0404

NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/13

10:00 a.m., February 1, 1988

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Abdallah	
	C. Enoch
	Jiang H.
	A. Rieffel, Temporary
	E. L. Walker, Temporary
J. de Groote	
	M. Hepp, Temporary
	A. M. Othman
G. Grosche	
	J. Reddy
	J. E. Zeas, Temporary
M. Massé	D. McCormack
Mawakani Samba	
	I. A. Al-Assaf
	C. Noriega, Temporary
J. Ovi	
H. Ploix	
	G. P. J. Hogeweg
	I. Sliper, Temporary
G. Salehkhou	O. Kabbaj
A. K. Sengupta	L. E. N. Fernando
	N. Adachi, Temporary
	N. Kyriazidis

L. Van Houtven, Secretary and Counsellor
D. de Vos, Assistant

Also Present

IBRD: L. De Wulf, B. N. Jones, Africa Regional Office. African Department: A. D. Ouattara, Counsellor and Director; E. L. Bornemann, Deputy Director; G. E. Gondwe, Deputy Director; D. T. S. Ballali, A. Bourhane, N. Calika, B. Delbecque, M. G. Fiator, H. Futamura, M. G. Gilman, J. M. Jiménez, S. M. Mshangama, D. J. Scheuer, G. B. Taplin. Exchange and Trade Relations Department: S. J. Anjaria, J. H. Felman, K. M. Huh, H. B. Junz, M. Nowak. Fiscal Affairs Department: L. K. Doe, C. Schiller. Legal Department: J. M. Ogoola. Western Hemisphere Department: K. Thugge. Secretary's Department: K. S. Friedman. Advisors to Executive Directors: P. E. Archibong, A. G. A. Faria, S. M. Hassan, K.-H. Kleine, J.-C. Obame, A. Ouanes, A. Vasudevan. Assistants to Executive Directors: J. R. N. Almeida, A. A. Badi, H. S. Binay, R. Comotto, F. El Fiky, W. N. Engert, P. Gorjestani, L. Hubloue, A. Iljas, S. King, K. Kpetigo, M. A. Kyhlberg, T. Morita, V. Rousset, D. A. Woodward.

1. KENYA - 1987 ARTICLE IV CONSULTATION, STAND-BY ARRANGEMENT, AND STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered the staff report for the 1987 Article IV consultation with Kenya and requests by Kenya for a stand-by arrangement in an amount equivalent to SDR 85 million and for arrangements under the structural adjustment facility (EBS/88/2, 1/7/88), together with a policy framework paper (EBD/88/5, 1/7/88). They also had before them a background paper on recent economic developments in Kenya (SM/88/24, 1/20/88), and an information notice on the real effective exchange rate (EBS/88/15, 1/28/88).

The Acting Chairman made the following statement:

> There follows for the information of Executive Directors the text of a memorandum that I have received from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Executive Directors of the Bank and IDA in their January 26, 1988 discussion in Committee of the Whole of a paper entitled "Kenya: Policy Framework Paper, 1988-90."
>
> The Executive Directors commended the Kenya Government for its good past performance and generally sound economic management within a difficult global environment, but noted the decline in the rate of growth since 1980 and the scope for further strengthening of economic performance. They concluded therefore that the policy framework paper under review provided an appropriate basis for further adjustment efforts, based on the formulation and implementation of specific policy measures aimed at improved growth performance and development of the Kenya economy.
>
> The Executive Directors suggested that, in carrying out this program of adjustment, the Government should pay particular attention to the following:
>
> - A strong private sector will be necessary to achieve good economic performance and to provide an adequate increase in employment opportunities for Kenya's growing population; therefore, steps should be taken to reduce constraints on the private sector, including relaxation of import and price controls, reduced direct state intervention in the agricultural sector, and reduction in the government budget deficit.
>
> - Measures should be taken to strengthen programs of family planning to encourage reduced population growth.
>
> - Improvements in the effectiveness of government operations will need to be made through civil service reform, in order that essential public sector services will be available as required.

A review of the functioning of parastatals, and implementation of the existing plans for their restructuring and divestiture, should be given priority.

- An appropriate exchange rate policy should be maintained, and greater interest rate flexibility should be allowed.

- Attention should be given to export diversification.

- Measures should be adopted which mitigate the adverse effects of adjustment on the more vulnerable segments of the population.

- Concrete measures should be prepared to address environmental issues.

- The need for land reform, and revisions of land taxes with the objective of discouraging underutilization of land, should be considered.

- In view of the increase in the external debt burden, the Government's intention to minimize nonconcessional borrowing was welcome.

- Finally, determined implementation of a specific program to implement these policies would be critical to the success of the overall adjustment effort and to the achievement of an adequate rate of economic growth.

The Executive Directors noted the substantial external financing requirements that were projected for the period 1988-90. It will require concerted donor action to meet these requirements, and the hope was expressed that the policy framework paper might be used to strengthen donor coordination in the implementation of the program.

Mr. Abdallah made the following statement:

The staff papers on Kenya give a comprehensive and balanced assessment of recent macroeconomic and financial developments and the medium-term prospects for the economy. As I agree with the general thrust of the staff appraisal, I will highlight the country's track record in macroeconomic management and point out the resolve of the authorities to implement the entire adjustment program with a clear intention of doing better whenever possible.

It is clear from Section II of the staff paper that in the first half of this decade the authorities, with the assistance of the Fund, the World Bank, and many bilateral donors, were able successfully to pursue and sustain a major process of stabilization and adjustment in the economy in the face of substantially adverse exogenous conditions. As the staff paper records, between 1981 and 1985, most indicators of economic and financial performance showed a marked improvement, despite the severest ever region-wide drought in 1984. Between 1981 and 1985, the overall budget deficit, including grants, was more than halved to 4 percent of GDP, although regrettably through a reduction in development expenditures; the external current account deficit, including grants, declined sharply from 8.3 percent of GDP to 1.6 percent--mainly due to sustained import compression, particularly of oil imports, rather than to an improvement in nontraditional exports. Inflation was reduced from a peak of 20 percent to 10 percent, as growth in the monetary aggregates, in particular emanating from the provision of domestic credit to the Government, was on average held below that of nominal income. Moreover, as Chart 1 clearly illustrates, the authorities have, since December 1982, been following a flexible exchange rate policy based on a peg to a basket of currencies, with a view to maintaining external competitiveness and promoting export diversification. This has entailed a cumulative real depreciation of 40 percent in foreign currency terms, and has also resulted in the depoliticization of this important policy instrument.

While these positive developments have been highlighted in previous Board discussions, less emphasis has regrettably been given to the resulting stagnation in domestic savings, despite the maintenance of positive real interest rates, which suggests that, in the short term, savings are probably more responsive to changes in real output than to changes in real interest rates. The combination of the low responsiveness of domestic savings to positive real interest rates, with the declining trend in external assistance--from 6 percent of GDP in the 1970s to 3 percent in the 1980s--has caused gross domestic investment as a proportion of GDP to stagnate, leading to a marked weakening in the growth momentum of the economy. Because of Kenya's very high annual average rate of population increase, estimated at 3.9 percent, the deceleration in growth momentum has meant that per capita incomes have tended to stagnate or even decline, instead of rising. Moreover, the external debt burden, inclusive of Fund credit--with an average interest rate of 6.1 percent and an average amortization rate of 8.6 percent--has increased from 40 percent of GDP to 50 percent, while the debt service ratio had gone up from 18 percent of gross export earnings from goods and services to 30 percent.

Exogenous influences, whether favorable as in 1986, or unfavorable as in 1987, have tended to have a destabilizing and seriously complicating effect on the domestic economic management of an open economy such as Kenya's. In 1986, the return of more normal weather conditions and an improvement in the terms of trade of 12 percent, after a decline of 16 percent in 1985, enabled the basically resilient Kenyan economy to rebound quickly, and to reduce its internal and external imbalances significantly. But, as the staff notes, this progress was short lived because of an estimated 25 percent fall in the terms of trade in 1987. More importantly, excess liquidity, generated through the significant improvement in the external accounts in 1986, fostered a marked spillover of domestic demand in 1987, leading to sharp increases in the budget and external current account deficits to peak levels of 8.1 percent and 5.2 percent of GDP, respectively, and to a mild resurgence of inflation to about 7 percent. Moreover, the sharp decline in export earnings caused the debt service ratio to rise to the historically high level of 33 percent, thus severely straining the country's trade and payments system.

The authorities have themselves recognized, as reflected on page 9 of the staff paper, that the situation was exacerbated by the relaxation in financial discipline which caused the budget deficit to rise to an unsustainable level and resulted in the undesirably large recourse to domestic bank financing. However, it should be noted that a major cause of the expansionary fiscal policy stance was several nonrecurrent expenditures, namely, the doubling of university registration, in order to clear the backlog of eligible students from previous years, the construction of sporting facilities for the All-African Games, the expenditure on certain defense items, and the granting of catch-up wage increases. It was also necessary to support the National Cereals and Produce Board (NCPB) in the purchase of grains arising from bumper harvests. This last policy move was unavoidable if--in the context of a burgeoning population, limited arable land resources, and the variability in weather conditions--desirable food production levels were to be maintained. It should be noted that despite two years of rapid growth in domestic liquidity, a substantial rise in quasi-money helped to contain inflationary pressures to well below recent historical levels. The continuing commitment of the authorities to maintain orderly international financial relations and to avoid debt rescheduling, even when debt service obligations and declining aid flows continue having an adverse impact on growth, is a priority. Notwithstanding the slippages in financial policies in 1986 and 1987, the authorities have already undertaken several corrective structural measures, which are fully reflected in the background paper. These measures include: the retrenchment of the civil service through the provision of more favorable early retirement provisions and the temporary freezing of the existing bureaucracy; the removal of price controls over consumer and manufactured items, with resulting adverse distributional effects; and the rationalization of manufacturing costs through their linkage to import parity levels. Public utility tariffs were revised upward, and petroleum product prices were adjusted in line with external price developments, while monetary policy was tightened.

The objective of this extensive review of economic and financial developments during the current decade has been to show the authorities' steadfast commitment to implement necessary corrective actions, even under the difficult circumstances of substantial variability brought about by externally induced shocks that are beyond their control. It was in this frame of mind, and in recognition that Kenya's problems were of a longer-term structural nature that the authorities took the initiative in asking the Fund to support Kenya's medium-term adjustment effort, through arrangements under the structural adjustment facility and a stand-by arrangement--notwithstanding that this is an election year.

The Government's own sessional paper, Economic Management for Renewed Growth (1986), together with the policy framework paper and the Memorandum of Economic and Financial Policies, provide a detailed exposition of the authorities' policy intentions over the medium term. The main thrust of policy measures during the next three years is broadly in accord with the suggestions that were made by the Board in January 1987, during the discussion of the 1986 Article IV consultation, namely, to accelerate the pace of structural policy reform in order to promote both enhanced growth under conditions of domestic financial stability, and medium-term external viability. In this regard, one should note that any serious attempt to initiate structural reform requires that prior analysis be carried out and that a feasible set of policy recommendations be made, in an appropriate time frame, and consistent with political feasibility and administrative capability. Furthermore, as the staff observed in the recent papers on growth exercises in financial programming, it may take up to three years for the beneficial effects of structural policy reforms to show up in the behavior of macroeconomic policy variables.

To ensure that the structural policy actions have a maximum beneficial impact, as indicated above and in greater detail in the policy matrix in Appendix III to EBS/88/2, the authorities have already undertaken many structural actions and will undertake a number of necessary studies as a basis for front-loaded reform. Regarding specific sectoral objectives, the staff has already pointed out that in agriculture, substantial pricing and marketing deregulation will be undertaken to foster an increased role for market forces; at the same time, improvements in the supply of inputs and the dissemination of better methods and practices should raise productivity and improve the quality of output. A key measure--because of its particular implications for budgetary performance--will be the organizational and financial restructuring of the National Cereals and Produce Board. In the industrial sector, significant progress is being made, with the assistance of the World Bank, in putting into place policies to liberalize imports, including industrial imports, to rationalize the structure of industrial incentives, and to promote export diversification, by attracting foreign capital, including foreign direct investment. In the fiscal area, existing procedures for three-year forward budgeting--especially of expenditures--are being refined to contain the growth of nonproductive outlays, while promoting the maintenance of existing capital stock and greater efficiency in new projects. The scope for increased revenue is also being explored, and a restructuring of the public enterprise sector is under way to restrict Government's role in the economy to areas of strategic interest.

To complement the reform of the financial system already undertaken, the authorities are also actively studying the modalities for adopting a more active rediscount policy, launching open market operations, and developing money and capital markets generally. It is worth stressing that many prior actions envisaged under the program have already been taken. On December 4, 1987, commercial banks were instructed to limit the expansion of their lending to the private sector--including parastatal enterprises--to levels consistent with the program's quarterly ceilings; the band between the maximum lending rate and the minimum savings rate was increased to 5 percentage points by raising the former to 15 percent and reducing the latter to 10 percent; and the exchange rate for the Kenya shilling against the SDR was adjusted to its current level of K Sh 23.36 from K Sh 21.03 at the end of June 1987, or by about 10 percent in foreign currency terms.

A particular concern of the authorities over the medium term is to compensate for past slippages in the implementation of financial policies. On the fiscal front, while recognizing that tax revenues are already at a high level, future budgetary revenues will be increased to 25 percent of GDP by 1990, largely through a more concerted effort to institute schemes for the partial reimbursement of the costs of providing education and health services. On the spending side, the ratio of expenditure and net lending to GDP will be held to the current level of 31 percent, implying a real expenditure cut of substantial magnitude. As a result, the budget deficit will be reduced by a significant margin of 4 percentage points of GDP in the current fiscal year, ending June 1988, and more slowly thereafter to 3.4 percent of GDP by 1990. Because of the authorities' determination to curb recourse to domestic bank financing to 0.5 percent of GDP by the end of this period, these ambitious targets imply, as Table 4 in the staff paper shows, financing gaps of 1.2 percent and 1.1 percent of GDP in FY 1988/89 and FY 1989/90, respectively. Moreover, as Table 5 shows, to counteract the overhang of domestic liquidity, monetary growth will be held to a level below that of nominal income by a firm tightening of credit policy. To promote domestic savings and confidence in the financial system, positive real interest rates will continue to be maintained and the monitoring of domestic nonbank financial intermediaries is being stepped up.

The country has an urgent need for external financing, as reflected in the staff's medium-term forecasts in Table 6. The staff has implicitly suggested that such external financing will be required to cover small gaps in 1989 and 1990, essentially to permit a recovery of gross reserve levels to about 1985 levels of slightly over three months of nongovernmental imports. While agreeing with such reserve targeting, the authorities, from several perspectives, view this as an unduly conservative assessment of their need for concessional external assistance, especially as it implicitly minimizes the importance of securing even higher growth in per capita income. First, it is not certain that, in SDR terms, the substantial forecast increase in nontraditional exports will materialize; after all, the pursuit of a flexible exchange rate policy since December 1982 has not hitherto brought about the hoped for increase in the share of such exports in total exports. Second, it is not clear that the forecast levels of nominal imports are consistent with the envisaged substantial liberalization of external trade restrictions, or that they adequately reflect the impact of price relationships embedded in the appreciation of the currencies of Western Europe and Japan, which have a combined share of about 65 percent in Kenya's imports. Moreover, the implied slow compounded growth rate of only 3.6 percent in nominal import levels may well imply a decline in real levels, and thus put at risk the attainment of real output growth forecasts. Against this background, it is clear that, even with the staff's forecast of an increased average annual inflow in net official foreign capital to about 5 percent of GDP through 1991, the external situation is much tighter than that emerging from the staff's medium-term balance of payments forecast. Moreover, this is likely to be exacerbated if the normally significant lag between the initial commitments and subsequent disbursements of such external assistance continues to prevail.

The authorities feel strongly that sustained growth in per capita incomes over the medium term--without creating an intractable debt problem--will call for much higher levels of external official assistance on concessional terms; in particular, they would like to see a more marked drop in the debt service ratio projected by the staff, preferably to about 20 percent by the 1990s. With this in mind, they have sought to convert the present stand-by and structural adjustment arrangements into an enhanced structural adjustment arrangement because of its greater "critical mass" and concessional characteristics. Despite their strong medium-term adjustment program, this has regrettably not proved feasible because the operational modalities for the enhanced structural adjustment facility are not in place. My authorities will be seeking a reconsideration in due course, and they would welcome management and staff clarification before the next review mission in April of the feasibility of such a conversion on the strength of their performance under the current arrangements. Meanwhile, they strongly request that bilateral donors follow the commendable examples of Canada and the United Kingdom in canceling Kenya's existing debts wherever possible, and in stepping up support--both through direct concessional assistance and through encouraging their private sectors to invest in Kenya--in order to help sustain Kenya's growth-oriented adjustment strategy.

Mr. Enoch made the following statement:

Despite having to tackle the developmental challenges of a low-income country, Kenya has generally maintained a commendably prudent economic course. The Fund has been able to play a supportive role, and the cooperation between this institution and Kenya has been exemplary. I commend Kenya for its meticulous external payments record and the categorical assurances given by the authorities that they fully intend to maintain this record. In addressing any new request for use of Fund resources, the Board should consider Kenya's record on all counts; this clearly means that we should give the request favorable consideration.

In any event, the program seems to be fundamentally along the right lines. In part, this arises because Kenyan economic policy already rests on a firm foundation, although some macroeconomic correction and structural reforms are needed. A number of the vital elements of a strengthened program, such as a flexible exchange rate and positive real interest rates, have already been largely put in place. I note that in his opening statement, Mr. Abdallah expresses some disappointment with the results of these policies so far. However, given developments in Kenya over the past few years, in the absence of these policies the position might have been much worse. Moreover, much of the real depreciation of the exchange rate has occurred only recently, and many of the effects may have yet to be seen. As Mr. Abdallah notes, Kenya's policy has led to the depoliticization of the exchange rate issue--which surely holds valuable lessons for many other countries.

The Kenyan economy, as the staff paper notes, is like that of many developing countries in that it is vulnerable to fluctuations in the terms of trade and to other external developments. Recently, there has not been a year that one might describe as "normal." These cycles have naturally had a substantial impact on many aspects of the economy's performance, and it has to be recognized that the authorities did not always make good use of the period of favorable factors to prepare for the next period of adverse developments. The high coffee prices in 1986 could have provided more of an opportunity for introducing external adjustment measures, which might have enabled the authorities to avoid some of the serious rundown in reserves that occurred in 1987. Moreover, the rapid monetary growth in 1987 could be creating problems for the future. Thus, it must be recognized that the current adjustment program is not premature. The authorities should be applauded for coming to the Fund before their problems threatened to get out of control. By looking at Kenya's medium-term prospects, as the program seeks to do, the country should be better protected against the vicissitudes that are likely to recur in the future.

I have few problems with the proposed program. As the staff notes, the policy package is judicious and well balanced. It is also comprehensive and displays active participation by the authorities--something which is frequently missing from other programs, which does little to encourage commitment. The basis for this participation, as the staff notes, is the Sessional Paper on Economic Management for Renewed Growth--issued in 1986--which has played a vital role in focusing the authorities' mind on their problems and in mobilizing the domestic support that is essential for successful adjustment. The authorities' commitment has been demonstrated in the numerous measures that have already been taken and in the precise nature of the programmed measures and their early deadlines.

I wish to mention a few of the policies being implemented. I welcome the authorities' intention to integrate the banking and nonbanking financial institutions. Under the previous stand-by arrangement, much of the intended effect of restraint on the banking sector was offset by credit expansion through nonbanks--so that the ceilings on bank credit were not breached. As Table 2 indicates, this effect is not expected to recur. I also welcome the authorities' intention to maintain appropriate producer prices, and their assurances that prices still subject to control will be reviewed expeditiously. In addition, the President of Kenya recently announced that the National Cereals and Produce Board will no longer act as the sole buyer and seller of grain, and that the Kenya Grain Growers Co-operational Union is to be restructured. The expected cut in government imports and the overhaul of the tax administration are also welcome.

However, I am concerned that my laudatory comments are somewhat surpassed by the tone of the staff papers. A number of the assumptions underlying the program appear to be over-optimistic and perhaps downplay the likelihood that Kenya has a number of difficult years ahead. The projected increases in imports look low, given the expected growth rate in the economy and considering the substantial liberalization of imports under the program. Moreover, traditional export receipts are, by necessity, projected to grow rather smoothly, although one can more realistically expect the rate of growth to fluctuate widely. On the other hand, projections for nontraditional export growth and for private direct investment seem to be on the cautious side. The policy framework paper notes that export measures are to be introduced before import liberalization, so that resources displaced in the import-competing sector can be induced to move to the newly stimulated export sector. Although this seems to be a sensible strategy, Table 8 indicates that the comprehensive export promotion program is scheduled to be designed and implemented by only June 1989, a year after import liberalization is due to begin. I urge the authorities to introduce the export promotion program earlier than is presently scheduled.

The staff papers present a clear warning on the need for adequate external assistance, which I strongly endorse. The commitments made so far are less than those envisaged earlier, perhaps partly because of a feeling in some quarters that Kenya has not been undertaking the necessary macroeconomic stabilization and structural adjustments. I urge donors to reconsider their efforts in view of the new program. Indeed, during the U.K. Prime Minister's recent visit to Kenya, she announced additional aid for the next two years in support of the Fund program. This assistance, as Mr. Abdallah notes in his opening statement, comes in addition to the United Kingdom's cancellation of Kenya's existing aid debts.

In his opening statement, Mr. Abdallah also raised the question of converting the present stand-by and structural adjustment arrangements into an enhanced structural adjustment arrangement. It would have been preferable to have avoided a stand-by arrangement and to finance all the Fund's assistance with concessional resources, but clearly this was impractical, given the nascent nature of the enhanced structural adjustment facility. As for conversion, the policy adopted by this Board is, of course, that conversion before the end of an existing structural adjustment program year should take place only in exceptional circumstances. Clearly, any severe deterioration in Kenya's terms of trade that more than reflects the overoptimistic projections, and that is matched by appropriate further measures, would fully justify a switch to an enhanced structural adjustment arrangement in midterm. In any event, my authorities might be willing to support early conversion if the current adjustment program were to be accelerated or strengthened to the degree commensurate with the additional financing available under the enhanced structural adjustment facility, particularly in the areas of price liberalization, agricultural marketing, and external trade and exchange, and if these measures were taken to, or near to, completion. My authorities are particularly keen that Kenya, with its commendable record on external payments, and suffering under a heavy debt burden, should benefit from the enhanced structural adjustment facility.

I support the proposed decisions.

Mr. Sengupta made the following statement:

Despite the many unfavorable exogenous factors, Kenya has made commendable progress toward stabilizing its economy by undertaking a combination of macroeconomic and structural adjustment measures. Whatever deviations in policies have taken place, they have generally reflected the exigencies of the circumstances, which are dominated by exogenous factors such as drought, the deterioration in the terms of trade, and the decline in foreign financial flows. However, these exogenous influences do not seem to have had any impact on the economy's "structural" adjustment--the main foundation for further progress. In any event, Kenya has made all its debt service payments and has not requested debt rescheduling.

The authorities should be commended for agreeing to a comprehensive adjustment program that has all of the most desirable ingredients: a higher growth rate and lower inflation rate--of about 10 percent--than were achieved in the previous six years; limitation of the fiscal deficit and monetary expansion; and an increase in foreign exchange reserves in the event of any adverse unforeseen developments.

The array of proposed policy measures is large in terms of coverage and depth. As is shown in the policy framework paper, as many as 45 measures out of a total of 58 planned measures will have been implemented before the end of 1988; moreover, 10 policy measures will be undertaken on a continuing basis. The staff acknowledges that the policy package is judicious and well balanced, and that while the program is difficult--requiring strong political commitment--its success hinges heavily on whether Kenya obtains the needed foreign support. In this connection, the staff has rightly indicated that donor commitments have fallen considerably below the levels that were agreed to at the 1986 Consultative Group meeting for Kenya.

The Kenyan population growth rate is about 4 percent, probably the highest in the world, and it is not likely to decline by much. It is therefore imperative that the real GDP growth rate be much higher than the population growth rate. How rapid the real growth rate should be depends on how long the domestic growth-inducing forces can be sustained when they are accompanied by adequate external support. Gross domestic saving as a proportion of GDP is almost 20 percent, which is relatively high compared with most low-income developing countries. My rough calculations show that the staff expects an incremental savings/income ratio of about 25 percent during 1988-90, which will not be easy to achieve, given the erosion of per capita incomes in the 1980s. Thus, to attain the target growth rate of about 5 percent a year in the three years under consideration, the investments needed in Kenya are likely to be significantly higher than the domestic savings can support. Kenya clearly cannot depend on costly foreign financing, because the debt service ratio has risen sharply, from 17 percent in 1981 to about 33 percent in 1987. Kenya needs a flow of concessional foreign resources.

I wish to raise two technical issues about the projected growth rates. Over the years 1988-91, imports will grow at only 4.7 percent a year in nominal terms. The staff should comment on its projections of import volume. Given that the annual GDP deflator increases by 5 percent during the same period, which is generally lower than the rise in the import price index, the growth in real imports may be negligible. If this surmise about imports is correct, the real investments needed to attain the target growth rate will have to be based on the use of domestic raw materials and inputs. Has the staff checked the availability of these inputs? Otherwise, to achieve the projected growth rates of GDP, real investments will have to be large, and will have to be supported by larger imports than those allowed for under the program. Higher real investment and import levels imply that there will be a larger trade deficit than is mentioned in the staff paper.

Nominal exports are estimated to increase by about 4 percent in 1988, and by about 9 percent a year thereafter, until 1991. The growth rate of products other than the traditional ones of coffee, tea, and oil is expected to rise substantially. According to the background paper, the demand for many nontraditional export items depends largely on the buoyancy of the African markets. As Mr. Abdallah has hinted, the increase in nontraditional exports may not respond to any further flexibility in the exchange rate policy. What then is the basis for the staff's optimism about the medium-term outlook for exports?

From Table 1 of the staff report, it is clear that total Fund credit outstanding to Kenya will decline from SDR 268.5 million in October-December 1987, to SDR 258.94 million in January-March 1990, because repurchases will be higher than the expected purchases--under the credit tranche policies and the structural adjustment arrangement--by about SDR 9.56 million. In the circumstances, how is the Fund's support expected to promote structural adjustment in Kenya? Is its involvement expected to catalyze additional resources? Furthermore, as

Mr. Abdallah indicates, it is clear that the authorities want to have an enhanced structural adjustment arrangement, but it appears that delays in bringing the new facility's modalities into place will not allow the staff to consider the authorities' interest in it. I hope that the staff will consider how Kenya can convert to an enhanced structural adjustment arrangement in a short period.

Given Kenya's good record--it has made all its debt service payments--Kenya provides the best opportunity for the staff to show that genuine structural adjustment can be accomplished if requisite concessional resource flows are provided.

I support the proposed decisions.

Mr. Mawakani made the following statement:

I support Kenya's request for stand-by and structural adjustment arrangements. I also support the decision on the exchange restrictions and generally agree with the thrust of the staff appraisal.

After a significant improvement in 1986, Kenya's economic and financial situation experienced a setback in 1987. Unfavorable weather conditions somewhat dampened activity in the important agricultural sector, and the inflation rate increased--reflecting expansionary monetary conditions. The external current account deficit widened owing to the decline in the world coffee price. These developments have created renewed financial pressures and led to a lower than expected rate of growth in GDP.

Given this background, the destabilizing effects of the fluctuations in Kenya's terms of trade in recent years, and the economy's great vulnerability to other external shocks, I welcome the authorities' initiation of a medium-term program based on the broad policy outlines contained in the Sessional Paper on Economic Management for Renewed Growth that was approved by the Kenyan Parliament in early 1986.

I endorse the specific medium-term development strategies that have been formulated to reduce financial imbalances, achieve an external position that is sustainable, and lay the foundations for accelerated economic and social development. Considering Kenya's impressive adjustment record, I am confident that, based on the wide local and external support that the policy framework commands, the authorities will maintain a strong political commitment to the implementation of the program.

The policy framework is comprehensive, combining both macroeconomic and structural elements with an emphasis on growth. The time frame for the implementation of a number of the policies in the 1988/89 financial program, as summarized in Table 1 of the policy framework paper, seems to be too restrictive. The limited nature of the time frame is especially apparent when one considers that most of the policies are expected to be implemented by the first program review in June 1988. I hope that Kenya will not be left alone in undertaking this formidable task, and that its strong commitment to accelerate structural adjustment in the many areas where progress has been relatively slow will be adequately matched by additional foreign support.

The authorities' adjustment policies are important steps in the right direction. The targeted reduction in the overall budget deficit to a sustainable level over the medium term seems warranted. The deficit reduction is expected to be achieved through revenue-raising and expenditure control measures, particularly by the limitation of the size of the civil service and the maintenance of a tight wage policy. The budget rationalization program is a welcome innovation that should improve the allocation of resources and support economic activity in the private sector. The efforts to increase public enterprise efficiency are also encouraging.

Monetary and credit policies appear to be broadly supportive of the fiscal, balance of payments, and inflation objectives. It is commendable that, in support of their traditional approach to adjustment, the authorities are also focusing on the broader structural issues relating to the financial system's efficiency. The development of effective financial instruments and markets is as important as the adoption of traditional adjustment measures, and it is heartening to note that substantial progress has been made in dealing with the excess liquidity problems and with the institutional weaknesses that have emerged in the financial sector. Moreover, the restoration of confidence in the banking system is welcome.

The staff projections for the medium-term outlook show that the economy's prospects are worrisome, especially because over the past few years, Kenya has received declining amounts of foreign assistance--despite the significant progress that it has made under a series of Fund-supported adjustment programs. As was indicated in Mr. Abdallah's opening statement, sustainable medium-term growth in per capita income will require much higher levels of external concessional assistance. Therefore, I urge the international financial community to support Kenya's adjustment efforts.

Mr. Reddy made the following statement:

I am in general agreement with the staff appraisal and support the proposed decisions. Given the nature of Kenya's problems, the need to minimize the debt service burden, and the record of Kenya's adjustment efforts, it would be a good candidate for an enhanced structural adjustment arrangement.

Kenya has made significant progress in the past three years in improving its growth performance without simultaneously accelerating the rate of inflation. The external position strengthened in 1986 due to the improvement in the terms of trade. Unfortunately, a sharp turnaround in the terms of trade in 1987 has increased the pressure on the balance of payments, with adverse consequences for the development program and the prospects for growth. Meanwhile, the fiscal deficit has increased rapidly to an unsustainable level. However, the authorities have responded adequately to these adverse developments by adopting a three-year adjustment program.

The authorities' commitment to limit the annual budget deficit under the program to about 4 percent of GDP is welcome. However, in light of recent experience, the attainment of a smaller budget deficit may require somewhat stronger efforts by the authorities, because the revenue to GDP ratio has increased considerably over the past two years, to a level that is already high compared with that of many developing countries. Therefore, the scope for increasing revenues further may be somewhat limited, and the burden of deficit reduction could fall largely on expenditure restraint. Appropriately, the authorities have committed themselves to controlling expenditures and improving the productivity of budgetary resources through the rationalization of expenditures--including the reform of the National Cereals and Produce Board (NCPB).

I share the authorities' view that the monetary targets should be consistent with the aims of reducing inflationary pressures, supporting external adjustment, and improving resource allocation. Moreover, structural weaknesses in the financial sector need to be addressed. I welcome, in particular, the authorities' efforts to develop a capital market and to maintain positive real interest rates, which will no doubt help to promote domestic resource mobilization and are crucial if the development process is to be sustained. The authorities' intention to encourage the financial system to provide longer-term credits and to finance small and medium-sized firms is also welcome.

It is important to increase the foreign exchange receipts to finance the required imports, service the external debt, and strengthen the international reserves. I support the authorities' efforts to diversify exports by promoting the agroindustrial,

industrial, and tourism sectors. Efforts to improve the export sector's efficiency and competitiveness, especially through the continued maintenance of a flexible exchange rate policy, are particularly important. The pace of import liberalization should be commensurate with the progress in export promotion, so that undue pressure on the external balance can be avoided.

For Kenya, like many African countries, commercial borrowing to finance the external deficit is not a viable option. Commercial borrowing would only make Kenya's problems less tractable; thus, the only viable solution is a determined effort by the authorities to implement strong adjustment measures, which should be supported by adequate concessional foreign assistance.

Mr. Noriega made the following statement:

The Kenyan Government's requests for stand-by and structural adjustment arrangements follow the authorities' implementation of strong measures aimed at correcting the internal and external disequilibria. The consistency of these measures, which are part of a more comprehensive and longer-run program, gives credence to the program, and I therefore support Kenya's requests.

I have previously noted the view that although the policies that have been pursued since 1981 have gone in the right direction, they have neither proceeded fast enough, nor gone deep enough into the roots of structural problems, to make the economy less vulnerable to foreign and weather shocks. Nevertheless, the adoption of the new program is encouraging, as it does appear to meet these concerns.

I recognize the efforts that are being made to reduce the public sector deficit and understand the authorities' reasons for not augmenting the share of revenues in GDP. Raising taxes may have an adverse impact on growth that is similar to a decline in investment and, therefore, unless the deficit reduction occurs through a decline in recurrent expenditures, the prospects for growth will remain constrained. It is important to note that the ratio of gross fixed capital formation to GNP has been maintained at, or slightly increased above, its early 1980s level. However, it is apparent that although the public share in gross fixed capital rose continuously from 1983 to 1986, it fell in 1987, and is programmed to fall further in 1988. This issue raises some doubts about the outcome of the program, which should include strong investment growth to support structural adjustment together with vigorous economic growth. The increase in the private sector's capital expenditures largely reflects the growth in transport and storage spending. The staff should elaborate on the appropriateness of the changing composition of capital expenditures, in light of the reforms in agricultural pricing and the organizational and financial restructuring of the National Cereals and Produce Board. If the Government cuts its capital expenditures, will private investment become more, or less, productive?

I attach great importance to restoring confidence in the banking system--particularly in the nonbanking institutions--through the work of the Special Investment Committee and the Deposit Protection Fund; the maintenance of parastatal sector deposits in the bank and nonbank institutions greatly helped to restore confidence.

Interest rate policy has been successful, enabling interest rates to absorb the liquidity that was injected during the previous exercises. Although interest rates have been the major instrument for allocating credit, the rise in the public sector's credit share should be carefully examined, especially if in the future private investment is expected to become the major source of investment.

I share Mr. Abdallah's concern about the delay with which nontraditional exports may react to exchange rate stimuli, and I would appreciate further staff comment on the issue. However, the economy's responsiveness should be strengthened, together with the Government's credibility. Two important factors should increase the Government's credibility: the request for arrangements under the structural adjustment facility, which may be viewed as a long-term commitment by the authorities to the maintenance of adequate policies; and the fact that the Fund's support is expected to attract enough external finance to cover the foreign financing gap. I wonder whether the current request for a structural adjustment arrangement is more helpful than waiting until an enhanced structural adjustment arrangement request can be processed.

The external sector will continue to be vulnerable, but this vulnerability, as well as the uncertainty that will always exist about the response of the export sector to structural adjustment measures and the availability of external assistance, should strengthen the authorities' resolve to advance along the path set forth in the present program. On the basis of the new program, I urge the international financial community to increase its support for Kenya.

Mr. Sliper made the following statement:

Clearly, 1987 has been a poor year, especially when viewed against the generally good performance in the first half of the 1980s. The fiscal deficit, excluding grants, ballooned to 10.5 percent of GDP compared with 6.6 percent in the previous year. Similarly, the current account deficit, again excluding grants, increased to nearly 9 percent of GDP, compared with 3 1/2 percent in the previous year. Monetary policy was lax, with domestic credit expanding 28 percent, compared with the inflation rate of about 7 percent.

In analyzing the deterioration in economic conditions it is particularly interesting to examine the causes, especially the relative roles of external events and policy slippages. Undoubtedly, external events contributed substantially to the poor 1987 performance. A reduction in the terms of trade of 25 percent is a massive shift by any standard. However, the terms of trade figure needs to be seen in context--1986 was a buoyant year for both coffee and tea prices, and thus the 1987 terms of trade decline was from the unsustainably high base in 1986.

Despite the difficult external situation, it is my impression that policy slippages did account for a large portion of the economic deterioration. This conclusion applies particularly to the fiscal position, as the increase in gross expenditures in 1987 of 25 percent was excessive. The massive increase in the numbers and real wages of public servants was especially disappointing. Mr. Abdallah noted in his opening statement that many of these new expenditures were nonrecurrent, and although this seems to be correct, it is equally clear that priorities should have been established and a more phased program undertaken.

The authorities should have reacted earlier to the imbalances. Of course, this is an easy judgment to come to with the benefit of hindsight. Nevertheless, the deteriorating economic position was highlighted vigorously during the Board's January 1987 Article IV discussion, as was the view that the authorities should pursue more cautious fiscal and monetary policies in the light of the fragility of the external position. Kenya is another classic example of how easy it is for financial policy to slip and how difficult it is to rectify these slippages.

I am struck by a cogent point that Mr. Abdallah made in his opening statement on the optimism of the staff's assumptions about the external position. While the forecasts may be attainable, the growth rates for both exports and imports seem to be generous; in other words, export growth is high and import growth is low. It certainly does seem that the risks are on the downside, because the external position is more fragile than it is assumed to be in the staff report. The degree of uncertainty in the external position reinforces the importance of adhering to the adjustment program.

The fiscal assumptions are also optimistic, particularly for 1988, as a 4 percentage point improvement in the deficit is forecast. The ambitiousness of the fiscal target is warranted, but I tend to doubt whether it is attainable. The staff report refers to significant revenue improvements owing to the greater use of user charges, particularly partial charging for education and health services. These are extraordinarily difficult policy measures to introduce; staff comment on the likelihood of the user charges being implemented to the degree that was foreshadowed in the staff report would be helpful.

The breadth of the policy package's measures is impressive, but they lack depth in a few areas. The policy shifts that have been identified and agreed to are in the priority areas, and thus I welcome the public enterprise reforms, the reduction in trade protection, the reduced reliance on price controls, and the reforms in the sectoral policies. However, the extent to which the authorities rely on reviews and studies--this being especially apparent in the fiscal area--is disappointing. Moreover, some of the program's measures are defined in rather vague terms--for example, "maintain a tight wage policy," "control establishment levels to obtain budgetary savings," and "begin to rationalize tariffs." Greater specificity in some aspects of the program plus some additional front loading would have been preferable. Nevertheless, the program is a comprehensive one, and if real and prompt action does follow many of the planned reviews and studies, these measures will contribute substantially to the adjustment process. I support the proposed decisions.

Mr. Adachi made the following statement:

It is regrettable that the economic progress achieved over the preceding years is being jeopardized by exogenous factors. The deterioration in the terms of trade has hampered the authorities' efforts to attain a viable external balance. The increasing debt service ratio, which is affected by exchange rate changes, also remains a major concern. The economic effects of the drought have brought excessive pressures to bear on fiscal and monetary policies and have resulted in a resurgence in the rate of inflation. Given the rapid population growth, Kenya is at a critical stage in its efforts to secure the foundation for future economic growth.

So far, the Kenyan authorities have implemented the adjustment program in an impressive manner under adverse conditions. The progress in policy implementation forms a suitable basis for further adjustment. Moreover, the commendable adjustment record, coupled with the authorities' strong commitment to orderly repayment of international debt, has had a particularly salutary effect on Kenya's creditworthiness in the international financial community. To take advantage of these favorable factors, however, Kenya has to address a number of structural and financial problems, which are well recognized by the authorities and are dealt with purposefully in the program. The program is well designed, and given the authorities' strong determination to implement it, I support the proposed stand-by and structural adjustment arrangements. Nevertheless, several points must be recognized if the program's objectives are to be achieved.

First, the emergence of inflationary pressure is very worrisome and underscores the need for fiscal consolidation. Although the first step has been made with the 1987/88 budget, concrete measures embodying the authorities' determination should be developed in 1988/89 and 1989/90. Therefore, I attach substantial importance to the forthcoming review of the program.

Second, the success of the program hinges critically on the attainment of efficient resource allocation, without which the investment needed for economic growth will not emerge. The achievement of efficient resource allocation requires an all-out attack on various fronts--but it especially requires the reform of the public enterprises. A slippage in public enterprise reform could result in adjustment fatigue and might lead to the collapse of the program.

The vulnerability of the Kenyan economy to exogenous factors highlights the need for the authorities to be prepared to implement additional measures to buttress the program. Moreover, the fragile balance of payments prospects--owing especially to the financial needs envisaged for 1989-90--might require further measures to underpin the authorities' efforts to achieve stabilization and sound economic growth. The staff should comment on the prospects for an enhanced structural adjustment arrangement; it is reasonable to assume that such an arrangement requires a stronger program than the existing structural adjustment arrangement.

Mrs. Walker made the following statement:

It is unfortunate that since the previous Article IV consultation, the authorities have been unable to adopt the fiscal restraint needed to avoid a deterioration in their balance of payments position in 1987. This is particularly true because in the past Kenya has made commendable progress in economic adjustment and, as Mr. Sliper noted, a clear indication of the need for action was given at the time of the previous Article IV consultation. The slippages in fiscal policy, along with the sharp deterioration in Kenya's terms of trade, have brought about the immediate need for Kenya to adopt the current economic adjustment program, although the lack of progress in structural reform in the past probably also contributed to the present problems.

The adjustment program, as outlined in the sessional paper and as supported by the requested stand-by and structural adjustment arrangements, appears to be appropriate in its direction and policy prescriptions, and I particularly welcome the attention given to such a wide range of policy areas. However, in light of the need to address the imbalances that surfaced in 1986/87, I am concerned about the depth of policy actions in some areas and would have welcomed more detail on policy actions in other areas. In addition, I found the timing of action on some structural adjustment measures to be too lengthy. Therefore, early action on a number of fronts, particularly in the specific structural areas outlined in the structural adjustment arrangement, in addition to further fiscal constraint, will be essential to the success of the economic adjustment program. The authorities must also be prepared to tighten policies further if international or other developments turn out to be more negative than is currently expected.

A readiness to further tighten policies is particularly relevant in the context of the fiscal situation. While I recognize that some expenditure developments last year were of a one-time nature, the budget deficit reached levels incompatible with the attainment of adequate growth levels or a sustainable balance of payments position, and every effort should be made to not exceed the budget deficit targets for 1988. In addition, it is essential that efforts to reduce the fiscal deficit remain strong in the next fiscal budget, which is to be discussed at the time of the midyear review.

The budget rationalization program will also be an important element in the effort to reduce domestic imbalances. In this regard, I support the authorities' intentions to increase the productivity of government investment, to restructure expenditures, and to improve the operations of the public enterprises. However, I found the timetable for action on rehabilitation and restructuring of public enterprises to be somewhat slow and I urge the authorities to implement these plans prior to June 1989, perhaps by targeting key enterprises for priority attention.

The reduction in the fiscal deficit should also serve to reduce the expansion of domestic credit. Reform of monetary policy--by relying more heavily on monetary policy instruments--is a welcome development, as are the steps to develop a capital market. The establishment of an operative Capital Market Development Authority will be a first step in this direction, although further steps should be taken soon after to assist the divestiture of public enterprises. Improvements in the efficiency of the financial system will also aid the absorption of the existing liquidity overhang. Therefore, I welcome the steps to be taken in this area in 1988 and look for additional steps in the future.

The medium-term balance of payments outlook is difficult, and it is clear that actions must be taken to strengthen export earnings and to lower import expansion to sustainable levels. In this regard, continued adjustment of the real effective exchange rate will be essential, and I welcome the authorities' commitment to this adjustment and the actions they have taken in this area. Reform of the import licensing and tariff systems will also be needed. The proposed design and implementation of a comprehensive export promotion program is important, although the deadline--June 1989--needs to be shortened. More rapid progress in enhancing export development will be necessary, and the review of the program should provide more details. Furthermore, the authorities intend to study export financing incentives during 1988, but I do not see any timetable for action on this front, nor any explicit mention of action to meet this goal.

I welcome the steps taken to make pricing policy more market oriented and those that will be taken by June 1988. Flexible pricing will be an important incentive to production. However, I would appreciate some analysis by the staff of how far the steps outlined will go in promoting liberalization of pricing policies.

The staff believes that further external assistance will be needed to enable Kenya to achieve the adjustment needed. I agree with Mr. Enoch that developments in external aid flows will most likely reflect the degree of adjustment undertaken.

I note the authorities' request to convert the structural adjustment arrangement and stand-by arrangement into an enhanced structural adjustment arrangement, when the modalities are in place. In light of Kenya's high level of Fund credit outstanding, its need for concessional financing, and its good record of cooperation with the Fund, it might be useful to explore the possibility of future conversion of these arrangements into an enhanced structural adjustment arrangement at the appropriate time, as long as the policies and targets embodied in the current programs are maintained and/or strengthened and are outlined in sufficient detail, and the speed of implementation is increased, particularly in the structural adjustment areas, so that, as Mr. Sengupta stated, genuine structural adjustment is achieved.

I welcome the authorities' commitment to implement the entire adjustment program, as was noted by Mr. Abdallah, and I encourage them to pursue this adjustment with vigor. I support the proposed decisions.

Mr. Grosche made the following statement:

As Mr. Abdallah explained in his opening statement, between 1981 and 1985, Kenya maintained highly successful stabilization policies. In 1986 and 1987, however, the stabilization policies were relaxed prematurely. Kenya has to cope with some difficult problems, such as unpredictable weather conditions and large fluctuations in its terms of trade. It cannot afford any loosening of financial discipline; otherwise, adjustment gains that have been painfully achieved will all too soon be eroded, undermining the long-term prospects for higher growth.

The authorities recognize the need for sound financial policies, and they are to be commended for their decision to undertake necessary corrective actions under difficult circumstances. The wide-ranging policy measures that the authorities will be implementing over the next three years will go a long way toward improving the base for more adequate growth.

The fiscal and structural adjustment policies require particular attention. There can be no doubt that the extremely high rate of population growth will require a further increase in food production; thus, the emphasis placed by the Government on promoting agriculture is highly appropriate. I welcome the measures that are still in preparation, particularly the more flexible approach to pricing and the restructuring of the National Cereals and Produce Board.

The extraordinarily high population growth rate also constitutes an enormous challenge in terms of creating additional employment opportunities. Therefore, I welcome the intention to include action on demographic issues in the policy framework paper, an area that is not often mentioned in such papers.

The pursuit of prudent fiscal policies will certainly require a strong political commitment by authorities to make sure that the policy momentum is maintained. The staff could usefully comment on the attainability of the fiscal objectives in light of recent developments and the latest data available. Given the critical importance of raising investment outlays, the authorities should try to make budgetary savings by further cutting recurrent expenditure, whenever and wherever possible. The reform of the public enterprise sector rightly deserves high priority, and I welcome the steps already taken in this respect. I also support the effort to improve the conditions for private initiatives so that the private sector can play a more important role in generating growth.

The authorities need to concentrate on export promotion and diversification, as well as on the ability to attract more foreign capital, including foreign direct investment, and I welcome their recent steps to further open the economy. In the past, Kenya's somewhat erratic policies toward foreign direct investment raised some doubts in the minds of potential investors. The Government should try to dispel the ideas advanced in some political quarters that foreign companies should sell the majority of their equity to Kenyan citizens.

I also encourage the authorities to sustain and, whenever possible, to expedite their efforts to liberalize the import system, maintain a flexible exchange rate policy, and improve incentives for private domestic savings. I hope that Mr. Abdallah, in suggesting that short-term savings are probably more responsive to changes in real output than to changes in real interest rates, is not implying that interest rates may be negative in real terms.

I am encouraged by Kenya's adjustment record until 1985 and by Mr. Abdallah's statement, as it confirms that his authorities are not only fully aware of the existing problems, but also prepared to take the needed actions. I therefore support the proposed decisions. I will certainly be willing to favorably consider Kenya's request for an enhanced structural adjustment arrangement, as soon as the facility becomes operational, and provided that the request can be underpinned by the prospect of sustainable and strong structural adjustment efforts.

Mr. de Groote made the following statement:

The Kenyan case is an encouraging one, because Kenya has persevered in its stabilization efforts, despite the serious terms of trade constraints, and is now reaping the first results of its courageous implementation of the growing-out-of-debt strategy recommended by the Fund and the World Bank. It is true that the high growth rate in 1986--close to 7 percent in real terms--was to a large extent exogenous in origin, and that it led to excess liquidity, demand pressures, and deterioration in the balance of payments. However, it is also beyond doubt that the measures previously adopted enabled Kenya to consolidate its recovery in 1986 and 1987, because these measures had established a sounder basis for the public finances and started the process of fundamental reform. Therefore, Mr. Enoch is right in stressing that the situation would have been much worse without the program, and that a more active exchange rate policy might have improved the results.

The quality of Kenya's performance, the outstanding record of its relations with the Fund, and the absence of debt rescheduling fully justify the assistance under the stand-by and structural adjustment arrangements. Mr. Abdallah makes a valid case for asking that the conversion of these credits into enhanced structural adjustment credits be considered in a positive spirit during the program's implementation, once the enhanced structural adjustment facility has been put into operation, and provided that further steps are taken in the direction of structural reform.

Kenya's annual access of 40 percent of quota under the stand-by arrangement is somewhat below the average actual annual access for 1986 of 43 percent. Table 1 of the staff report shows that Kenya's use of Fund credit under tranche policies will total only 165 percent in July 1988, and will then fall to just above 100 percent in 1990. These are modest access figures compared with those for Jamaica, Zaïre, Somalia, and Mexico, among others. Table 7 indicates that total external public debt will reach a maximum of 34 percent of GDP in 1988, while the debt service ratio peaked at 37 percent of GDP in 1987. I wonder whether the frugality of the Fund's intervention is due to an expectation that Kenya will shortly gain access to the enhanced structural adjustment facility, or to an expectation that approval today of the decisions on the stand-by and structural adjustment arrangements might have a catalytic effect on new concessional financing. If such prospects for new financing fail to materialize, a need might arise to review Kenya's access if Kenya continues to implement the program and has to rely on Fund credit to cover its external liquidity gap, which is the precondition for the success of its growing-out-of-debt strategy.

Indeed, Kenya still remains very vulnerable to external factors. Coffee and tea exports have accounted for more than half of Kenya's export earnings over recent years. Negative developments in the prices of these commodities will threaten not only export earnings, but also government revenues. Kenya is a relatively industrialized country for the region; 27 percent of its exports go to neighboring countries, and thus a decline in Kenya's neighbors' export earnings immediately harms Kenya's own promotion of manufacturing industries and nontraditional exports. Furthermore, with 33 percent of revenue coming from import taxes, the compulsory restrictions on imports required by shortages of foreign currency will cause part of the government deficit to be monetized, thereby increasing the risk of inflation. Considering Kenya's external vulnerability and dependence on import taxes, and in keeping with the spirit of the program, calling for the liberalization of trade and the reduction of tariffs, the authorities should closely monitor and gradually decrease the heavy reliance of Kenya's tax structure on import taxation. Yet, we must remain aware of the impossibility of Kenya achieving liberalization and export growth without having enough foreign exchange reserves to help it through the transition period that precedes the emergence of the favorable results of adjustment.

In any event, the program includes other objectives that will be hard to achieve, such as increasing the GDP growth rate while narrowing the current account deficit by restraining government investment to slow import growth. Only a rapid rate of output growth, in response to the development of exports, will permit the attainment of the goal of growth with adjustment. In this connection, the World Bank Board's discussion has identified a number of important aims for Kenya's structural adjustment which might be helpful. Development of private sector initiatives and the strengthening of family planning, deserve special attention.

Kenya's program poses a particular challenge to the Fund's adjustment model at the level of both analysis and the response of other members. Do real interest rates affect savings, or are the latter more responsive to income? Will the projected increase in nontraditional exports materialize as a result of exchange rate adjustments? Will the amount of inputs remain adequate to support the projected real growth of output? Has it been duly taken into account that Kenya's potential export markets are limited to its neighbors, where it has a locational advantage? Mr. Abdallah has expressed doubts in all these areas, and the staff papers do not explicitly describe all of the assumed interrelationships. Are we entitled to expect the positive results on which the program is predicated, or are these simply the result of the application to Kenya of the Board's general belief in the validity of the Fund's adjustment model? The staff should elaborate the program's underlying assumptions.

The response of other countries is rightly regarded by Mr. Abdallah as a crucial element for the success of Kenya's program. The Kenyan case must be actively considered by other Fund members, because Kenya is implementing the most comprehensive adjustment program in Africa. Kenya's authorities and people have shown courage, and have a clear vision of how to achieve their growth objectives. I am confident that they will continue to strengthen the adjustment program during its implementation, with the conversion to an enhanced structural adjustment arrangement in view.

Mr. Ovi made the following statement:

I support the requests for stand-by and structural adjustment arrangements. I basically agree with the staff's sympathetic assessment of Kenya's past record, its present economic situation, and the merits of its economic program, as outlined in the sessional and policy framework papers.

Kenya's record of economic adjustment has been good, despite, as the staff points out, the difficult circumstances. Several important adjustment measures have already been taken, particularly in the agricultural sector. Interest rate and exchange rate policies, along with the continued relaxation of price controls, also form a good base for further adjustment efforts.

However, the comprehensive economic adjustment program, as presented in the staff paper, is based on somewhat optimistic assumptions about external developments. Kenya remains highly vulnerable to international developments. The improved terms of trade were reflected in the turnaround of the balance of payments in 1986, but worsening terms of trade turned the balance into a deficit in 1987. Given present predictions, one cannot foresee any substantial improvements in the terms of trade, and with no major contributions expected from foreign demand, the staff's assessment of the measures that should be undertaken seems to be somewhat too optimistic.

As the authorities realize and as Mr. Abdallah mentioned in his opening statement, the looser fiscal policy that was pursued during the previous two years needs to be reversed. I am puzzled by some of the explanations of the loosening of fiscal policy in 1987 and of the policy implications for the future. The staff paper refers to increasing civil service and wage costs, as well as to certain investment projects. In addition, support was needed for the National Cereals Produce Board, although expenditure in this area apparently declined from 1985/86 to 1986/87. However, in the table on page 10, the deterioration in the fiscal balance is attributed almost entirely to an increase in development expenditure and net lending. Mr. Abdallah, in his opening statement, offers a somewhat different set of explanations, with the main emphasis being on nonrecurrent expenditures--including some wage catch up. It is surprising to see wage increases classified as nonrecurrent expenditures. If they were "nonrecurrent" expenditures, one would expect there to be an automatic decline in future growth of expenditures, or at least an increased potential for restraint. Consequently, it is puzzling that most of the substantial improvement expected in the fiscal balance in 1987/88 is expected to be derived from the revenue side.

I fully agree with the staff that the authorities must be prepared to further tighten policy should the assumed international developments not materialize. In that event, the staff suggests, the authorities should also try to move faster in implementing structural adjustment policies. I am interested to know what kind of measures the staff has in mind.

Despite the unusual comprehensiveness of the adjustment program, it raises a number of important questions on how its aims are to be achieved. The adjustment program will build on measures that are aimed at increasing productivity and at providing special incentives to strengthen the private sector. I would appreciate an explanation from the staff of the measures needed to stimulate investments, especially considering the apparent difficulty in accumulating domestic savings even during a period of high real interest rates.

I would also like to hear from Mr. Abdallah, or the staff, how the problems in the labor market, originating from the very rapidly growing population, will be solved by the adjustment program.

A major factor in successful implementation of the adjustment program is the provision of the necessary financing. So far, developments in this respect have been disappointing. Increased donor support is needed, although Mr. Abdallah's rather open-ended invitation to donors hardly seems to be realistic. The Nordic countries, which have substantial bilateral assistance programs in Kenya, feel that it would be appropriate to look more closely at the need for improved donor coordination.

The authorities have requested a stand-by arrangement in combination with a structural adjustment arrangement. Although a stand-by arrangement is not entirely appropriate in Kenya's present situation, it seems to be the only solution. Kenya is a good candidate for an arrangement under the future enhanced structural adjustment facility: indeed, I hope to see the present arrangement replaced as soon as possible by a strong enhanced structural adjustment arrangement.

I support the proposed decisions.

Mr. Jiang made the following statement:

Kenya successfully implemented a broad range of policy adjustments during the first half of the decade and, helped by favorable weather conditions, its economic performance in 1986 was impressive--internal and external imbalances were substantially reduced, and rapid growth, with low rates of inflation, was achieved. However, this progress was short lived because of the estimated 25 percent fall in the terms of trade in 1987. This sharp decline in export earnings caused the debt service ratio to rise to a historical high of 33 percent, with the current account deficit also rising, to 5.2 percent of GDP. The purchase of grains arising from bumper harvests, and a relaxation of financial discipline, also caused the overall budget deficit--including grants--to rise, to 8.1 percent of GDP. It is remarkable that, even under such difficult conditions, the authorities maintained orderly international financial relations and did not seek debt rescheduling, relying instead on their own efforts to address the imbalances by undertaking structural corrective measures.

The policy framework paper and the Memorandum of Economic and Financial Policies, which give a comprehensive and detailed description of the authorities' policy intentions over the medium term, point mainly in the right direction in promoting enhanced growth through comprehensive structural reform, financial stability, and medium-term viability.

Kenya, like many other developing countries, is very sensitive to exogenous influences, whether they are natural or artificial, favorable or disastrous. Therefore, a favorable external economic environment will play an important role in the process of structural adjustment in Kenya.

Kenya urgently needs external financing. The donor countries have been asked to reverse the declining trend in aid flows of recent years, and the authorities wish to replace the present stand-by and structural adjustment arrangements with an enhanced structural adjustment arrangement. Given Kenya's difficult situation, its record of good performance, and the adjustment efforts now being made, sympathetic consideration should be given to the authorities' request.

I support the proposed decisions.

Mr. Massé made the following statement:

I welcome the measures presented in the staff papers, which form a wide-ranging and ambitious policy package that merits the support of both the Board and the donor community. I endorse the staff appraisal and the proposed decisions.

The authorities have established a strategy of structural reform aimed at maintaining rapid growth of per capita income. Thorough implementation of the envisaged measures is essential; in this respect, continuing price liberalization can make an important contribution. More generally, I agree that, where possible, the Government should attempt to accelerate the implementation of structural reforms to strengthen the prospects for growth.

An area where some acceleration of reform could be helpful is the financial system. While I welcome the authorities' intention to move toward a greater reliance on market forces in allocating financial resources, I note from Attachment III of the staff report that it is expected that the authorities will not begin to free long-term interest rates until December 1989. This seems to be an unduly cautious timetable for such an important reform.

The substantial reduction in the budget deficit expected in 1987/88 is welcome. While the subsequent declines in the deficit are expected to be more modest, the staff feels that a sustainable level will be reached by 1990/91. However, this assessment of sustainability seems to depend importantly on the provision of adequate amounts of concessional aid. Therefore, if there is an unexpected shortfall--just as if the international environment would be less favorable than is currently projected--the authorities will need to react quickly to strengthen their adjustment effort. On a related point, the authorities' program includes an ambitious growth objective: again, in the face of unforeseen adverse shocks, or in the event of shortfalls in external assistance, it could be necessary, or even unavoidable to project somewhat slower growth.

I encourage the authorities to continue their present exchange rate policy and keep the exchange rate under review, given the ongoing liberalization efforts and the need to strengthen export performance over the medium term.

Like Mr. Abdallah, I think that the support of this adjustment effort with an enhanced structural adjustment arrangement is well worth considering. Moreover, I hope that the thoroughness of the adjustment effort will not be diminished in the course of such a transition.

Mr. Hogeweg made the following statement:

It is my impression that the authorities are willing to try to adequately address Kenya's difficult circumstances. I commend the authorities for their efforts, and I hope that the donor community will respond accordingly. I support the proposed decisions.

The staff's conclusion that recent slippages in financial policies have led to a deterioration in Kenya's medium-term outlook are among the factors that have again made it necessary for Kenya to embark on a major adjustment effort. At the same time, Mr. Abdallah's opening statement stresses the structural nature of Kenya's problems and warns that no immediate effects from the structural adjustment policies can be expected. These two statements together are a cause for some concern. Of course, some structural measures do generate quick results, but more important than the speed of structural adjustment alone is the essential need for adequate accompanying macroeconomic policies. Macroeconomic policy slippages are particularly regrettable because they in effect turn back the clock.

Given the high rate of population growth, it is understandable that the authorities tend to judge the performance of their economy in terms of per capita growth and aim at high rates of economic growth. However, it is doubtful whether an optimal adjustment effort--with an eye on the future--can simultaneously support high growth rates. More generally, growth should be seen as the result of prudent and well-balanced policies, not as something that can be guaranteed by the adequate provision of resources of sufficient concessionality.

I was somewhat surprised by Mr. Abdallah's explanation that Kenya's external situation is really much tighter than the staff's medium-term balance of payments forecast suggests. Specifically, Mr. Abdallah questioned whether the substantial forecast increase in nontraditional exports will materialize, and whether the forecast import levels are consistent with the liberalization of trade restrictions and with the attainment of the real output forecasts. I would appreciate staff comment on these forecasts because they seem to undermine the staff's appraisal underlying the proposed use of Fund resources.

The authorities favor an enhanced structural adjustment arrangement over the present combination of stand-by and structural adjustment arrangements, because it would allow greater access to Fund resources at more concessional terms. Without doubt, greater concessional flows would allow higher import levels, thereby alleviating one constraint on growth. However, since the authorities would prefer an enhanced structural adjustment arrangement within the present adjustment effort, the question arises whether resources under the enhanced structural adjustment facility should substitute for a disappointing level of bilateral aid flows. Of course, that was not the rationale behind the enhanced structural adjustment facility initiative.

Mr. Al-Assaf made the following statement:

During the previous Article IV consultation with Kenya, the authorities' achievements in overcoming the consequences of the adverse weather conditions of 1984/85 were justly recognized. At that time, the Executive Board also urged the authorities to continue their stabilization efforts, which were seen as necessary because of the perceived fragility of the external situation. This view proved correct, and perhaps the best recommendation one could make today is that the stabilization efforts should be continued and possibly intensified. The proposed stand-by and structural adjustment arrangements aim at doing just that, and I therefore join other speakers in supporting the proposed decisions.

The task facing the authorities, in the context of the proposed stand-by arrangement in particular, is a difficult one. The authorities' margin for maneuver is likely to be restricted over the program period by three factors: the need to restrict external borrowing to avoid a further increase in the debt service burden; the importance of maintaining a stance of monetary policy consistent with a reduction of inflationary pressures; and the need for the adjustment process to remain sufficiently supportive of economic growth to be consistent with either an increase, or, at least, stabilization of per capita income.

The behavior of the international economy will have a significant bearing on the performance of the Kenyan economy. An additional important factor will be the donor countries' support for the adjustment process in 1988-90. In this regard, it is somewhat worrying that the broad commitment agreed to during the 1986 Consultative Group meeting has so far been slow to materialize. However, I was pleased to note that on page 20 of the staff report that the staff still believes "that the projection of foreign assistance could be on the conservative side, and amounts larger than anticipated are likely to be secured through the normal annual or biannual lending programs from main donors, especially in the outer years of the projection period." I hope that such a view will not prove to be too optimistic, and I would welcome any elaboration by the staff.

I sympathize with Mr. Abdallah, who noted in his opening statement the dilemma faced by his authorities in their use of structural adjustment and enhanced structural adjustment facility resources. To the extent that a conversion of the present structural adjustment arrangement into an enhanced structural adjustment arrangement will remain consistent with the Fund's operational modalities, I hope that an appropriate solution might be found by the time of the next review under the stand-by arrangement.

Mrs. Ploix made the following statement:

The adjustment program is well prepared and provides a good basis for the necessary policy changes. Therefore, I support the proposed decisions. I note from Mr. Abdallah's statement that the authorities have expressed an interest in converting the structural adjustment arrangement into an enhanced structural adjustment arrangement. Given the nature of Kenya's problems and the quality of this program, I believe that Kenya is a good candidate for an enhanced structural adjustment arrangement.

Kenya's economy is well diversified: it is self-sufficient in food production, the infrastructure is quite developed, and the imbalances in the economy remain manageable, thanks to the policies implemented since 1981. It is thus not surprising that the medium-term strategy being reviewed today reflects this situation; the authorities envisage a wide range of measures encompassing all sectors, but no dramatic policy changes.

This does not imply that some politically difficult measures are not necessary. Some painful measures will have to be implemented, especially to reach the reduction in the overall budget deficit targeted for 1987/88 and to bring it to a sustainable level within the three-year period of the policy framework paper. In this regard, the Government's strategy to improve revenue collection and limit wage-related expenditures appears to be appropriate. The restructuring of public expenditures, aimed at ensuring that current outlays are both adequate and meet the Government's priorities, will also be an important step in this process.

Besides reducing its internal and external imbalances, Kenya must promote faster GDP growth to cope with the growth of its population. As in other countries, the key to economic growth is an improved environment for the development of the private sector. In this respect, the reform of public enterprises and of the financial system, the plans to set up a capital market, and the gradual removal of pricing and marketing controls, are welcome. These measures should play a decisive role in promoting the efficiency of the agricultural and manufacturing sectors, thereby improving Kenya's competitiveness in both domestic and export markets.

Mr. Salehkhou made the following statement:

The staff papers and Mr. Abdallah's opening statement have duly elaborated the economic and financial performance of Kenya over the past few years and highlighted various unfavorable exogenous factors that have adversely affected the economy. They have also thoroughly explained the steps taken by the authorities to cope--with the support of the Fund--with various problems caused by these exogenous factors. The staff papers also reveal the seriousness of these externally induced difficulties, which are interdependent and tend to hamper or slow the achievement of the authorities' growth objectives. I have no difficulty in approving Kenya's requests for use of Fund resources under stand-by and structural adjustment arrangements, and I broadly endorse the first annual arrangement under the structural adjustment facility.

The intended measures envisaged in the policy framework paper are broadly adequate to meet the objectives of the program. However, given the disappointing results of the 1986 Consultative Group Meeting, I share the authorities' concern about the viability of the program's projected external financing requirements and thus about the impact of a probable financing gap on the intended liberalization of existing foreign exchange deposits and imports. It is heartening that the Government has adopted sectoral policy reforms to enhance in particular the capability of the banking and fiscal sectors. The amendment of the banking laws, the improvement of the quality of banking supervision, and the introduction of more effective and perhaps nontraditional instruments of monetary management should enable the authorities to smooth out more efficiently the short-term and abrupt fluctuations in the general level of prices and demand, which arise from the implementation of long-term investment projects.

I fully agree with Mr. Abdallah that, in the short term--and, in my view, even in the long run--savings are less responsive to changes in real interest rates than to changes in real output. The stagnation of Kenya's domestic savings, despite the maintenance of positive real interest rates--which in turn have caused the stagnation of gross domestic investment and a weakening of growth momentum--once again seriously calls into question the validity of changing interest rates as a key instrument of monetary policy, especially in developing countries. A review of the effectiveness of interest rate policy, which is always given disproportionate emphasis in Fund-supported programs, and consideration of alternative solutions for low savings and capital formation along the lines introduced in the study of Islamic banking--which have resulted in impressive results in the few economies where they have been applied--are overdue. Adoption of such viable alternative solutions would clearly result in higher domestic savings and alleviate the need for scarce external financing and foreign investment.

The budgetary measures that are intended to develop a more efficient administration and improve the quality of the revenue-collection system are of great importance. I fully share the staff's views that the overall budget deficit should be decreased to a sustainable level, the selection of development projects must be based on the need to lower the capital/output ratios, and external borrowing should be limited so that a realistic debt-servicing ratio is maintained. I sympathize with the authorities' concern about the tight external situation and the prevailing long lags between donor commitments and subsequent disbursements, but the program is highly, and perhaps imprudently, dependent on foreign assistance. The absence of alternative solutions, which I have already alluded to, for the promotion of domestic savings, and the likely shortfall in external financing--particularly for 1989-90--may distort the program's structure and force the Government to undertake further adjustment measures. To ascertain the availability of external financing and, in particular, to learn more about the measures intended to close the $0.3 billion financing gap, a further review of the program's projected external financing requirements with the Consultative Group for Kenya is warranted.

I endorse the staff recommendation that the Executive Board grant temporary approval of the existing exchange restrictions; and the Fund should be cautious in urging the authorities to fully liberalize imports, given the absence of sufficient reserves and the amount of available domestic and external financing. The authorities should be commended for their efforts to prudently manage debt, and any suggested policies that may increase the current historically high level of debt service--which would further strain Kenya's trade and payments system--should be discouraged.

I fully support the authorities' wish to convert the proposed stand-by and structural adjustment arrangements into an enhanced structural adjustment arrangement, once the operational modalities for the latter are in place. As I have previously maintained in the context of the Fund's relations with a member of my constituency, members should not be penalized for requesting Fund support in the early stages of their balance of payments difficulties. Any prospective improvement in Fund programs should be made in accordance with the principle of uniformity of treatment.

Mr. Kyriazidis said that he supported the proposed decisions and Mr. Abdallah's proposal to convert the structural adjustment arrangement to an enhanced structural adjustment arrangement once the operational modalities had been brought into place. The case for conversion had been well made by several speakers.

The Board's attention should be drawn to a point that was related to Mr. de Groote's argument, with which he agreed, about the frugality of the Fund's intervention in Kenya, Mr. Kyriazidis noted. Table 1 in the staff report indicated that in terms of volume, the proposed stand-by and structural adjustment arrangements were simply refinancing operations that would keep Fund credit to Kenya at about a constant level over the coming two years--although under more favorable terms through the use of the structural adjustment arrangement. When the staff and management considered the possibility of a conversion to, or provision of, an enhanced structural adjustment arrangement, they should go beyond the refinancing of current Fund credit to Kenya and look more deeply into the appropriate volume of Fund support for a country that had cooperated with the Fund and was facing substantial balance of payments financing gaps in the near future.

The staff representative from the African Department noted that many Directors were concerned about the program's lack of specificity. The staff agreed with Mrs. Ploix that developments in Kenya over the past few years had been broadly in the right direction--although there had been some slippages--and that no dramatic changes were needed in any one policy area; indeed, the program had sought to balance actions in many sectors. In effect, Kenya had been following correct policies and was being asked under the program to continue them with increasing emphasis. However, the program would not be an easy one to implement, and as Mr. de Groote had noted, it would also be a challenge for the Fund. A key element of the program was the various reviews, with the first one coming as early as April 1988.

Despite the authorities' willingness to take corrective actions, the staff had faced several serious problems in discussing the program with them, the staff representative continued. The authorities had approached the Fund at an early date for assistance--because the substantial reserve loss in 1988 had greatly concerned them--and had been prepared early in the discussions to formulate a strong financial adjustment package. The staff believed at the time that the authorities deserved early Fund support; thus, the specification of several areas of structural reform had been left for a later stage, after the conclusion of adequate studies. That delay did not imply that the authorities were unwilling to adopt structural adjustment measures; in fact, the authorities' medium-term policy thrust emphasized actions in structural areas. However, many of the available studies on which policy actions could be based were outdated, and the authorities' and the staff's opinions differed partially on the required speed and priority of adjustment measures in certain areas. Moreover, as a developing country, Kenya suffered from serious problems in the administration of policy changes, although its record under previous programs gave the staff strong assurances that necessary policies would be implemented in due course.

Despite the program's risks, the staff believed that continuing close relations with the authorities would enable adequate progress to be made in completing the studies on time and in obtaining early agreement on the required policy packages, the staff representative considered. Since the program had been negotiated, studies in a number of fields had already begun. Experience had shown, particularly in Kenya, that when the authorities were involved in carrying out the studies, policy implementation had been more effective.

There were other reasons for the delays in policy implementation, the staff representative observed. For instance, although it seemed to be an undue delay to fully liberalize interest rates only by 1989, adequate account must be taken of the institutional structure of Kenya's financial system, which was dominated by a small but very strong group of largely foreign-owned financial institutions. Over the past few years, the authorities had been adjusting the banking law in order to strengthen the position of the domestically owned financial institutions to enable them to compete adequately when more market-oriented policies were introduced. The authorities were quite concerned that if a market orientation were introduced before the banking law reforms had adequately taken hold, the main result would be the breakdown of domestically owned financial institutions.

The reason why import growth would be slow over the three-year program period was that there had already been a substantial increase in import volume in 1986, and because the global figures that Directors had referred to included some large nonrepeatable defense and civilian aircraft purchases, the staff representative explained. If the latter purchases were excluded from the import figures, there was clearly substantial room for the rest of the economy to absorb imports during the program. In SDR terms, the rate of growth of imports other than defense and civilian aircraft purchases was nearly 7 percent a year on average.

The export growth rate relied heavily on expansion of nontraditional exports, the staff representative said; many of the policies that were needed to help that expansion were already being put in place, with the exchange rate policy being one of the most important. The growth of nontraditional exports would also be facilitated by the recent improvements in several of Kenya's neighboring economies, and by the foreseeable expansion of Kenyan exports--mainly horticultural products--to Europe and the Middle East. In the past, the growth of total exports had stagnated largely because increases in the exports of some products had been offset by declines in others, but the staff's forecasts indicated that that would not likely recur and, in any event, the program's overall export figure had taken into account the projections for many individual products. The relative export growth of individual products was still an area that the authorities would need to examine closely; in effect, the growth of individual export items would determine whether additional policy adjustments would be needed during the program period. As it was essential that total export growth closely parallel the currently projected levels, the authorities realized that they might be asked to implement additional measures.

The program's projected level of investment relied very heavily on reductions in the capital output ratio, increased maintenance outlays, and an investment shift from the public to the private sector, where the capital output ratio was much lower, the staff representative explained. Moreover, during the program period there would only be a few highly capital-intensive projects. Moreover, the projected level of savings would not rise much above the levels of previous years, but would be above 1986/87's level; and although the staff expected that the positive real interest rates would greatly increase financial savings, the staff did not foresee it substantially influencing the domestic savings rate during the three-year program period. Over the previous few years, the level of quasi-money had increased dramatically and formed an increasing proportion of total financial savings; the staff hoped that that trend would be reinforced by the financial policies that were already in place.

Kenya's access under the stand-by arrangement had been determined by balancing Kenya's high debt service ratio against the need for additional financing in the hope that the Fund would play a catalytic financial role, the staff representative indicated. However, the staff had implicitly assumed that the enhanced structural adjustment facility would become operational during the program period and that additional resources would emerge at that time.

The relatively optimistic 1988 fiscal target largely reflected a downward adjustment owing to the one-time only expenditures of 1987, the staff representative pointed out. The nonrepeatable expenditures had consisted of transfers to the National Cereals and Produce Board and were equivalent to the sizable amount of 1.3 percent of GDP. The reduction in the budget deficit of 4 percentage points was a large one and would require considerable attention by the authorities--especially to avoid the overexpenditures that had occurred in the past. Even so, the planned 1988 budget adjustment would involve progress on both revenues and expenditures. Revenues would account for the greater portion of the fiscal adjustment, rising by an amount equivalent to 5 percent of GDP, while expenditures would fall by 1.2 percent of GDP.

Clearly, the authorities would have to face the problem that increased user charges would be a difficult revenue measure to rely on over coming years, the staff representative observed. However, that strategy had already been approved by the Cabinet and endorsed by the Parliament: the 1988/89 budget would include a meaningful increase in user charges, both for education and health services. With the help of several consultants, the authorities were in the process of reviewing the revenue system, and would discuss the additional revenue measures--involving changes in both tax levels and tax administration--with the staff in April. The new revenue system study was being undertaken because the authorities and the staff had felt that the previous, 1981 study was outdated.

Although it was recognized that the export sector would need increased financing to reach the projected levels, the authorities and the staff were not yet convinced that a specific trust fund or financing package was needed, and believed that such financing would perhaps become a disguised subsidy, the staff representative commented. Action on the exchange rate was a better means of promoting export growth than an import subsidy. The authorities had previously reviewed export financing and had found that all exporters who had legitimate claims had been able to obtain the necessary financing.

Substantial progress had already been made in the envisaged pricing policies, the staff representative remarked. The staff report indicated that only 12 agricultural items and 40 industrial groups were controlled--the latter mainly because domestic industries had a monopolistic position.

Of those 40 industrial groups, 20 would be freed in 1988, with the remaining ones expected to be decontrolled by the end of the program.

The authorities would shortly be issuing a new set of regulations for foreign direct investment, the staff representative said. They had made progress in opening a one-stop government investment advisory service that was aimed at facilitating all the administrative arrangements required by a new foreign investor. They also planned to strengthen the advisory service's functions in parallel with the number of applications that it received. At present, the authorities aimed at providing all the necessary services for a foreign investor within three months, and they expected to be able to reduce that period over the next few years.

It was clear that without the introduction of the program's financial reforms it would be difficult to achieve a degree of structural adjustment sufficient to improve both the growth rate and policy implementation, the staff representative noted. Although substantial improvements were being made in the program's implementation, with the current account deficit in the balance of payments being reduced to 1 1/2 percent of GDP, and with improvements being made in the fiscal and monetary areas, it was clear to the staff that, unless additional assistance was provided to Kenya in the coming years, the program's targets would not be met and there would be an increasing need for the authorities to adopt stricter financial policies and prompt structural reforms.

An aspect of the program that had concerned the staff was the inability to obtain clear indications from many donors of the amount of medium-term assistance they would provide, the staff representative from the African Department concluded. The difficulty in estimating the volume of aid beyond the short term led the staff to believe that the current projections for capital inflows in the latter part of the program were on the conservative side. The staff knew that several important donors and lending agencies had not yet finalized their plans but had indicated that their assistance would continue at high levels. However, the continuation of substantial aid flows did not mean that the authorities should delay the implementation of the program's measures.

The staff representative from the Exchange and Trade Relations Department said that whereas discussions with the authorities had been under way for some time, the Board's decision on the enhanced structural adjustment facility had not been reached until late December 1987. The staff had, therefore, been faced with the issue of whether the additional time that would have been required to implement an enhanced structural adjustment arrangement would have led to an undue delay in the provision of needed financial support for Kenya. The staff had by no means ruled out the possibility of later considering the provision of an enhanced structural adjustment arrangement for Kenya, and, in that connection, the comments of Directors had been most useful.

In accordance with the Board's general approach to structural adjustment, the staff representative considered, a judgment would have to be made about Kenya and coming cases as to what constituted a substantial effort to both correct balance of payments difficulties and foster growth. Although several structural policy measures were being formulated in Kenya, the staff believed that an enhanced structural adjustment arrangement would be appropriate for Kenya only when a better definition could be given to the authorities' intentions in the area of structural policies. Progress in that area would be an important factor in determining the content of, and Kenya's access under an enhanced structural adjustment arrangement. Moreover, it should be borne in mind that enhanced structural adjustment facility resources, or any other Fund resources, were not substitutes for bilateral aid flows and had not been regarded as such; hence the staff papers' emphasis on adequate donor assistance on concessional terms.

In assessing Kenya's access under the proposed stand-by arrangement, it was perhaps not appropriate to look only at the average figures for access to Fund resources, because those masked a considerable range of external access, the staff representative from the Exchange and Trade Relations Department concluded. For example, in 1987, countries' annual access under stand-by and extended Fund arrangements ranged between 19 percent and 85 percent. A number of other countries that had been mentioned had access below 40 percent on an annual basis, while in Kenya's case, 40 percent access seemed to be within the Fund norm; thus, there had been no intention to be especially frugal with Kenya. Furthermore, the staff would want to be cautious in linking too closely the question of access to that of repurchases falling due. The access policy was obviously based in part on balance of payments need, which included debt service payments and repurchases to the Fund. However, in accordance with the usual practice, the tendency in determining actual access had been to emphasize gross access rather than net access.

Mr. Abdallah said that the Government's attitude to the private sector was especially significant. The private sector formed about 70 percent of the economy and its share had been expanding over the previous two years. That shift was favored by the Government, which would support any measures that facilitated that process.

The desire in Kenya that foreign multinational corporations should sell some 50 percent of their equity to Kenyans was based on a political impulse that had been abandoned over the previous two years, Mr. Abdallah continued. Clearly, there were not enough financial resources to buy out even 25 percent of some foreign corporations. In any event, the aspiration would have been better understood if it was appreciated that the private sector--including foreign multinationals--did cause problems at times. Some of the smaller Kenyan companies had encouraged foreign corporations to buy them out, and that had given the impression in parts of the public sector that the takeovers had been engineered politically and that multinationals should sell much of their equity to Kenyans. The private sector was not monolithic, but consisted of groups with differing interests. Indeed, much of the pressures against import liberalization were coming from the private sector. Some multinationals were actually pressing the

Government to close off Kenya to imports, so that their markets could be shielded from foreign competition. Thus, in general, pressures against the emergence of a liberalized economy came from not only the Government, but also the private sector, including foreign multinational corporations.

He had not meant to imply that there was room for weakening of the positive real interest rates, Mr. Abdallah stated. There was an ongoing discussion in the Kenyan Parliament and press on the benefits arising from different possible rate policies. Since the benefits of a positive real interest rate policy were slow in coming, the debate had become more contentious and the policy more difficult to sustain, but that did not imply a weakening of the Government's commitment to maintain positive real interest rates. The positive real interest rate policy would be sustained, as would the flexible exchange rate policy.

The level of Kenya's nontraditional exports depended on conditions in neighboring countries' economies, which in turn depended on the Fund-supported adjustment programs, Mr. Abdallah explained. Kenya and Zimbabwe were the net creditors in the 17-member country preferential trade area in East Africa, and there was little doubt that if Kenya were able to extend more medium-term credit to the other member countries, it would be able to increase its exports to them. However, because those credits would reduce Kenya's foreign exchange earnings, they would not be an unambiguous advantage, and given the pressures on Kenya by its preferential trading partners to import more, its external sector was constrained. The basic problem was that Kenya's neighbors did not have the resources to pay for Kenyan exports; that was why, for example, the competitive Kenyan cement industry was operating below capacity.

Several user charges had already been raised be universities and hospitals, and they would be further increased by about 40-50 percent over the medium term, Mr. Abdallah added. Charges were being raised almost every six months.

In some areas of the parastatal sector, the Government was moving fast in its privatization efforts, Mr. Abdallah noted. It had been announced that two state-owned banks were to be privatized, and because a rudimentary stock exchange already existed, privatization did not have to wait for the establishment of the Capital Development Authority. It was hoped that when the authority was established, the volume of shares and other marketable resources would be increased.

The high population growth rate was a serious problem, and the Government was making every effort to ameliorate it, Mr. Abdallah observed. But the international donor community also had a role to play in helping Kenya to achieve real positive per capita economic growth rates, especially considering some of Kenya's inherent limitations, such as the fact that only 18 percent of the land was arable. Although the adjustment process had been sustained for a long time, there was still a problem of how to create jobs for university graduates--which the informal sector, and not the private sector, was doing--and infrastructure was needed, such as a rural road network to move produce to markets.

It was important to realize that because the Kenyan people were fairly pragmatic and did not have ideological attitudes to economic management, one of the means of maintaining popular support for an adjustment program was to base it on systematic studies, Mr. Abdallah said. The studies were not a way of evading responsibility, but of informing the people of what they ought to know. When the staff studies were carried out, the relevant people in industry and universities were consulted, and that helped the authorities to prepare the people for policy changes. It had been found that unless a staff study was excellent, it generated much skepticism, with people feeling that Kenyans could have done a better job.

Whatever volume of resources the Fund supplied to Kenya, the Fund's catalytic role would be vital, Mr. Abdallah considered. It was disappointing that, of the commitments made at the consultative meetings, not even 50 percent had been filled. More aid coordination was needed, and the Fund and the World Bank should feel that they had a duty to exert pressure on donors; otherwise adjustment fatigue would emerge, and the will of authorities in countries that were committed to adjustment would be weakened. Moreover, there would be a domino effect, because other East African countries were looking at Kenya to see what it would achieve in agriculture and industrialization before deciding whether to follow its example. Therefore, sustaining the adjustment momentum through continued Fund assistance would benefit not only Kenya, but also the many other countries in the region.

The appeal for foreign aid was vital, and anything that the Directors could do to emphasize that point with their authorities would be constructive, Mr. Abdallah concluded.

Mr. de Groote said that when he had questioned the proposed access for Kenya, he had done so on the basis of 1986 data. There admittedly had been a wide range of access, but Kenya qualified for the higher end of the range, given the fundamental nature of the adjustment program that the authorities planned to implement.

The Acting Chairman made the following summing up:

> Directors commended the authorities for successfully stabilizing the economy during the first half of the current decade, noting in particular the generally prudent macroeconomic management and some of the structural reforms undertaken by the authorities in the face of adverse exogenous factors, including drought, declines in the terms of trade, and reduced aid inflows. They also commended the authorities for addressing, with Fund assistance, the internal and external imbalances which emerged after 1986. while recognizing the impact of the deterioration in the terms of trade in 1987, Directors noted that during the

short-lived improvement in Kenya's terms of trade in 1986, financial policies were unfortunately allowed to become very expansionary. The resulting imbalances have created the need for the authorities to once again embark on a rigorous adjustment effort. The authorities' overall strategy includes not only macroeconomic policy adjustments, but also relies heavily on increased productivity, proper pricing incentives, export promotion, and diversification, and renewed emphasis on the private sector. It also emphasizes the development of the agricultural sector and rural areas, the reform of public enterprises, and additional financial sector reforms. The overall strategy was particularly appropriate, Directors observed, in view of Kenya's extremely rapid rate of population increase and its associated growth requirements, and also in view of the vulnerability of the economy to exogenous shocks.

Directors noted that the program which the authorities will be implementing in the three-year period from 1988-90, supported by an 18-month stand-by arrangement and arrangements under the structural adjustment facility, aims at raising the rate of growth while lowering the rate of inflation. The budgetary deficit is to be reduced substantially to permit a significant reduction in the growth of domestic credit and broad money. On the external side, the program aims at a significant reduction in the current account deficit by 1990, and at raising the level of gross reserves to the equivalent of three months' imports. While commending the authorities for their strong political commitment to a well-balanced policy package, Directors indicated the need for the authorities to pursue tighter policies if the international environment turns out to be more unfavorable than presently projected and if, as some Directors feared, the medium-term balance of payments projections turned out to be too optimistic. They also urged the authorities to accelerate the implementation of the structural adjustment policies that would strengthen the growth prospects of the economy. In that context, several speakers requested greater specificity in the content and timing of structural reforms.

Directors noted the crucial role fiscal policy will play in the adjustment process, not only in relieving inflationary pressures, but also in promoting a more efficient allocation of resources. While welcoming the sharp reduction in the budget expected to be achieved in 1987/88, they indicated that a lasting attainment of the authorities' fiscal objective will require improvements in revenue collection, restraint in wage-related expenditures, a reform of public enterprises, including the National Cereals and Produce Board, and improved project selection. Directors also expressed serious concern about the low and declining level of foreign assistance and emphasized the need for substantially higher levels of external bilateral and multilateral assistance in order to secure the success of the program. The potential role of foreign direct investment also led some Directors to encourage the authorities to adopt a more positive environment for such investment.

The importance of maintaining real positive interest rates, while encouraging their market orientation, was also stressed. Directors supported the authorities' program of promoting growth of the capital market and reform of the financial system as a means of increasing financial savings and improving the efficiency of resource allocation.

Directors noted that the authorities had pursued a flexible exchange rate policy, and they urged the authorities to continue with the flexible exchange rate policy to support the objectives of the program and strengthen Kenya's external competitiveness and diversification. Directors welcomed the planned import liberalization program, which aims at the full liberalization of the system in the medium term, and also the emphasis of the program on export diversification.

Directors added that the authorities will need to continue to pursue a cautious external borrowing policy to maintain Kenya's external debt service burden at a manageable level.

Finally, speakers generally indicated their willingness to consider the expressed intention of the Kenyan authorities to request the conversion of the present stand-by and structural adjustment arrangements into an enhanced structural adjustment arrangement, when that facility becomes operational, provided that the Kenyan adjustment program remains on course and, in the view of some Directors, that it is underpinned by stronger and more timely structural adjustments. Some Directors stressed that the enhanced structural adjustment arrangement should be supported by bilateral assistance and was not a substitute for such assistance.

The next Article IV consultation with Kenya will be held on the standard 12-month cycle.

The Executive Board then took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision relating to Kenya's exchange measures subject to Article VIII, Section 2(a), and in concluding the 1987 Article XIV consultation with Kenya, in the light of the 1987 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 approval under Article VIII, Section 2(a), arising from limitations on foreign exchange for imports and rental income remittances as described in EBS/88/2 (1/7/88). In the circumstances of Kenya, the Fund grants approval for their retention until December 31, 1988, or the conclusion of the next Article IV consultation with Kenya, whichever is earlier.

Decision No. 8782-(88/13), adopted
February 1, 1988

Stand-By Arrangement

1. The Government of Kenya has requested a stand-by arrangement for a period of 18 months from February 1, 1988 for an amount equivalent to SDR 85 million.

2. The Fund approves the arrangement set forth in EBS/88/2, Supplement 2.

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

Decision No. 8783-(88/13), adopted
February 1, 1988

Structural Adjustment Arrangement

1. The Government of Kenya has requested a three-year structural adjustment arrangement, and the first annual arrangement thereunder, under the structural adjustment facility.

2. The Fund notes the Policy Framework Paper for Kenya set forth in EBD/88/5 (1/7/88).

3. The Fund approves the arrangement set forth in EBS/88/2, Supplement 3 (2/4/88).

Decision No. 8784-(88/13), adopted
February 1, 1988

2. GABON - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on the second review under the 25-month stand-by arrangement for Gabon approved on December 22, 1986 (EBS/88/3, 1/12/88).

Mr. Mawakani made the following statement:

Gabon's adjustment program, supported by a stand-by arrangement, has to date been successful in reducing the internal and external imbalances. The rate of inflation has declined substantially, and a slight resumption of GDP growth is expected in 1988. Moreover, all the performance criteria--through end-September 1987 in the revised program--have been observed, and it is likely that those for end-December 1987 will also be met.

The significant adjustment attained over the past 12 months reflects the resolute implementation of the policies envisaged under the program as well as those introduced later, on the occasion of the first review, in June 1987. As a result of the authorities' adjustment efforts, it is estimated that the budget deficit, on a payments order basis, was reduced from 14.9 percent of GDP in 1986 to 8.5 percent of GDP in 1987. Similarly, the external current account deficit, including official transfers, has fallen from 31.2 percent of GDP in 1986 to 19.4 percent of GDP in 1987, owing to a large compression of imports. On the inflation front, the performance during the same period has also been encouraging. Indeed, the rate of inflation declined to about 2 percent in 1987 from its 1986 level of 6 percent.

For 1988, the authorities are committed to vigorously pursuing the economic and financial adjustments that they embarked on in mid-1986. The authorities' main objectives are to further reduce internal and external imbalances, and to diversify the economy's productive base. The main thrust of the adjustment process will continue to be on the fiscal side, as the budget is considered to be the major element in restoring the strength of Gabon's finances. Therefore, the 1988 budget objective is to reduce the Central Government's budget deficit, on a payments order basis, to 6.2 percent of GDP from 8.5 percent of GDP in 1987. To this end, a series of revenue measures, which are well described in the staff report, have already been introduced, and additional steps have been taken to curtail and control public expenditures.

The external objective is to bring the current account deficit, including official transfers, down to 15.2 percent of GDP in 1988. The authorities think that the ongoing policy of austerity--aimed at containing overall demand--combined with a restrictive monetary policy, is appropriate for achieving the reduction in the current account deficit. However, they are aware that the attainment of the budget and balance of payments targets in 1988 and in the medium term will continue to rely heavily on the evolution of oil prices and the exchange rate of the dollar. Therefore, as is indicated in the letter of intent, the authorities remain ready to react as necessary to new developments to attain the program's objectives.

intensification of the dialogue with the World Bank along the lines suggested by Mr. Mawakani in his opening statement is particularly welcome.

On the basis of a firmer policy foundation, Gabon will certainly be in a better position to take full advantage of the benefits of the recovery in its oil production scheduled for 1990 or 1991.

I fully support the proposed decision.

Mr. Grosche said that the authorities were to be commended for the successful implementation of the program's adjustment measures. Having started in an extremely difficult economic situation, the authorities' efforts seemed to be paying off. External and internal financial imbalances had been reduced remarkably, and the current year might be the first since 1985 in which positive economic growth was recorded. The progress achieved thus far was best summarized by the staff's cautious appraisal that, under present circumstances, the objective of medium-term balance of payments viability could be reached by the early 1990s.

However, there could be little doubt from the staff report that the authorities would have to continue their adjustment efforts vigorously and in a comprehensive manner, and that there was no room for policy slippages if the adjustment gains were to be consolidated and strengthened, Mr. Grosche considered. It might even be necessary to accelerate adjustment in the fiscal and monetary areas. More specifically, the economy remained highly vulnerable to external developments, and important reforms still had to be implemented. It was disappointing that crucial structural reforms had been delayed. Given the sluggish export performance and the uncertainties about the oil markets, the desired increase in economic growth seemed to be achievable only through a freeing of productive resources and the emergence of a stronger productive base.

However, he was pleased that the authorities were prepared to take additional corrective measures to cope with unfavorable developments, Mr. Grosche said. He wondered if the recent developments in the oil markets did not already make such corrective measures necessary. The staff's 1988 oil price assumption seemed to be too optimistic.

The authorities should conclude their discussions on a structural adjustment program with the World Bank and implement it as quickly as possible, Mr. Grosche concluded. He supported the staff appraisal and recommendations.

Mr. de Groote made the following statement:

It is fortunate that we can consecutively examine two African countries where the authorities have clearly committed themselves to correct exogenously imposed difficulties through courageous programs that have an important structural adjustment content.

The implementation of the adjustment program in 1987 under the most adverse circumstances, and the new program described in the Minister of Finance's letter to the Managing Director, justify Gabon's resumption of purchases under the existing stand-by arrangement.

Three elements of the revised program are especially impressive. First, the authorities' readiness to react quickly to attain the program's objectives, a readiness clearly affirmed in Mr. Mawakani's opening statement. Second, the importance of the envisaged structural measures to broaden the capacity of the non-oil sector. Third, the intention to gradually replace the Government's role in the growth process by private investment, for which there are ample opportunities, given Gabon's exceptional endowment of non-oil natural resources. Of course, the staff is correct to stress that the displacement of the Government's economic role by private investment can be achieved only if the present high cost levels are reduced. Incidentally, the staff does not give us information on the recent course of production costs in Gabon, although such information was included in a previous report to the Board.

Gabon is typical of the countries that have been dragged through the glories and miseries of the oil market. The income it has derived from the high oil prices has not been lost; infrastructure has been developed in a way that can now make investment of private funds profitable. Commercial banks have not failed to recognize this basic strength of the Gabonese economy; they granted a new loan at the beginning of 1988.

The need for budgetary measures remains critical. It is especially worrisome that the falling revenue from non-oil sources had to be compensated for by the highly volatile revenue from oil. It is therefore crucial that additional measures be considered, such as an increase in the value-added tax. However, I am skeptical about the effectiveness of increased import taxes and customs duties, and the elimination of the accelerated clearance of goods at customs. Such measures can be easily circumvented. My skepticism derives from the time I was working with Mr. Mawakani in Zaïre, 22 years ago, when we realized that measures of these kind led rapidly to a decrease--instead of an increase--in government revenues; so we turned our backs on import taxes to decisively liberalize imports, lower import duties, and simplify administrative procedures.

I congratulate the authorities for their decision to freeze increases in public sector remuneration, reduce the work force in the public sector, and eliminate the practice of multiple salaries--measures that would be more effective if they were part of a structural adjustment program that had more basic aims than public sector restraint. I therefore particularly welcome the favorable course of the authorities' negotiations with the World Bank.

I hope that the Fund can continue to actively support Gabon, which is clearly adjusting correctly. Gabon is important in the context of the Board's upcoming discussion on the debt strategy, because the question arises whether, successful though it may be, the strategy being pursued still needs to be complemented by some of the techniques that are going to be examined by the Board.

I am pleased that Mr. Mawakani and his authorities have managed to convince the staff that Gabon is entitled to receive access to Fund resources under a stand-by arrangement of about 75 percent of quota. I hope that more countries will qualify for such treatment.

Mr. Rieffel made the following statement:

In retrospect, the benefits of the staff's insistence on strengthening Gabon's economic program in the context of the first review under the stand-by arrangement are clear. In addition to meeting the performance criteria, a number of important targets for 1987 were exceeded, and the pace of adjustment in the second half of the year was encouraging.

Looking forward, however, I am not so impressed with the 1988 program. I am left with a sense that a stronger effort is not only desirable, but also feasible. For example, whereas the staff expresses the view that external viability is possible in the early 1990s, I believe that it could be attainable in 1990, especially if the recently discovered oil reserves are as important as the initial findings suggest.

I hope that the authorities will take note of the Managing Director's remarks at a press conference in Indonesia last month in which he was reported as emphasizing the disadvantages of debt relief.

The fiscal results in 1987 were generally satisfactory, but there is no explanation in the staff paper of why capital expenditures in 1988 are expected to be CFAF 7 billion larger than projected at the time of the first review. It would be preferable to have a higher level of capital expenditures and a lower level of current expenditures, but without more savings in current expenditures in 1988, the lower figure for capital expenditures seems to be more appropriate.

It was especially gratifying to see that there were no extrabudgetary expenditures in 1987, and that a decree formally banning such expenditures was published at the end of the year.

The measures that were taken to constrain wages are also impressive, and their effective implementation may be the key to successful fiscal restraint in 1988. Nevertheless, still more needs to be done to reduce the high cost structure of production in Gabon.

The decision by the members of the Central African Monetary Union to raise the structure of deposit rates is welcome, but as this chair inquired in July 1987, I wonder whether the members should not consider some adjustment in the exchange rate.

The slow pace of structural reform in Gabon is the cause for greatest concern. Of course, the active role being played by the World Bank in helping the authorities to address structural weaknesses is welcome, but it is not clear from the staff paper that the approach is an ambitious one. For example, the staff paper mentions that the Government is studying the possibility of liberalizing the prices of several goods and services, yet there is no apparent or actual commitment to liberalize any prices under the 1988 program. It is difficult to believe that there are not some liberalization actions that could be undertaken immediately.

Parastatal reforms could be pursued at a faster pace, but the staff appraisal does not identify any specific areas where the pace could be accelerated. I understand that the World Bank's analysis will take the lead in this sector, but the Fund staff's perspective on what should be done is always welcome. The authorities should try to outdo the World Bank in establishing a timetable for parastatal reform. The 1988 program has room for overperformance, and the authorities should take advantage of it.

I support the proposed decision.

Mr. Salehkhou made the following statement:

The second review under the stand-by arrangement with Gabon gives us another opportunity to evaluate the undesirable effects on developing countries of wild gyrations in the price of an essential commodity. Gabon, after successfully implementing a very strong adjustment program--in the first part of the 1980s with the support of an extended Fund arrangement--has had to cope with a major crisis after the arrangement ended.

GDP fell by 4 percent and 17 percent in 1986 and 1987, respectively, exports fell by 7 percent in 1985 and 50 percent in 1986, while oil exports fell by 60 percent in 1986. Similarly, the terms of trade deteriorated by 10 percent and 50 percent in 1985 and 1986, respectively. Government finances, which rely heavily on oil receipts, were naturally affected; revenues fell by 20 percent in 1986 and 48 percent in 1987. These figures show the extent of the external shock that the Gabonese economy has had to cope with.

The authorities are to be commended for having reacted promptly and courageously by launching and implementing a far-reaching adjustment program with the support of a 25-month Fund stand-by arrangement. The twin thrusts of the program, namely, reducing the internal and external imbalances, and diversifying the economy's productive base, are well justified.

It is heartening that, so far, the authorities have been able to not only stick to the original program, but also implement additional measures that were agreed with the staff during the program's first review--a point that is emphasized in Mr. Mawakani's opening statement. It should also be noted that all the performance criteria for end-June and end-September 1987 have been observed. The large magnitude of the adjustment effort is reflected in the fact that the budget and external account deficits were almost halved between 1986 and 1987.

The authorities have also reached agreements with their creditors on rescheduling and the provision of new bank loans, thus fully financing the adjustment program. It is likely that the negotiations with the Paris Club creditors, for the rescheduling of the 1988 maturities, will be concluded shortly.

As for the 1988 program, the authorities are to be commended for sticking to the thrust of the program. The internal and external imbalances remain large and should be reduced over the medium term, as the staff recognizes. Another problem is the sharp growth of debt and debt service payments, to which the authorities should pay due attention.

The 1988 program is appropriate, and I hope that even the sluggish growth that is envisaged will materialize. Given the uncertainties surrounding both oil prices and the dollar value of oil export receipts in CFA francs, the authorities should stand ready to review the main components of the program with the Fund staff to avoid damaging policy slippages.

However, the Fund and the international financial community should recognize that the authorities have only limited scope to implement further adjustment measures. Given Gabon's institutional arrangements, exchange rate action is precluded while the scope for monetary measures is limited. The brunt of the adjustment effort has been, and will continue to be, on the budget. The measures that have already been implemented are socially and politically difficult; the investment budget has already been reduced sharply.

In these fields as well as in others the authorities have embarked with the World Bank on profound reforms; this is particularly true of the public sector enterprises. These reforms take time and should be carefully crafted if they are to gain popular support and be successful.

The international financial community should therefore be understanding of Gabon's difficulties in implementing the adjustment program. The authorities have shown courage and resolve, and Gabon is not without favorable economic prospects. The recent discovery of relatively large oil deposits should, over the medium term, help Gabon to regain its external viability.

I support the proposed decision.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/12 (1/29/88) and EBM/88/13 (2/1/88).

3. COTE D'IVOIRE - STAND-BY ARRANGEMENT - EXTENSION; AND USE OF FUND RESOURCES - COMPENSATORY FINANCING FACILITY

a. Stand-By Arrangement - Extension

The Fund decides to extend until February 29, 1988, the period set forth in paragraph 3 of Executive Board Decision No. 8752-(87/172), adopted December 15, 1987. (EBS/88/14, 1/28/88)

Decision No. 8785-(88/13), adopted
January 29, 1988

b. Use of Fund Resources - Compensatory Financing Facility

Paragraph 2 of Executive Board Decision No. 8753-(87/172), adopted December 15, 1987, as amended to read:

"2. The Fund notes the representation of Côte d'Ivoire, waives the limitation in Article V, Section 3(b)(iii), and approves the purchase in accordance with the request, as of the date on which the stand-by arrangement set forth in EBS/87/249 becomes effective in accordance with Decision No. 8752-(87/172), adopted December 15, 1987, as amended." (EBS/88/14, 1/28/88)

Decision No. 8786-(88/13), adopted
January 29, 1988

4. DEVELOPING FORWARD FOREIGN EXCHANGE MARKETS - PUBLICATION

The Executive Board approves the proposal for publication, in the Occasional Paper series, of the staff paper entitled "Developing Forward Foreign Exchange Markets" as set forth in SM/88/1 (1/4/88).

Adopted January 29, 1988

APPROVED: October 18, 1988

LEO VAN HOUTVEN
Secretary