic financing, in contrast to the program, was from nonbank sources. As a result, net bank credit to the Government at end-June 1989 was about K Sh 2.0 billion below the program benchmark. However, the stock of unpresented cheques increased from K Sh 1.1 billion at the end of June 1988 to K Sh 2.95 billion at the end of June 1989.

5. Overall domestic credit developments through the first half of 1989 were more contractionary than programmed. Net domestic credit grew by 8.3 percent in 1988/89 (July-June), compared with 13.7 percent in the program. Credit to the Government increased by only 2.3 percent during this period, in contrast to the targeted 12.8 percent, while credit to the nongovernment sector rose by 11.6 percent, compared with the programmed 14.2 percent. Broad money, however, expanded by 17.8 percent in 1988/89, in contrast to a growth of 17.0 percent in the program, while net foreign assets were higher than projected. Positive real interest rates continued to be maintained.

6. External sector policies during the first half of 1989 were in line with the program. The exchange rate was flexibly managed, depreciating by 2.7 percent in real effective terms during this period. At the same time, official external borrowing on nonconcessional terms was confined to US$56.4 million for loans in the 1-12 year maturity range at the end of June, 1989.

7. Progress was also made during the first half of 1989 in implementing the program's structural policy measures. Producer prices were raised in February for beans and in July for maize and wheat to improve the incentives for agricultural producers to expand production. In the area of parastatals, the financial and organizational restructuring of the National Cereals and Produce Board (NCPB) has proceeded essentially as scheduled. The Government also began to charge market rates of interest on direct loans to public enterprises, completed the study of development finance institutions, and began to allow Kenya Railways to operate on commercial principles. Fiscal structural reforms introduced in mid-1989 included the elimination of the export tax on coffee and tea, the lowering of the effective corporate tax rate and the top rate of personal income tax, an increase in income tax allowances,

and, to widen the income tax net, the introduction of a tax on the value of gross sales of agricultural produce.

8. Within the context of the Government's financial sector adjustment program, a number of policy actions have been taken. To ensure positive real interest rates, the minimum savings deposit rate for commercial banks was raised 2 percentage points to 12 percent in April. At the same time, with a view to encouraging commercial banks to make longer term loans, the maximum lending rate for loans with maturities greater than four years was raised from 15 percent to 18 percent. In mid-1989, a revised Banking Bill was passed by Parliament and is awaiting Presidential assent. It should strengthen the supervisory role of the Central Bank vis-à-vis the commercial banks, limit advances to insiders, and redefine exposure and capital adequacy requirements. At the same time, legislation was tabled to establish a Capital Markets Authority, a semipublic institution to promote, develop, and regulate the securities market. In support of these reforms, in June 1989 the World Bank approved for Kenya a US$125 million financial sector adjustment credit and financial sector technical credit.

9. The implementation of the industrial sector adjustment program, which came into effect in mid-1988 and is being supported by the IDA and other multilateral and bilateral donors, continued in 1989. In line with the program's aims of encouraging investment and nontraditional exports, the quantitative restrictions on import items in Schedule IIIB were removed in mid-1989, and replaced by tariffs as the sole form of protection. At the same time, the number of tariff categories for all import schedules was rationalized and reduced from 17 to 12. In the process, the weighted average of tariffs for items in Schedules I, II, and IIIA combined were reduced. While average tariffs were raised for the items in Schedule IIIB, the actual increases in these tariffs were, with only three exceptions out of a thousand, smaller than those proposed by the recent consultants' study on tariff equivalents. Moreover, the import licensing system has been streamlined; the weekly data provided by the new monitoring system indicate that the time it takes from applying for an import license to acquiring the corresponding foreign exchange has been reduced considerably and there has been an improvement in confidence in the system. As a result of these measures, the program's structural performance criterion relating to import liberalization has been met before the targeted end-September 1989 date. With an eye toward further enhancing export prospects, a study was completed on export incentives for Kenyan industry. The Government has taken several measures to strengthen the functioning of the investment approval process, which can also play an important role in enhancing export prospects through foreign participation in, for example, manufacturing-in-bond and export processing zones. A Cabinet Sub-Committee on Investment, headed by the Vice President, has been established to remove some of the bottlenecks in the investment project approval process. At the same time, the management of the Investment Promotion Centre has been strengthened. It is expected that project approval delays will be significantly reduced. With respect to the restructuring of development finance institutions (DFIs), a study on this topic was completed in June 1989. Cabinet approval was obtained on the principles and guidelines

to guide the restructuring program, and a detailed DFI action plan has been prepared and approved.

Policies for 1989/90

10. In line with the program's objectives, the program fiscal target for 1989/90 is to be confined to an overall cash deficit of K Sh 7.65 billion, or 4.2 percent of GDP (6.8 percent excluding grants). Net external financing of the program cash deficit will amount to K Sh 5.6 billion or 3.1 percent of GDP (K Sh 204 million, net of Appropriations-in-Aid (A in A) financing), while domestic financing will be about K Sh 2 billion or 1.1 percent of GDP (with K Sh 1.1 billion or 0.6 percent of GDP from the banking system). In the event that the net external financing (excluding A in A financing) or domestic nonbank financing of the budget deficit exceeds that programmed, the target *for net bank credit to the Government during 1989/90 as measured at the end of* June 1990 will be adjusted downward by the amount of the excess. Consistent with the Government's intention to limit the size of the float, the level of unpresented cheques at the end of June 1990 will be no larger than their end-June 1989 level. In formulating the 1990 annual program, the fiscal targets will be reviewed in the light of macroeconomic considerations, fiscal and balance of payments prospects, and the availability of additional external concessional assistance.

11. Total revenue will be raised by 0.9 percent of GDP to 24.1 percent of GDP in 1989/90; or about 0.4 percent of GDP is expected to be raised from newly introduced user charges in health, education, and other public services, while the remainder is projected to come primarily from additional tax receipts from import duties and sales tax on imports. As in the previous fiscal year, about 0.6 percent of GDP is projected to come from new discretionary tax measures, with about 40 percent of the increase in revenue from these measures from the increase in the sales tax on beer in April 1989 together with the reform of sales taxation, while the remainder is to be derived from tariffs, excises, and miscellaneous other measures. The introduction of a presumptive tax of 5 percent levied on the value of gross sales of agricultural goods is expected to yield revenue of about K Sh 812 million, and this tax will more than offset the projected loss in receipts of about K Sh 510 million from the elimination of the export tax on coffee and tea. A bill to replace the sales tax by a multiple tax rate value added tax (VAT) on manufactured goods and a 17 percent tax on business services was tabled in mid-1989, and the VAT will be implemented on January 1, 1990. The introduction of the VAT is projected to yield K Sh 180 million (0.1 percent of GDP) in net additional revenue in 1989/90. It is intended that the VAT will be extended to the retail level. Moreover, during 1989/90, K Sh 860 million will be raised from newly introduced user charges for health, education, and other public services. In particular, K Sh 228 million will be raised from the introduction of additional charges for hospital services in district and provincial hospitals as well at the Kenyatta National Hospital. In the education sector, higher fees for tuition and boarding at the universities, reduced allowances at the teacher training colleges, and the netting out of existing charges on parents from budgetary grants to some secondary schools, will yield about K Sh 564 million to the budget.

12. In terms of expenditure policy, the Government will continue with its budget rationalization program. In line with the fiscal program's aims to restrain expenditure growth and to begin to correct the prevailing imbalance between wage and nonwage operating and maintenance expenditure in recurrent outlays, the increase in the wage bill (personnel emoluments in all Ministries, including subventions to Teachers Service Commission) will be limited to 7.5 percent in 1989/90, compared with the preliminary estimate of 16 percent in 1988/89. This will require a deceleration in the growth of government employment to about 3.5 percent and a containment of average wage increases to the 4 percent normally arising from within-grade salary movements. The following measures have been introduced to help achieve this target: (1) the freezing of all posts which have been vacant for more than six months as of April 26, 1989; (2) a ban on further upgrading or creating of posts during 1989/90, except with specific authority from the Treasury; (3) control over recruitment of non-technical and lower grade job groups; (4) the withdrawal of guaranteed employment in Government for trainees from Government training institutions; and (5) a reduction in the number of untrained teachers. The Government will also provide for a real increase in outlays for operating expenses in priority sectors, including education, health, road maintenance, water supply, and agricultural services. A system for the monthly monitoring of the wage bill and operating expenses will be implemented during 1989.

13. With regard to public enterprise reform, the financial restructuring of the NCPB has been completed with a write-off of K Sh 5.3 billion in the 1988/89 budget. The ongoing organizational restructuring of the NCPB (including cereal sector reform) is expected to be completed in 1991. The financial restructuring of the Kenya Railways and the South Nyanza Sugar Company are expected to be completed by 1991/92. During 1989, the Government began to monitor the financial performance and flow of funds of 10 sample nonfinancial public enterprises with the intention of extending the coverage so as to facilitate measurement of the consolidated public sector deficit by 1990/91. The Government has also initiated work to formulate a policy framework for public enterprises with technical assistance support from the UNDP. A draft of the proposed policy paper is expected to be completed in December 1989. An action plan for restructuring (or divesting) two development finance institutions and their portfolios--the Industrial Development Bank (IDB) and the Industrial and Commercial Development Corporation (ICDC)--has been prepared. By June 1990, a decision will be taken as to the subsidiaries of these institutions that will be privatized, restructured or liquidated. Finally, the Government is concerned about the operating situation of Kenya Airways and believes that a substantial infusion of equity capital will be required in the next three years to upgrade equipment, strengthen management, and improve maintenance capacity. Additional borrowing to address these problems will be consistent with the overall program targets to be negotiated, and will be the subject of close consultation with the Fund and the World Bank in view of the heavy capital borrowing requirements.

14. During the remainder of 1989 the Government will continue with its reform of the financial system, with a view to improving the efficiency of resource

mobilization and allocation and to broadening the range of financial instruments available to savers and investors. In particular, with technical assistance from the Fund, reserve money management will be introduced gradually and active use of available monetary policy instruments through the Monetary Policy Committee will be initiated. The available monetary policy instruments will be refined. Interest rates will be maintained positive in real terms. In pursuit of the program's target of market determination of interest rates by June 1991, and in view of the recent inflationary pressures, the minimum savings deposit rate for commercial banks will be raised by one half percentage point to 12.5 percent by October 15, 1989. Simultaneously, the commercial banks' maximum lending rate for maturities of three years or less will be raised to 15.5 percent and the maximum lending rate for maturities in excess of three years will be 18 percent. This latter adjustment raises the interest rate on loans of maturities between three and four years from 15 percent to 18 percent. If at the end of November, the annual weighted average inflation rate is above 10 percent, the Government will further raise the interest rate ceiling on loans of three years or less to 16 percent by the middle of January. Interest rate policies will be reviewed further at the time of the discussions for the second annual arrangement under the ESAF. Finally, an effort will be made to remove some of the inefficiencies in the financial system by strengthening the capacity of the Central Bank's staff to supervise banking institutions. Restructuring programs have been prepared for weaker financial institutions. To encourage the development of a capital market, the Capital Market Authority will be established by early 1990 and the Capital Issues Committee's jurisdiction over the pricing of domestic equity issues will be removed shortly thereafter.

15. Monetary policy will continue to be geared toward reducing inflationary pressures and with a view toward achieving a manageable external account position. For the first half of 1990, the credit targets will be as indicated in attached Table 1. These indicative targets, which will be reviewed at the time of the elaboration of the annual program to be supported by the second annual arrangement under the ESAF in early 1990, are projected to be consistent with a 8.2 percent increase in broad money in 1989/90.

16. In the external sector, the current account deficit in 1989 is expected to be wider than originally programmed; it is now expected to widen slightly from 5.3 percent of GDP in 1988 (revised) to 5.5 percent in 1989 (rather than falling to 4.0 percent of GDP from 4.5 percent as envisaged in the program). Exports receipts are now projected to be less than originally envisaged, reflecting lower coffee exports in the light of recent trends in coffee prices in July and August following the collapse of the International Coffee Agreement, as well as lower net services receipts. It appears that import growth for the year as a whole will be higher than originally projected, in part reflecting the import liberalization measures discussed earlier but also that government imports, while falling, are higher than originally foreseen. Receipts from tourism are anticipated to be only slightly lower than programmed since recent developments appear not to have much of an adverse effect on the tourism industry. The programmed build-up in net official reserves of SDR 58 million, however, is expected to be achieved, since external capital inflows are likely to be substantially higher than originally

projected. The exchange rate will continue to be flexibly managed; by the end of July it had depreciated by 4.7 percent in real terms from its end-1988 level, based on provisional estimates.

17. Within the context of the industrial sector adjustment program, the study commissioned to calculate equivalent tariffs also contained a section examining the impact on domestic industry of unrestricted import licensing. More detailed work in this latter area has started and will be ultimately directed toward the preparation of an action program for restructuring viable public enterprises adversely affected by liberalization. A proposal to study and recommend policies for restructuring the textile industry in particular has already been approved by IDA for funding through its Project Preparation Facility. As regards the export compensation scheme, the Government clearly recognizes the need to improve administrative arrangements to ensure prompt payment of export compensation. The aim is to reduce delays in receiving compensation, targeting one month as the maximum time for receiving reimbursement. Further work contributing to a comprehensive medium-term export promotion program is currently in the pipeline. In this connection, an initial study to evaluate the enabling environment for an export processing zone near Mombasa has been commissioned and should be completed before the end of the year; another study financed through a World Bank Special Project Preparation Facility and a Project Preparation Facility to evaluate and design another export processing zone near Nairobi will be commissioned by the end of 1989 and completed by mid-1990. The Government expects to formulate a program for export processing zones by June 1990. With regard to price controls, in September, the price of animal feed was decontrolled, reducing the number of controlled items to 19 under the General Order.

18. Finally, we would like to assure you that the Government of Kenya is firmly committed to achieve the objectives set out in our structural adjustment program and will take any further measures that are necessary in this regard.

Sincerely yours,

Professor George Saitoti
Vice President
and Minister for Finance

Eric C. Kotut
Governor
Central Bank of Kenya

Attachment

Table 1. Kenya: Quantitative Performance Criteria and Benchmarks Under the First Annual Arrangement Under the Enhanced Structural Adjustment Facility 1989

Performance criteria and benchmarks	1988	1989 June Benchmark	1989 September Performance criteria	1989 December Benchmark	1990 March Indicative target	1990 June Indicative target
			(In millions of Kenya shillings)			
Total domestic credit 1/						
Ceiling	...	55,044	56,897	58,080	57,371	57,712
Actual	52,666	52,422	...	...	...	...
Net credit to the Government 2/						
Ceiling	...	15,620	17,420	17,270	15,631	14,772 5/
Banking system	...	(19,321)	(21,891)	(21,741)	(20,241)	(19,382)
CSFC	...	(-3,701)	(-3,701)	(-3,701)	(-3,840)	(-3,840)
Debt assumed of parastatals	...	...	(-770)	(-770)	(-770)	(-770)
Actual	14,811	13,670	...	...	...	...
Banking system	(18,512)	(17,510)	...	...	...	...
CSFC	(-3,701)	(-3,840)	...	...	...	...
			(In millions of U.S. dollars)			
New nonconcessional external loans contracted or guaranteed by the Government 3/ (cumulative per calendar year)						
1-12 years' maturity						
Ceiling	...	100.0	100.0	100.0		
Actual	72.8	56.4	...	...		
Less than 1 year's maturity, other than related to imports						
Ceiling	...	—	—	—		
Actual	—	—	...	...		

Benchmark	1988 December Outstanding	1989 June Benchmarks	1989 September Benchmarks	1989 December Benchmarks
			(In millions of SDRs)	
Minimum cumulative increase in net official international reserves from end-December 1988 4/				
Benchmark	...	42	37	58
Actual	-113	80	...	...

Sources: Central Bank of Kenya; and staff estimates.

1/ Total domestic credit of the banking system is the sum of net credit to the Government, other public sector credit, and private sector credit. It includes bank credit utilized by the Cereals and Sugar Finance Corporation (CSFC).

2/ Net credit to the Government is net credit to the Government from the banking sector. The ceiling excludes the operations of the CSFC and excludes the amount of public enterprise debt assumed by the Government, and reclassified from outstanding private sector credit, which as of September 30, should amount to K Sh 770 million (relating to the assumed debt of the following corporations: (1) Kenya Chemical and Food Corporation (K Sh 512 million), Kenya Furfural (K Sh 54 million), The Wheat Board (K Sh 38 million), Fluorspar (K Sh 136 million) and East African Airways (K Sh 30 million).

3/ In conformity with existing regulations, no public enterprise will borrow on nonconcessional terms without government guarantee. For purposes of converting new nonconcessional external loans into U.S. dollars, the U.S. dollar exchange rates cabled to the Central Bank of Kenya from the Federal Reserve Bank of New York for January 3, 1989 will be used.

4/ Net official international reserves are defined as Central Bank's holdings of net foreign assets (excluding use of Fund credit), the Government's holding of net foreign assets (excluding reserve position in the Fund), use of Fund credit, and reserve position in the Fund. The information for the last two items is obtained directly from the Fund.

5/ This target will be adjusted downwards to the extent that net external financing of the deficit during the July 1989 - June 1990 period, excluding A in A financing, exceeds K Sh 204 million, or to the extent that domestic nonbank financing exceeds K Sh 0.9 billion.

KENYA - Relations with the Fund

(As of September 30, 1989)

I. Membership Status:

a. Date of membership	February 3, 1964
b. Status	Article XIV

A. Financial Relations

II. General Department

a. General Resources Account:

(i) Quota		SDR 142.0 million
(ii) Total Fund holdings of Kenya's currency		SDR 366.82 million (258.32 percent of quota)
(iii) Fund holdings of Kenya's currency subject to repurchase		SDR 237.02 million (166.91 percent of quota)
Of which:	credit tranche	SDR 80.98 million (57.02 percent of quota)
	EAR	SDR 92.36 million (65.04 percent of quota)
	CFF - cereal	SDR 23.69 million (16.68 percent of quota)
	CFF - export	SDR 40.00 million (28.17 percent of quota)
(iv) Reserve tranche		SDR 12.22 million (8.60 percent of quota)

Kenya - Relations with the Fund (continued)

b. Special Disbursement Account:

(i) Structural adjustment loan	SDR 28.40 million (20 percent of quota)
(ii) Enhanced structural adjustment loan 1/	SDR 21.30 million (15 percent of quota)

III. Current or Previous Stand-By Arrangements and Special Facilities

(a) Previous arrangements:

One extended arrangement approved in July 1975, and seven stand-by arrangements approved, respectively, in November 1978, August 1979, October 1980, January 1982, March 1983, February 1985, and February 1988. Amounts range from SDR 17.25 million to SDR 241.50 million. Cumulative purchases made under these arrangements amounted to SDR 521.0.

(b) Special facilities:

(i) Under the compensatory financing facility for export shortfalls and cereal imports, Kenya made purchases of SDR 60.4 million (58 percent of then quota) in June 1982, SDR 37.9 million (27 percent of quota) in December 1985, and SDR 40.0 million (28 percent of quota) in October 1988.

(ii) A loan under the structural adjustment facility became effective on February 1, 1988. Purchase of SDR 28.4 million was made in February 1988. The arrangement was replaced by an ESAF on May 15, 1989.

(iii) A loan under the enhanced structural adjustment for SDR 241.4 million for 36 months became effective on May 15, 1989. Purchase of SDR 40.23 million was made on May 31, 1989.

1/ Utilization of outstanding ESAF comprises SDR 21.30 million from the Special Disbursement Account (SDA) and SDR 18.93 million from the ESAF Trust.

Kenya - Relations with the Fund (continued)

IV. SDR Department

(a) Net cumulative allocation - SDR 36.99 million
(b) Holdings: amount to SDR 6.25 million or 16.89 percent of net cumulative allocation

V. Administered Accounts

(a) Trust Fund Loans:

(i) Disbursed - SDR 46.91 million
(ii) Outstanding - SDR 2.55 million

(b) SFF Subsidy Account:

(i) Payments by Fund - SDR 13.84 million

(c) ESAF loans: Trust Account

(i) Disbursed - SDR 18.93 million
(ii) Outstanding - SDR 18.93 million

VI. Financial obligations to the Fund:

	Overdue Financial Obligations (9/30/89)	Principal and Interest Due				
		1989 1/	1990	1991	1992	1993
Principal	--	32.3	77.7	29.3	58.8	44.4
Repurchases	--	31.4	76.2	29.1	58.8	41.5
Trust Fund Repayments	--	0.9	1.5	0.2	--	--
SAF Repayments	--	--	--	--	--	2.8
Charges and interest including SDR and TF (provisional)	--	4.1	20.1	14.5	10.3	5.3
Total	--	36.4	97.7	43.8	69.1	49.7

B. Nonfinancial Relations

VII. Exchange System: Pegged to composite. At end-August 1989 the exchange rate was K Sh 21.3858 = US$1

1/ 10/1/89 - 12/31/89.

Kenya - Relations with the Fund (concluded)

VIII. Last Article IV Consultation

The 1989 Article IV consultation (EBS/89/84, 4/27/89, and SM/89/83, 5/9/89) was concluded by the Executive Board on May 15, 1989. The following decision was adopted:

1. The Fund takes this decision relating to Kenya's exchange measures subject to Article VIII, Section 2(a), in the light of the 1989 Article IV consultation with Kenya conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Kenya maintains restrictions on payments and transfers for current international transactions subject to Fund approval under Article VIII, Section 2(a), in the form of limits for remittances of rental income of nonresidents and of a foreign exchange budget on the basis of which licenses for nonliberalized import items are issued. In the circumstances of Kenya, the Fund grants approval for their retention until June 30, 1990, or the conclusion of the next Article IV consultation with Kenya, whichever is earlier.

Kenya is on the standard 12-month cycle for Article IV consultations.

IX. Technical Assistance

CBD: Technical assistance missions on Kenya's financial system (March and May-June 1984), on bank supervision procedures (June 1988), and on the operational aspects of monetary policy implementatin (November 1988).

FAD: Technical assistance in fiscal field (1981).

BUR: Technical assistance mission on money and banking statistics (November 1987).

Relations with the World Bank Group

The World Bank has a large ongoing program in Kenya. As of March 31, 1989, it had committed almost US$2.5 billion, of which US$2.0 billion had been fully disbursed (Table 1).

1. Agriculture

The Bank's assistance to agriculture is centered around a policy reform program supported by a quick-disbursing sector adjustment credit which was approved in June 1986. Among the components of this program are: (i) measures to increase the availability and distribution of agricultural inputs (especially fertilizer); (ii) movement towards price flexibility and deregulation; (iii) rationalization of government expenditure in the sector; (iv) the divesting of some agricultural parastatals and the restructuring of others in the context of better defined policies on parastatals; and (v) improvements in agriculture credit programs. Second tranche was approved in February 1988.

These policy measures are complemented by ongoing investment projects in coffee rehabilitation, forestry, agriculture research, rehabilitation of animal health services and the provision of country-wide extension services.

For the future, Bank assistance to the sector will continue to emphasize adjustment lending with a view to broadening and consolidating a policy framework that is conducive to a more vigorous contribution to growth by agriculture. Investment lending will continue to complement the policy reforms with greater attention being given to implementing the results from pilot projects in the areas of agriculture credit, livestock development, land and environmental management and arid and semi-arid agricultural techniques. The Bank is currently developing and testing new methodologies or approaches in these areas in order to ensure replicability before embarking on large scale national investments.

2. Energy

The Bank's efforts in this sector are concentrating on lessening Kenya's dependence on imported oil through hydroelectric development, geothermal development, and petroleum exploration promotion. While future lending will be consistent with the least cost recommendations of the recently completed power study, greater attention will be focussed on alleviating policy constraints (e.g. pricing and distribution) to attain a more efficient and integrated energy sector.

3. Industry/finance

Until recently, Kenya's industry has obtained World Bank lending through development finance intermediaries. In support of an industrial reform program in June 1988 an industrial sector adjustment credit for

Kenya - Relations with the World Bank Group (continued)

Table 1. The Status of Bank Group Operations in Kenya

A. Statement of Bank Loans and IDA Credits as of March 31, 1989

Amount (less cancellations)

(In millions of U.S. dollars)

Loan or credit no.	Year	Borrower	Purpose	Bank	IDA	Undisbursed
Forty three (43) loans, of which six were cancelled, thirty-six (36) credits and two (2) Third Window Loans Fully Disbursed 1/				826.82	467.95	
1107	1981	Kenya	Fifth Education		40.00	16.98
2098	1982	Kenya	Forestry III	11.50		6.80
1237	1982	Kenya	Cotton Processing and Marketing		22.00	3.50
1238	1982	Kenya	Integrated Rural Health and Family Planning		23.00	9.35
1387	1983	Kenya	National Extension		15.00	7.27
2319	1983	Kenya	Secondary Towns	7.00		6.98
1390	1983	Kenya	Secondary Towns		22.00	13.41
2359	1984	Kenya	Kiambere Hydroelectric	95.00		24.09
2409	1984	Kenya	Second Highway Sector	5.00		3.65
F017	1984	Kenya	Second Highway Sector		40.00	43.07
1486	1984	Kenya	Geothermal Exploration		24.50	5.69
1566	1985	Kenya	Water Engineering		6.00	2.64
2574	1985	Kenya	Third Telecommunications	32.60		21.00
1673	1986	Kenya	Sixth Education		37.50	43.90
1675	1986	Kenya	Petroleum Exploration Technical Assistance		6.00	5.27
1718	1986	Kenya	Agricultural Sector Management		11.50	8.85
1738	1987	Kenya	KIE 2nd Small Scale Industry		6.00	6.67
1758	1987	Kenya	Animal Health Services		15.00	14.96
1820	1987	Kenya	Second Railway		28.00	26.07
1849	1988	Kenya	Agriculture Research		19.60	19.91
A0360	1988	Kenya	Industrial Sector Operation		10.00	—
1904	1988	Kenya	Population III		12.20	11.63
1927-0	1988	Kenya	Industrial Sector Operation		102.00	46.63
1927-1	1989	Kenya	Industrial Sector Operation		53.70	53.48
1973	1989	Kenya	Geothermal Development		40.70	40.82
1974	1989	Kenya	Rural Services		20.80	20.02
			Total	977.92	1,023.45	462.64
			Of which: has been repaid	282.44	14.99	
			Total now outstanding	695.48	1,008.46	
			Amount sold			
			Of which: has been repaid	11.74		
			Total now held by Bank and IDA	683.74	1,008.46	
			Total undisbursed	62.53	400.12	462.64

1/ In addition, Kenya was one of the beneficiaries of 10 loans totalling US$244.8 million, which were extended for the development of common services (railways, ports, telecommunications, and finance for industry) operated regionally for the three partner states of the former East African Community (EAC).

Kenya - Relations with the World Bank Group (continued)

Table 1. The Status of Bank Group Operations in Kenya (concluded)

B. Statement of IFC Investments in Kenya as of March 31, 1989

Fiscal year	Obligor	Type of business	Amount in millions of U.S. dollars Loan	Equity	Total
1967, 1968, and 1973	Kenya Hotel Properties	Hotels	5.2	0.7	5.9
1970, 1974, 1977, 1979, 1981, and 1988	Pan African Paper Mills	Pulp and Paper	25.7	6.3	32.0
1972	Tourism Promotion Services	Hotels	2.4	— 1/	2.4
1976	Rift Valley Textiles Ltd.	Textiles	6.3	2.8	9.1
1977	Kenya Commercial Bank Ltd.	Capital Market	2.0	—	2.0
1980, 1983, and 1987	Development Finance Company of Kenya Ltd.	Development Finance	8.1	1.3	9.4
1981	Kenya Commercial Finance	Money and Capital Market	5.0	—	5.0
1982	Bamburi Portland Cement Co., Ltd.	Cement and Construction Material	4.4	—	4.4
1982	Diamond Trust of Kenya Ltd.	Money and Capital Market	—	0.8	0.8
1982, 1986	Industrial Promotion Services (Kenya) Ltd.	Money and Capital Market	—	2.0	2.0
1983	Tetra Pak Converters Ltd.	Pulp and Paper Products	2.2	0.4	2.6
1984	Leather Industries of Kenya Ltd.	Tanning	2.1	0.6	2.7
1985	Madhu Paper International Ltd.	Pulp and Paper Products	37.1	2.0	39.1
1986	Equatorial Beach Properties	Tourism	5.6	—	5.6
1986	Oil Crop Development Ltd.		9.7	1.4	11.1
1987	Agro Development Limited	Agri-Business	1.3	—	1.3
	Total Gross Commitments		117.1	18.3	135.4
	Less cancellations, terminations, repayments and sales		90.9	6.0	96.9
	Total Commitments now held by IFC		26.2	12.3	38.5
	Total Undisbursed		1.5	1.2	2.7

1/ US$44,937.

Kenya - Relations with the World Bank Group (continued)

US$112 million was approved. In order to stimulate investment, promote export production, and make industries more efficient, the reform program covers areas such as trade liberalization, tariffs, price controls, export promotion, corporate taxation, financial sector policies, and industrial public enterprises. A complementary financial sector adjustment operation was approved in June 1989. It addresses inter alia interest rate reforms, rationalization of the banking regulatory framework, restructuring of depository institutions, and the development of capital and money markets.

4. Infrastructure

Highway projects and the promotion of railways have accounted for most of the lending to date. A major water supply project for Nairobi was approved in July 1989. In addition, the Bank is preparing an urban development project whose main feature will be to enhance the financing and management capacity of municipal authorities.

5. Population

The third IDA-financed project to help the Government promote fertility was approved in 1988 and is now being implemented.

6. Education and health

The Bank's attention is currently directed at developing viable financing and management capacity in both sectors. Lending operations designed to promote more efficient utilization of resources and to implement appropriate mechanisms to increase cost sharing are being prepared.

7. Adjustment lending

The World Bank negotiated and fully disbursed two structural adjustment loans (SAL) to Kenya. The first, negotiated in March 1980, was for US$70 million and was fully disbursed by September 1980. The second, negotiated in July 1982 for SDR 130 million, was disbursed in two tranches: in September 1982 and January 1984. The SAL programs were implemented under adverse external circumstances which negatively affected Kenya's performance. The protracted balance of payments crises of 1981 and 1982, as well as the coup attempt in August 1982, forced adjustments in the Government's policies and led to delays and reversals in policy initiatives included in the SAL programs. The speed of implementation was also affected by a shortage of technical personnel and the preoccupation of the authorities with short-term stabilization efforts.

Kenya - Relations with the World Bank Group (concluded)

It has been agreed between the Bank and the Government that, for the near future, Bank financial support for the Government's structural adjustment efforts will take the form of sector adjustment loans rather than the comprehensive SAL. As noted above, an agricultural sector adjustment loan was approved by the Bank's Board in June 1986, an industrial sector adjustment loan was approved in June 1988, and a financial sector adjustment loan was approved in June 1989. Further sector adjustment operations are scheduled in agriculture, education, and health.