FOR AGENDA

EBD/88/5

January 7, 1988

To: Members of the Executive Board

From: The Secretary

Subject: Kenya - Policy Framework Paper

Attached for consideration by the Executive Directors is the policy framework paper under the structural adjustment facility for Kenya which, together with the staff report for the 1987 Article IV consultation with Kenya and its request for a stand-by arrangement and for arrangements under the structural adjustment facility (EBS/88/2, 1/7/88), will be brought to the agenda for discussion on a date to be announced.

Mr. Jiménez (ext. 6952) or Ms. Calika (ext. 6948) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

KENYA

Policy Framework Paper

Prepared by the Kenyan authorities in collaboration with the staffs of the Fund and the World Bank

January 6, 1988

I. Background

Structure of the economy

1. In 1986 Kenya had a per capita income of SDR 281 which places it toward the upper end of the range of low-income countries, as categorized by the World Bank. Social indicators are better than for most other low-income African countries.

2. Agriculture is the leading sector of the economy, generating 27 percent of GDP and employing about 70 percent of the labor force. Only about 18 percent of the land area receives enough rainfall to be considered as high- or medium-potential for cultivation, and the density of population on arable land is two-and-a-half times greater than the sub-Saharan average. Reflecting the variations in climate arising from variations in altitude and rainfall, Kenya's agricultural sector is well-diversified, producing coffee, tea, and horticultural crops mainly for the export market and cereals (principally maize), livestock products, pulses and sugar for the domestic market. Under normal weather conditions, food imports are essentially limited to a small part of wheat and edible oil requirements, and thus the country is largely self-sufficient in food. Smallholders account for about 70 percent of agricultural production. Smallholder yields are about half the yields on large farms, and one third of the yields on research plots. Over the medium-term, increased production in Kenya will depend essentially on yield increases on existing cultivated land.

3. Kenya's manufacturing sector generates 12 percent of GDP, and currently accounts for 80 percent of domestic utilization of manufactured products. Manufactured exports account for 8 percent of manufacturing output and 15 percent of total export receipts, but have been declining in recent years. The growth of the manufacturing sector has been stimulated by rising agricultural incomes, high levels of protection, and substantial Government financial support for manufacturing investment in the 1970s. In 1986 the average rate of effective protection for the sector was about 90 percent, but with substantial variations among subsectors. Inefficient activities are more highly protected than efficient ones. Ownership of medium- and

large-scale industry is a blend of public, foreign private, and the domestic private sectors.

4. Energy supply and consumption in the Kenyan economy are classified into the "traditional" sector, comprising wood and its derivative, charcoal; and the so-called "modern" sector, comprising petroleum products, electricity, and coal. The traditional sector accounts for about 70 percent of total energy supply and consumption, while the modern sector accounts for the remaining 30 percent. About three-fourths of modern sector energy is provided by imported petroleum and a small amount of imported coal, with the remaining one-fourth coming from domestic hydroelectric and geothermal resources.

5. In recent years, government revenues have averaged 23 percent of GDP, and government expenditures have averaged 31 percent of GDP. These ratios are above average for low-income countries. During the 1970s, the Government made considerable investments in a wide variety of commercial activities. Beginning with the Report of the Working Party on Government Expenditures in 1982, the Government has recognized that this strategy had yielded problems, namely that the parastatal enterprises were inefficient and were a drain on the budget, while essential government services such as highway maintenance were under-financed. In the period since then, the Government has checked the expansion of the parastatal sector, and in 1983 a Task Force on Divestiture was established to explore the potential for reducing the size of the sector.

6. Structural problems which affect the economy are the large volatility of the terms of trade and the need to reinvigorate growth in the agricultural sector, which will continue for a long time to be the chief source of growth. In addition, for the longer-term the Government must promote a faster growth rate in other areas of the economy to support a wider base of growth. The Government also needs to restructure government expenditure, with the aim to increasing maintenance outlays, controlling the wage bill, and promoting more efficient investment projects in order to lower the capital output ratio in the public sector. Kenya's high debt service ratio also deserves special attention to ascertain that commitments continue to be discharged on schedule. Over the recent years, net capital inflows into Kenya have been declining in terms of GDP, making it more difficult for Kenya to generate the necessary financing for the investment levels which are consistent with a higher growth rate in the economy.
A fundamental constraint on raising per capita incomes in Kenya is the fact that Kenya has the most rapidly growing population (3.8 percent per annum) in the world. This reflects an exceptionally high fertility rate, and an infant mortality rate which is the lowest among the low-income African countries.

Long-term trends

7. During the period 1965-80, Kenya's GDP growth rate (6.4 percent) was double the average (3.2 percent) for low-income countries

generally. Growth was particularly rapid during the first decade after independence (1963-73), due to the expansion of smallholder cultivation, introduction of high-value crops, adoption of high-yielding maize varieties, and import-substituting industrial growth, oriented to the East African Common Market. The average rate of inflation was kept below 4 percent during this period. Following the first oil crisis, growth decelerated to 4.5 percent per annum during 1973-80. Inflation rose to an average of about 14 percent a year. This reflected the tapering off of the specific positive factors which had fueled earlier agricultural growth, delays in implementing needed measures to overcome inefficiencies in agricultural pricing and marketing, the diminution of opportunities for efficient import-substitution, the dissolution of the East African Community in 1977, and drought conditions in 1979-80. The efficiency of investment, as measured by the incremental capital-output ratio, deteriorated by almost half between the early 1970s and the early 1980s.

8. GDP growth decelerated further to 2.4 percent per annum during 1980-85, which included one year of political crisis (1982) and one year (1984) of exceptionally severe drought. During this period the Government also embarked on a stabilization program. The need for stabilization arose from the erosion of fiscal discipline in the "coffee boom" of the late 1970s and the deterioration in the external terms of trade arising from the second oil crisis (1979). The Government was very successful in stabilizing the economy. The overall budgetary deficit was reduced from 9.5 percent of GDP in 1980/81 (10.3 percent excluding grants) to 5.3 percent in 1984/85 (7.0 percent excluding grants), while the growth rate of domestic credit and broad money was curtailed. Real wages were allowed to fall and interest rates were increased to positive real levels. In the external sector, the current account deficit was reduced from 12.5 percent of GDP in 1980 (14.2 percent excluding grants) to 1.6 percent in 1985 (3.4 percent excluding grants), while gross foreign exchange reserves rose from 2.3 months at end-1980 to 3.2 months of imports at end-1985. The exchange rate was flexibly managed and aided in the external adjustment. During this period, the Government also embarked upon a comprehensive structural adjustment program supported by the World Bank and IMF. Important achievements included increases in agricultural producer prices, improvements in agricultural extension, a clearer system of classifying imports for purposes of import licensing, and initial steps toward a more uniform tariff structure. However, in some other areas including controls on imports competing with domestic production, export promotion, and reform of agricultural marketing, progress was slower, reflecting preoccupation with urgent stabilization problems and, on some issues the need for a fuller consensus building process within the Government. Reflecting the successful implementation of stabilization, inflation decreased from a peak of 20 percent in 1981 to 10 percent in 1985. Because of the combination of increasing debt, arising from increased borrowing on commercial terms following the second oil crisis and sluggish export receipts, the debt service ratio rose sharply from

12 percent in 1980 to 29 percent in 1985. However, Kenya made all debt service payments and did not request debt reschedulings.

Recent economic developments, 1986-87

9. In 1986, Kenya's external environment improved substantially, as higher coffee prices and lower oil prices resulted in a 12 percent improvement in the external terms of trade. The current account deficit was reduced to 1.3 percent of GDP (3.4 percent excluding grants) and an overall balance of payments surplus was recorded. The exchange rate continued to be managed flexibly and despite the improved external position was depreciated by 4 percent in real terms during the year. Reflecting good weather and the impact of the agricultural sector adjustment program (paragraphs 14-17 below), the agricultural sector performed well; the higher agricultural incomes and ready availability of imported inputs also contributed to a strong performance in the manufacturing sector. Real GDP growth was 6.5 percent, the highest rate in many years. Real income (including the income effect of the terms of trade improvement) increased by about 9.0 percent. Reflecting the favorable developments with respect to food production and stable energy prices, the rate of inflation dropped to 4.3 percent. In FY86/87, government expenditure rose to 33.4 percent of GDP (from 30.6 percent of GDP in FY85/86) and the budget deficit increased to 8.1 percent of GDP, compared to 5.6 percent of GDP in FY85/86 (excluding grants the deficit increased to 10.5 percent of GDP from 6.6 percent), largely on account of transfers to the National Cereals and Produce Board to purchase and store the bumper grain harvest; expenditures on education to double the intake of university students and teachers and expand the education system; preparation for the all African games; and wage increases intended to compensate partially government employees for several years of declining real wages. Domestic credit and broad money expanded at a high rate, creating a liquidity overhang. However, the maintenance of nominal interest rate levels in the face of declining inflation resulted in substantially positive real interest rates.

10. In 1987 coffee prices have fallen, and Kenya's external terms of trade are expected to deteriorate by 25 percent. The external current account deficit is projected to widen to 5 percent of GDP (8 percent excluding grants). With less favorable weather conditions, real GDP is expected to grow by 5.1 percent. In order to stabilize the economy, the Government has adopted a FY87/88 budget providing for expenditure restraint and reduction of the budget deficit to 4.2 percent of GDP. A tighter monetary policy aimed at substantially reducing the monetary expansion is also being implemented. The inflation rate is expected to rise to about 7 percent, reflecting the impact of developments in the previous fiscal year.

II. Macroeconomic and Structural Objectives and Policies, 1988-90

Development strategy: The Sessional Paper

11. In early 1986 the Government published its Sessional Paper on Economic Management for Renewed Growth. The objective of the Sessional Paper is to provide a framework for Kenyan development for the remainder of this century. The policies to be followed during the medium-term period 1988-90 will reflect the Sessional Paper. The Paper emphasizes that, in order to provide productive employment for a labor force which is expected to increase by 86 percent between 1985 and 2000, an acceleration of output growth is needed. GDP growth is targeted to be 5.6 percent annually. The Paper states that the private sector must play the dominant role in revitalizing Kenya's economy, and that the Government will establish market-based incentives to channel private sector activity in desirable directions, while relying less on instruments of direct control. Emphasis is placed on increased productivity in agriculture and in rural nonfarm activity, a dynamic informal sector, and the restructuring of industry to improve its export competitiveness. In the area of trade and industry, more uniform import tariffs and more liberal import licensing are expected to promote greater efficiency in the manufacturing sector, and encourage exporting. The exchange rate will be managed in such a way as to maintain Kenya's competitiveness in world markets taking into account the process of import liberalization. The Paper devotes considerable attention to rural-urban balance, with an emphasis on town and secondary city development in order to avoid concentration of urban population growth in Nairobi and Mombasa. The local authorities are to be strengthened, and the District Development Committees are to play an increasing role in planning rural development.

Medium-term macroeconomic framework, 1988-90

12. Over the period 1988-90, the Government's objective will be to sustain the recent improvement in the economy's growth performance, aiming at GDP growth of 4.8-5.4 percent per annum and at a low inflation rate, while strengthening the balance of payments in order to progressively reduce the current account deficit, excluding grants, to a sustainable level of 4.1 percent of GDP by 1990. In order to achieve these objectives, the Government intends to take action in a number of areas including most importantly:

(a) Further improve farmer incentives, agricultural input supply, and agricultural services, particularly for smallholders;

(b) Re-orient trade and other industrial incentives to encourage increased efficiency and promote the growth of manufactured exports, together with measures to encourage a revival of industrial investment;

(c) Further adjust the exchange rate, in tandem with changes in the trade regime, in order to encourage exports, and discourage imports without the inefficiencies arising from administrative import allocation;

(d) Take actions to reduce the budget deficit, so that it is compatible with the available foreign financing and domestic financing of the deficit will be noninflationary, and will not crowd out the private sector;

(e) Implement budget rationalization, so that delivery of essential government services can be maintained, and in some cases expanded, in an environment of expenditure restraint; and

(f) Limit the use of nonconcessional sources of external finance, together with increased mobilization of concessional finance from official sources.

13. Because past government policies have been more favorable to economic growth in Kenya than in most low-income African countries, the impact of planned measures on economic structure and performance during the medium-term period 1988-90 will be gradual rather than dramatic. However, the foundations will be laid for more rapid growth, as envisaged in the Sessional Paper, during the 1990s. Agricultural output, which grew by 2.8 percent annually during 1980-85, and then by 4.8 percent in 1986, is expected to increase by 4.5 percent annually over 1987-90, arising from increased yields, especially on smallholdings. Manufacturing output, which increased by 3.8 percent annually during 1985 and then 5.9 percent in 1986, is expected to increase by 5.0 percent over 1987-90, reflecting the processing of agricultural products, a gradual recovery in manufactured exports, and a revival of manufacturing investment. The gradual acceleration of overall growth is expected to come primarily from improvement in the efficiency of investment, since the savings rate is expected to rise only slowly during the program period. The behavior of exports will be strongly influenced by the prospects for coffee, which has been subjected to quota once again. Export volume is expected to increase by about 4 percent annually, with manufactured exports increasing by 5 percent annually in real terms.

Agricultural policies

14. In order to promote an acceleration of agricultural growth to 4.5 percent, the Government in 1986 began to implement an agricultural sector adjustment program. The general thrust of the program is to rationalize the role of government institutions and interventions in the agricultural sector. The Government will continue its efforts to provide through deregulation a more favorable environment for private sector provision of those agricultural services, notably output marketing and input supply, which can be efficiently provided by the private sector. At the same time, the Government will strengthen its provision

of those agricultural services that can be most effectively provided by the Government, notably research and extension. The relatively high rate of agricultural growth is expected to arise from increased use of fertilizers, pesticides, and animal health services, and greater farmer knowledge reflecting improved extension services.

15. The Government's general objectives in the area of output pricing and marketing are to provide appropriate price incentives to producers; expedite payments to farmers by marketing boards; promote the development of marketing channels; decrease any consumer food subsidies implicit in the domestic price structure; and provide for food security. Specific measures will vary for the different agricultural products. In particular:

(a) In the area of grains (maize, wheat and rice), the Government will continue to announce each February floor producer prices, taking into account import and export parity prices. The Government has undertaken a study of the grain marketing system, with the objective of reducing the fiscal burden of public sector grain marketing operations and increasing the number of participants in the system. By February, 1988, the Government will, on the basis of this study, define the roles of participants in the system, implement an organizational and financial restructuring of the National Cereals and Produce Board, and develop a food security plan.

(b) For the major export crops, coffee and tea, the current system of flexible producer pricing based on export auctions will be continued. The Government instructed coffee cooperatives in May 1986 to confine their payments deductions to processing and marketing costs. Announcements of Government-controlled consumer prices each February will reflect decreased subsidization of domestic tea consumers.

(c) The Government is presently undertaking a study of the sugar industry, with a view toward reducing the cost of production and processing and will implement by June, 1988 an organizational and financial restructuring of the South Nyanza Sugar Company.

(d) The Cotton Lint and Seed Marketing Board (a parastatal) has recently cleared up its overdue payments to farmers and, by June, 1988, the Board will divest its processing and marketing functions, thereby becoming a purely regulatory body.

(e) Beef pricing and marketing were deregulated in February 1987, and the Government is deregulating milk marketing in areas where KCC does not operate and expediting payments by the Kenya Cooperative Creameries.

16 Agricultural input supply will be improved through liberalizing the fertilizer import system, improving distribution incentives, assuring

the supply of maize seeds, phasing out subsidies for livestock services and upgrading their quality, and promoting the development of input distribution channels. The Government will continue in the near future to regulate fertilizer pricing and marketing, in view of the importance of donor-provided fertilizers in fertilizer supply. However, this will be done in a manner which will relax constraints on private fertilizer trade. Beginning in 1986, the Government has increased the number of importers and distributors; allowed major end-users to import directly; assured minimum allocations to established importers; and increased retail margins to provide adequate incentive for distribution to rural smallholder areas. By November 1987, with a view to improving fertilizer pricing, a revised pricing system will be introduced based on benchmark international prices to ensure adequate marketing margins, using the same basis for pricing donor-provided and commercially procured fertilizer.

17. In order to disseminate improved agricultural technologies more effectively, the Government is increasing funding for agricultural extension, especially transportation, training, and other nonwage expenditures. In addition, the Government has recently restructured the Kenya Agricultural Research Institute to provide it with adequate authority and methods for managing priorities in the national agricultural research program, with special emphasis on adaptive research and regional programs.

Trade and industrial policies

18. In order to accelerate the growth of the industrial sector, the Government intends to implement an industrial sector adjustment program, for which it will seek financial support from IDA and other donors.

19. A key element of the program will be the reorientation of industrial incentives. In order to lower and even out the structure of effective protection, while making it transparent, the Government will reform the protective system, consisting of progressive introduction of unrestricted licensing of imports and tariff reductions. However, the speed of liberalization is being hindered by the low level of foreign exchange reserves and the uncertainty surrounding the large financing gap in the external sector projected for 1988-90. Equally important is the uncertainty about the timing of disbursements of anticipated foreign assistance. The Government will be reducing the number of import schedules from the present four to three in January 1988, in accordance with agreements reached with the World Bank. Import items in the new Schedule I, which include primarily raw materials, intermediate inputs and capital goods, will be reduced by about 20 percent, compared with the old Schedule IA, with some of the items transferred to the new Schedules II and III. Goods in Schedule I, which accounted for 43 percent of 1986 imports, will be licensed without restrictions when it is determined that the external financing gap for 1988 is filled, probably by January 1988. Schedule II, which accounted for 35 percent of imports in 1986, will include mainly fertilizers, petroleum and pharmaceuticals. It will be somewhat larger than the old Schedule IIAS,

and imports under this Schedule will be licensed without restrictions, after the appropriate supervising agency has verified quality, price and need. The new Schedule III, which accounted for 22 percent of 1986 imports, will include all other goods and will be subdivided into three categories. Category IIIA, which accounted for 10 percent of 1986 imports, corresponds to the old Schedule IB (goods which enjoyed a high degree of priority and unrestricted licensing) with some items added from the old Schedule IA. The Government will treat items in Schedule IIIA similar to items in Schedule I. Consequently, about 88 percent of imports will be free of restrictions. An extensive review of imports and balance of payments developments will be undertaken in April/May 1988, at which time the formalization of the above arrangements will be considered. In the 1988/89-1990/91 budgets, the tariff rates will be simplified by reducing the number of tariff levels by about half, mainly at the top end of the range. This measure will also reduce the effective rate of protection and narrow its range as import liberalization proceeds.

20. An increasing share of Kenya's future industrial growth and export receipts will have to come from manufactured exports. To facilitate this, the existing export compensation scheme will be improved and consideration will be given to supplementing it with a simplified duty drawback scheme to ensure universal coverage, full rebate of taxes paid and prompt payment. Action will be taken as soon as possible, but no later than June 1988. In addition, manufacturing-in-bond, with incentives comparable to those offered by other countries, will also be implemented by June 1988. Simultaneously, a comprehensive medium-term export promotion program will be designed so that implementation can commence by June 1989. This program could include an export financing scheme, an export credit guarantee scheme and organizational and information support from a joint Government/private sector council.

21. Eliciting a supply response to the revised incentives will require new investments, which implies action on a number of fronts. Since price controls serve as a disincentive to investment in industry, the Government will decontrol 10 prices controlled under the General Order by June 1988, and another 10 will be decontrolled by December 1988. The remaining items will be decontrolled gradually, with import liberalization. Other incentives for foreign and domestic investors *will be introduced by June 1988: the marginal effective rate of company* tax will be lowered; the one-stop investment facility will be implemented; the Foreign Investment Protection Act will be amended to make transfers of equity and capital gains on sale of assets more equitable; and the granting of work-permits will be made transparent.

22. In the areas of industrial public enterprises and development finance institutions, the Government will launch studies to: (i) redefine the strategic role of the development banks (Industrial and Commercial Development Corporation, Industrial Development Bank, Development Finance Company of Kenya), develop a plan for restructuring their financial position, organization and portfolios and suggest new functions; and (ii) review existing data and reports to classify

industrial public enterprises into those that need rehabilitation or restructuring, those that can be divested and those that should be retained. These studies will be completed by June 1988, action plans prepared by December 1988, and progress made on implementation by June 1989. Finally, by December 1988, the Government will clarify and streamline the monitoring of industrial public enterprises that will be retained in the public sector, with a view to allowing them greater autonomy by evaluating their performance against agreed objectives.

Public sector policies

23. The Central Government budget deficit will be progressively reduced to a sustainable level presently estimated at 3.4 percent of GDP by FY 89/90 (6.0 percent excluding grants). This will be accomplished mainly through expenditure restraint, since the ratio of government expenditure to GDP (33 percent) presently is well above the level targeted in the Sessional Paper and needs to be lowered to facilitate the recovery of private investment. In order to protect the delivery of essential government services in a context of expenditure restraint, the Government will implement a budget rationalization program to correct the imbalance between nonwage operating and maintenance expenditure, which has been seriously underprovided, and the three remaining discretionary categories of government expenditure, i.e. personnel expenditure, expenditure on government capital formation, and transfers to parastatals. (A fifth category, payments for debt service and pensions, is relatively inflexible over the medium term). The Government will quantify nonwage operating and maintenance expenditure requirements in selected sectors, including education, health and agriculture, and will also review its staffing requirements, with a view to reducing overstaffing and increasing productivity. Wage policy will be kept consistent with the rationalization objective. Drawing upon these studies, three-year forward budget plans will be formulated for selectively increasing nonwage operating and maintenance expenditure and for containing and rationalizing (with respect to project portfolio, programs, etc.) expenditures in other categories. The Government is reviewing, with the collaboration of the World Bank, the composition of expenditure. These forward budget plans will be reflected in the annual budgets beginning June 1988. In formulating the personnel expenditure plan, the goal will be to ensure that such expenditure will be within sustainable limits.

24. Kenya's tax structure is well diversified and the revenue effort is higher than in most lower middle-income countries. However, the administration of the tax system will need to be strengthened in order to meet revenue requirements and respond to the rapid growth in the number of taxpayers in the years ahead. Toward this end, the Government will seek technical assistance for the modernization of the Kenyan tax system. This project will include strengthening institutional capacity for tax policy analysis in the Treasury, and introduction of computerization and other administrative improvements in the Income Tax, Sales Tax, and Customs and Excise Departments. In addition, since at present user charge collections are relatively low from efficiency, equity, and

resource mobilization perspectives, the Government will prepare a program of user charges in each of the next three budgets to increase collection of these charges. To the extent that these reforms do not generate the targeted increases in the revenue ratio; other measures will be undertaken.

25. Public enterprises reform will continue to be an important element of the Government's program. During the past few years, progress has been made in improving the monitoring and control of the financial operations of public enterprises, especially the financial flows between these enterprises and the Government. A computerized external and internal debt reporting system has been established, and the Office of Auditor General for parastatals has been created. The State Corporation Act, which was enacted in July 1986, provides the Government with a clearer legal framework to extend its supervision of public enterprises, collect money from them, and sell the Government's share in them. A system of preparing forward budgets for recurrent and development expenditures for public enterprises has been introduced. This system will be implemented in a flexible manner, since it is not the Government's intention to establish rigid ex ante control over public enterprise inputs. Over the medium term, the Government will shift emphasis to setting targets for, and monitoring, public enterprise output and efficiency indicators, including profitability. This will be done on the basis of corporate plans for key enterprises, such as the one recently adopted for Kenya Railways.

26. In view of the likely slow increase in export earnings, the growth of Kenya's debt-servicing capacity will be limited during the next three years. The bulk of Kenya's external public debt is in the form of bilateral and multilateral loans and is mostly on highly concessional terms, with long maturities and grace periods, and significant grant element. Although commitments from official sources have remained highly concessional, the overall degree of concessionality has been declining because of increased borrowing from commercial sources during the last three years. Debt service payments have been rising sharply, reflecting both the expansion in debt and higher interest rates. Consequently, in the period 1988-90 Kenya will continue its policy of minimizing commercial borrowing in order to ensure a decline in the debt service ratio over the medium term. The debt service ratio which reached 29 percent in 1986 is projected to reach 32 percent in 1987, reflecting the sharp drop in export receipts, and then to gradually fall to 26 percent in 1990.

Financial sector

27. In monetary management, the Government will continue to move towards greater reliance on market forces in allocating financial resources to their most productive uses. Noninflationary sources of government financing will be emphasized and an attempt will be made to introduce more generalized monetary policy instruments. Kenya's financial system, although well developed for a country of Kenya's per capita income level, suffers from some major inefficiencies. These

include an inappropriate dichotomy in regulations and supervision between banks and nonbanks and the lack of involvement by the commercial deposit-taking institutions in the provision of longer-term finance for fixed investment and development. The recent amendment to the Banking Law attempts to reduce the dichotomy between banks and nonbanks by incorporating measures to strengthen the capital base, improve the quality of portfolio, and increase the regulations by the monetary authority. In 1986, certain provisions of this amendment were implemented. Those dealing with a minimum amount of paid-up capital and confining investment and trading to certain types of assets were implemented in early 1987, while those provisions dealing with minimum capital-deposit ratio and restrictions on nonbank financial institutions to own equity in banks will be implemented by May 1988. The other provisions of the amendment will become effective by notice.

28. The Government is determined to allow increased market determination of interest rates and to reduce control on the lending spreads. In particular, in 1988 the Government will increase the spread between the maximum lending rate and the minimum deposit rate to allow banks greater freedom in differentiating risk. The auction system for Treasury bills will be strengthened and a secondary market for Treasury bills will be facilitated by establishing a discount facility of the Central Bank by June 1989. Regulations that presently differentiate banks and nonbank financial institutions will be amended towards more even treatment by December 1989. Also, by that date, existing legislation will be amended to permit these institutions to issue new financial instruments, including bearer negotiable certificates of deposit.

29. Kenya has a relatively underdeveloped capital market. In its review of the tax system, the Government will examine the degree to which taxes provide disincentives to issuers of public equity and debt instruments and to investors in such securities. A Capital Markets Development Authority will be established by June 1988 to develop and regulate the capital market. The establishment of full service brokers will be encouraged.

Infrastructure

30. Kenya is better equipped with infrastructure than most low-income African countries. Public expenditures on infrastructure during 1988-90 will be directed not only at increased maintenance but at generally meeting growth of demand arising from the projected growth of the economy and population. A special effort will be made to improve infrastructure in secondary towns planned as centers of rapid growth of employment, based on industries and services catering to the needs of surrounding rural areas. In the power sector, the ongoing Kiambere and Turkwel Gorge hydroelectric projects will be completed in 1988 and 1991, respectively. A Power Sector Master Plan which provides for least-cost sequencing of future power projects has recently been completed; this plan provides a framework for donor assistance to this capital-intensive

sector, including a geothermal project planned for 1990, and other power investments. In the water supply sector, the Government is preparing a Nairobi Water Supply III project for start of construction in 1989, and is continuing to implement the rural water supply program with the ultimate objective of providing water near every home by the year 2000. In the transportation sector, priority is being devoted to necessary resealing of existing bitumen roads and regravelling of existing gravel roads, and to improvement of farm-to-market rural access roads. In addition, a recovery program for Kenya Railways, including institutional reform, expanded training, and essential equipment and spares, has recently been launched, with the objective of reversing the recent declining trend in the Railways' operating and financial performance.

31. Pricing policy will continue to aim at an adequate rate of return (generally 8 percent) for power-generating projects and Nairobi water supply. For rural electrification and rural water supply, where much of the capital cost is financed by grants from donors, beneficiaries will be expected to pay operating and maintenance costs, but not necessarily capital costs.

Population and human resource development

32. Although Kenya's fertility rate remains exceptionally high, there has recently been a significant decline in desired family size and an increase in the proportion of married women who do not want more children. However, in 1984 the proportion of married women using modern methods of contraception was only 8 percent. Thus, there is a substantial unmet demand for contraception. The Government has recently adopted district-level targets for family planning acceptors, and a program to step up implementation of family planning, strengthen its planning and coordination agencies, and provide greater support to NGOs and community-based organizations involved with family planning activities, which will be supported by IDA's Population III Project. The target will be to bring down the total fertility rate from 7.7 in 1984 to 5.6 children by the year 2000.

33. The health and education sectors face serious financial problems and distortions in the pattern of public expenditures. A rising share in the total of personnel costs has resulted in insufficient supplies of complementary inputs and hence declining quality. A bias towards curative care and higher education have implications for equity since middle-income and urban groups are better able to take advantage of these services where government subsidies are greater, given the low user charges and poor cost recovery, especially in hospitals and universities.

34. The Government plans to adopt a phased approach to user charges in the health sector, beginning with the introduction of charges at the Kenyatta National Hospital in Nairobi earlier this year. In addition, the Ministry of Health has begun to develop a national health plan and review its organizational structure with a view to putting a new

structure in place by mid-1988. In the education sector, a Presidential Working Party on Education and Manpower Training has been established to make recommendations concerning measures to control expenditures on education. Discussions are taking place in the Government on issues of increasing fees, particularly for higher education, and other revenues; reducing costs and the trade-offs with quality; possibilities for effective provision of vocational and technical training, in view of the targeted growth of industry; and organization and management in the sector. The final report of the Presidential Working Party will be submitted in March 1988, following which the Government will implement those recommendations which it accepts.

Environmental issues

35. Kenya's forest lands, in both the highlands and the lower, semi-arid areas, are being degraded by encroachment by farmers and pastoralists, and by overcutting generally. Despite a widespread tree planting program, the standing stock of wood is being depleted by about 1 percent annually. While environmental damage is less advanced than in many other predominantly semi-arid African countries, the present adverse trends must not go unchecked. A recent World Bank forestry sector report has recommended a program for addressing these issues, including strengthening forest legislation; providing increased resources for forest protection; promoting farm forestry; and promoting peri-urban fuelwood plantations (including relaxing price controls on urban fuelwood and charcoal supplies). The Government is presently considering these recommendations.

III. Social Impact

36. Since the magnitude of prevailing financial imbalances and price distortions is less in Kenya than in most other African countries that are currently embarked on adjustment efforts, the magnitude of corrections aimed at is correspondingly lower, and thus the potential distributional impact of adjustment is less adverse than in some cases. Moreover, the program is intended to restore the economy's growth momentum sufficiently to permit a modest increase (0.8 percent annually) in real consumption per capita despite the planned increase in the domestic savings ratio. The improvement in producer prices will benefit Kenya's predominantly smallholder agricultural sector, while the removal of trade and price controls will shift incentives away from trading in favor of producers. Nevertheless, the Government recognizes the possible adverse effects of the program on particular groups and will seek to minimize these effects on lower income groups both through the design and sequencing of policies and, where necessary, through special interventions aimed at addressing the social costs of adjustment.

37. The potential adverse effects arise primarily from three sources: pricing policy, industrial restructuring and budget rationalization. Since low income urban families spend about 40 percent of their income

on food, they are likely to be adversely affected by the ongoing reduction in consumer subsidies implicit in the domestic price structure. However, for a number of food items, the margin between the producer and consumer price is partly attributable to inefficiencies in the marketing system. To the extent that these inefficiencies are curtailed, the impact of decreased implicit consumer subsidies could be mitigated. Moreover, most of the poor are agricultural producers in the rural areas and will therefore reap the benefits of higher producer prices while being relatively unaffected by increases in urban food prices. Decontrol of prices of manufactured products is not expected to have an adverse impact on consumers since there will be a simultaneous improvement in the availability of competing imports.

38. Much of Kenya's import-substitution industry is sufficiently efficient that it should be able to respond to increased import competition through modest increments in efficiency (aided by restructuring in some cases) rather than widespread plant closings and layoffs. Moreover, the envisaged measures in this sector will be sequenced in such a way that expansion in newly favored activities will take place simultaneously with contraction of activities receiving reduced incentives. In particular, measures to expand investment (price decontrol, export promotion, capital market development, and making the protective structure simple and transparent) will be implemented early in the program period, while the lowering of protection will take place in later years.

39. In the budgetary area, the planned measures to reduce subsidies to parastatals and to develop a leaner and more efficient public administration will mean that the public sector will no longer be a source of growth in employment. While the resources thus released will permit a more rapid expansion in private sector employment, particularly in the context of an acceleration in the rate of economic growth, there will nevertheless be a need to phase such a reduction in a manner that would not exacerbate social problems, and if necessary devise special interventions to deal with any frictional unemployment. An IDA mission on employment and growth is expected to work with government to develop an overview on employment prospects and in the context of this work as well as the planned review of public expenditures, government will develop a strategy for implementation in the second and third year of the program. The budget rationalization arising from this public expenditure review will also address the low levels of nonwage operating and maintenance expenditures and thus benefit the poor through improved delivery of education, health and other essential services. The planned increase in collection of user charges will take into account the ability to pay as well as other factors.

IV. External Financing Requirements, 1988-90

40. The adjustment policies to be pursued during the program period are expected to progressively reduce the current account deficit, excluding grants, from 8 percent of GDP in 1987 to 4 percent of GDP by 1990.

Kenya's gross external financial requirements during 1988-90, consisting of the current account deficit, debt amortization, and necessary increases in reserves (expected to be only 2.2 months' imports at end-1987), are expected to be about $2.7 billion.

41. Disbursements from existing grant and loan commitments are expected to be $0.8 billion. In order to contain the debt service ratio within 31 percent over the next few years, and subsequently lower it, the Government intends to restrict the contracting of new nonconcessional loans to $75 million annually. New grants and loan commitments from official sources, excluding the World Bank/IDA adjustment lending, are expected to yield disbursements amounting to US$1.1 billion over the 1988-90 period. Adding the proposed stand-by and SAF arrangements, and projected disbursements from other private sources, total disbursements from expected new commitments are projected at US$1.7 billion.

42. This leaves a financing gap of $0.3 billion over the three-year period. The Government will attempt to fill this gap with the Industrial Sector Adjustment Credit from the World Bank and by mobilizing additional finance from bilateral sources, including possible cofinancing for World Bank adjustment lending. To the extent that a shortfall remains, the Government would not be able to implement its program as envisaged, thereby yielding slower growth, and possibly stagnation of per capita incomes and per capita consumption.

Table 1. Kenya: Summary and Timeframe for Macroeconomic and Structural Adjustment Policies, 1987-90

	Objectives and targets	Strategies and measures	Timing
1. <u>External policies</u>			
a. Exchange rate	Ensure growth and structural improvement in balance of payments.	Review and adjust exchange rate to expand and diversify export base and compensate for removal of quantitative import restrictions and adoption of moderate tariff structure.	From time to time.
b. Imports	Make protection transparent and smooth out the dispersion in the structure of industrial incentives.	See section 2b. below for details.	
c. Exports	Increase nontraditional exports.	See section 2b. below for details.	
d. External debt	Improve information on external debt and limit debt service ratio.	Limit public sector external borrowing on nonconcessional terms.	Continuous.
		Establish a statistical system on private sector external debt.	By end-1988.
2. <u>Sectoral policies</u>			
a. Agriculture	Maintain production incentives.	*Set floor producer prices for grains (maize, wheat, rice) with appropriate reference to import parity and export parity principles.	Announce floor producer prices February of each year.
		Continue with auction pricing for coffee and tea exports.	Continuous.
		Decontrol beef producer prices.	In 1987.
		*Speed up payments to milk producers by Kenya Cooperative Creameries.	By December 1987.
		*Instruct coffee cooperatives to refrain from making payment deductions other than those related to processing and marketing costs.	By December 1986.

Table 1. Kenya: Summary and Timeframe for Macroeconomic and Structural Adjustment Policies, 1987-90 (continued)

	Objectives and targets	Strategies and measures	Timing
		*Clear up the overdue payments of the Cotton Board to producers.	By March 1987.
	Reduce cost of sugar production and processing.	*Undertake a study of the sugar industry with a view toward reducing cost of production and processing.	1988.
		*Implement an organizational and financial restructuring of the South Nyanza Sugar Company.	By June 1988.
	Improve marketing arrangements. Reduce financial burden on the budget of grain marketing operations.	*Define the role of various participants in the grain marketing system and implement an organizational and financial restructuring of the NCPB.	By February 1988.
		*Divest the processing and marketing functions of the Cotton Board.	By June 1988.
		*Grant licenses to milk marketing enterprises.	By June 1988.
	Provide for food security.	*Develop a food security plan.	1988.
	Improve agricultural input supply.	*Prepare annual import plan; assure minimum allocation to established importers; allow major approved end-users to import directly; increase the number of authorized importers and distributors.	July of each year.
		*Revise fertilizer pricing system on the basis of benchmark international prices; introduce adequate marketing margins; and price donor-provided and commercially procured fertilizers on the same basis.	November 1987
	Disseminate and develop improved agricultural technologies.	*Provide adequate funding for agricultural extension.	Continuous.
		*Consolidate agricultural research efforts into a well-prioritized national research program.	1987.
b. Industry	Import liberalization.	Import licensing schedules to be reduced from four to three, and licenses for imports on Schedules I and IIIA to be issued without restrictions.	January 1988, or when the financing gap for 1988 is filled.

Table 1. Kenya: Summary and Timeframe for Macroeconomic and Structural Adjustment Policies, 1987-90 (continued)

Objectives and targets	Strategies and measures	Timing
	Implement additional measures to further import liberalization according to the agreement in the Industrial Sector Adjustment Credit with the World Bank.	June 1989 and June 1990.
	Reduce the number of tariff levels by about half, mainly at the top of the range.	June 1988, June 1989, June 1990.
Export incentives.	Strengthen the administration of the export compensation scheme to make payments prompt and reliable.	Continuous.
	Supplement and eventually replace the existing export compensation scheme with a simplified duty drawback scheme.	June 1988.
	Design and commence implementation of a comprehensive export promotion program.	June 1989.
	Promote manufacturing in bond and study export financing incentives.	1988.
	Introduce green channel system (simplified and quicker administrative approval system) for exporters.	In 1987.
Improve credit availability.	Encourage aid donors to provide grants and loans for on-lending to commercial banks for agro-based and export industries.	1988.
Promote informal sector growth.	Improve credit availability to informal sector firms.	1989.
	Establish new tendering procedures that favor informal sector firms in bidding for all government contracts.	Continuous.
Promote investment.	Allow foreign investors greater access to domestic credit.	In 1987.
	Simplify and streamline procedures for investment approvals.	In 1987.
	Review Foreign Investment Protection Act.	In 1987.

Table 1. Kenya: Summary and Timeframe for Macroeconomic and Structural Adjustment Policies, 1987-90 (continued)

	Objectives and targets	Strategies and measures	Timing
		Revise depreciation allowances for tax purposes to reflect devaluation or inflation.	1988-90.
		Amend Foreign Investment Protection Act to make transfers of equity and capital gains on sale of assets more equitable.	June 1988.
3. Fiscal policy	Adjust fiscal position.	Gradually reduce overall deficit to available foreign financing and noninflationary domestic financing.	Continuous.
	Increase the productivity of budgetary resources while reducing the level of expenditure in terms of GDP.	Assess nonwage operating and maintenance expenditure needs in agriculture, transportation, education, and health sectors.	By April 1988.
		Increase allocations as appropriate for nonwage operating and maintenance expenditure.	June 1988 and June 1989.
		Confine development expenditures to fewer projects, to projects with high efficiency, and to projects which take into account district priorities. Give highest priority to improving the utilization of existing capacity and to improving the operations of completed projects. Redesign, rephase, or cancel all externally aided projects which do not correspond to sectoral priorities or rationalization objectives.	Continuous.
		Review civil service staffing requirements.	By April 1988.
		Prepare three-year forward budget plans for personnel expenditure, for expenditure on government capital formation, and for transfers to parastatals.	Continuous.
		Reflect forward budget plans in adopted annual budgets.	Continuous.
	Increase revenue.	Undertake a comprehensive study of the tax system with a view toward encouraging savings and investments as well as raising revenue.	Report by April 1988.

Table 1. Kenya: Summary and Timeframe for Macroeconomic and Structural Adjustment Policies, 1987-90 (continued)

	Objectives and targets	Strategies and measures	Timing
		Implement its agreed recommendations.	June 1988 and June 1989.
		Introduce computerization and other administrative improvements in income tax, sales tax, and customs and excise departments.	1988-90.
		Prepare a program and increase user charge collections.	June 1988, June 1989, and June 1990.
4. Public enterprises	Confine public enterprises to essential government services and, in the process of public enterprise reform, try to induce indigenization.	Determine enterprises to be restructured or divested. Define procedures for restructuring and divestiture, taking into account indigenization.	By December 1988.
		Begin implementing the agreed classification.	By June 1989.
	Improve the economic efficiency and financial performance of public enterprises which will remain in the public sector.	Clarify and streamline the monitoring of industrial public enterprises.	December 1988.
5. Monetary and financial policy	Move toward greater reliance on market forces in allocating financial resources.	Increase the band between the maximum lending rate and the minimum savings rate. Allow interest rates for loans to fluctuate within this band.	Early 1988.
		Begin freeing long-term rates and allow them to be set between lenders and borrowers.	December 1989.
	Introduce noninflationary sources of government finance.	Strengthen auction system for treasury bills and develop a secondary market for treasury bills.	By June 1988.
		Issue wider variety of maturities of treasury bills.	1988.
	Introduce more generalized monetary policy instruments.	Utilize cash ratio, rediscount policy, and open market operations.	Beginning in 1987.
	Remove inefficiencies in the financial system.	Implement all the provisions of the amendment to the Banking Law.	1988 and 1989.
		Strengthen central bank supervision of banking institutions.	Continuous.
		Amend the regulations that differentiate between banks and nonbank financial institutions toward more even treatment.	December 1989.

Table 1. Kenya: Summary and Timeframe for Macroeconomic and Structural Adjustment Policies, 1987-90 (concluded)

	Objectives and targets	Strategies and measures	Timing
		Help the Agricultural Finance Corporation and the Cooperative Bank of Kenya in their efforts to collect arrears.	By April 1988.
		Change the loan terms of development finance institutions to comply with the Government's development objectives.	
	Develop the capital market.	Revise the tax system to encourage capital market activity. Eliminate double taxation of dividend income.	By June 1988.
		Establish a Capital Markets Development Authority.	By June 1988.
		Amend existing legislation to permit banks and nonbanks to issue new financial instruments.	By December 1989.
6. Pricing policy	Strengthen market forces in the price-setting mechanism.	Decontrol retail beef prices.	1987.
		*Adjust consumer prices of maize, wheat flour, and rice in line with producer prices with a view to avoid subsidies.	February 1988 and February 1989.
		*Increase domestic retail prices of tea toward export parity.	February 1988 and February 1989.
		Establish Monopolies and Price Commission to monitor practices that restrain competitive forces.	1988.
		Decontrol ten prices under the General Order.	June 1988.
		Decontrol additional ten prices under the General Order.	December 1988.
		Remove remaining price controls on manufactured products in coordination with import liberalization.	
		For other domestic monopolies not subject to import competition, change the pricing formula from cost to import parity, as appropriate.	1988.

*Refers to measures already incorporated in agreements with the World Bank.

Table 2. Kenya: External Financing Requirements

(US$ million)

	1987	1988	1989	1990
Total financing requirement	788	959	954	829
Current account, excluding official transfers	608	523	459	381
Public MLT debt amortization	385	390	423	388
(World Bank/IDA debt amortization)	(49)	(57)	(64)	(73)
(IMF repurchases)	(109)	(87)	(127)	(99)
(Other public MLT)	(227)	(246)	(232)	(216)
Change in reserves	-205	46	72	59
Disbursements from existing commitments	788	420	202	126
Grants	205	112	--	--
Public MLT loans	551	308	202	126
Bilateral creditors	247	98	57	25
Multilateral creditors	195	177	118	83
(Of which: World Bank/IDA)	(130)	(129)	(83)	(60)
(Of which: adjustment lending) 1/	(30)	(30)	(--)	(--)
Private creditors	109	34	27	18
Other capital (net)	31	--	--	--
Disbursements from expected new commitments	--	441	598	631
Grants	--	112	233	242
Public MLT loans (excluding IMF)	--	176	236	312
Bilateral creditors	--	83	123	173
Multilateral creditors 2/	--	18	38	64
(Of which: World Bank/IDA)	--	(15)	(29)	(49)
Private creditors	--	75	75	75
IMF - stand-by and SAF	--	118	86	26
Other capital (net)	--	35	43	51
Subtotal	788	861	800	757
Initial financing gap	--	98	154	72
Disbursements from expected World Bank/IDA adjustment lending 3/	--	54	54	--
Co-financing	--	44	44	...
Residual financing gap	--	--	58	72

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

1/ Agricultural sector adjustment credit.
2/ Project lending only.
3/ Industrial sector adjustment credit, excludes possible financial sector loan/credit.

Table 3. Kenya: Key Indicators, 1980-90

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
GDP at market prices (growth rate)	5.5	4.3	0.1	1.5	2.3	3.7	6.5	5.1	4.8	5.1	5.4
GDY growth rate 1/	2.6	-0.7	-1.0	--	5.2	0.9	9.0	0.1	4.8	5.3	5.4
GDP/capita growth rate	2.2	0.2	-3.7	-2.4	-1.5	-0.1	2.5	1.2	1.0	1.3	1.6
GDY/capita growth rate 1/	-1.3	-1.4	-4.5	-3.8	1.2	-2.8	4.9	-3.6	1.0	1.5	1.6
Consumption/capita growth rate	-3.2	-7.5	-2.4	-4.8	2.5	-3.7	1.3	1.9	0.5	0.7	1.1
Consumer price index	12.9	20.2	14.3	10.1	10.8	10.5	4.3	7.3	7.0	5.2	5.2
Debt service (in U.S. dollars)	260	322	382	405	446	497	573	596	607	655	610
Debt service/Exports 2/	12.2	16.6	21.7	24.8	25.3	29.2	28.9	32.0	30.6	29.9	25.5
Debt service/GDP	3.7	4.8	6.1	7.1	7.6	8.5	8.3	7.9	7.7	7.7	6.5
Gross investment/GDP	30.0	28.4	22.4	21.1	21.0	21.8	25.7	24.8	24.1	23.3	22.6
Domestic savings/GDP	18.6	19.4	17.8	20.7	19.6	20.7	25.8	19.9	20.3	20.7	21.1
National savings/GDP	15.8	17.7	15.0	18.4	17.0	18.3	22.9	17.0	17.4	17.8	18.4
Marginal national savings rate	1.1	2.0	-13.9	1.9	-1.4	1.0	0.2	0.1	0.3	0.3	0.3
Public investment/GDP 3/	10.7	10.7	8.8	7.2	8.0	7.1	9.0	9.0	8.2	7.6	7.0
Government savings/GDP	0.8	0.8	1.1	1.3	0.5	-0.2	-0.1	0.3	0.9	1.0	1.1
Private investment/GDP	13.0	13.3	10.8	11.6	9.5	11.8	12.6	13.8	13.9	13.7	13.6
Private savings/GDP	15.0	16.8	13.9	17.2	16.5	18.6	23.0	16.6	16.5	16.8	17.4
Public/Private investment ratio	82.6	80.0	81.9	61.8	84.1	60.6	71.2	65.6	58.7	55.4	51.2
Government revenue/GDP 4/	24.4	25.2	24.3	23.1	23.0	22.7	23.3	23.7	24.2	24.8	25.0
Grants/GDP	0.6	0.8	1.3	1.6	0.7	1.7	1.1	2.4	2.9	2.7	2.6
Government expenditure/GDP 4/	32.2	34.8	32.1	28.2	27.6	30.6	30.6	33.4	31.3	31.3	31.0
Deficit/GDP 4/	5.7	9.5	6.5	3.6	3.9	5.3	5.6	8.1	4.2	3.8	3.4
Export growth rate 5/	5.4	-4.2	-0.4	1.6	1.9	5.9	10.2	-7.2	2.8	6.1	4.8
Exports/GDP 5/	27.2	25.0	24.8	24.9	24.8	25.3	26.2	22.6	23.4	23.8	23.5
Imports growth rate 5/	10.0	-21.0	-16.5	-18.1	17.9	-6.2	17.3	-9.0	1.8	2.7	-0.4
Imports/GDP 5/	-46.7	-35.3	-29.5	-23.8	-27.4	-24.8	-27.3	-27.5	-27.2	-26.4	-24.9
Current account (in U.S. dollars) 6/	-1,005	-676	-342	-155	-228	-201	-237	-599	-525	-466	-389
Current account/GDP 6/	-14.2	-10.1	-5.5	-2.7	-3.9	-3.4	-3.4	-7.9	-6.7	-5.5	-4.1
Current account (in U.S. dollars) 7/	-885	-558	-293	-38	-111	-91	-88	-397	-302	-230	-144
Current account/GDP 7/	-12.5	-8.3	-4.7	-0.7	-1.9	-1.6	-1.3	-5.2	-3.8	-2.7	-1.5

1/ GDP at constant prices adjusted by gains and losses from changes in terms of trade.
2/ Ratio of public debt to exports of goods, all services, and private transfer receipts.
3/ Public includes central government, municipalities, councils, and parastatals.
4/ Year ending June 30.
5/ Exports and imports defined as including nonfactor services. Growth rates in terms of real shillings.
6/ Excludes grants.
7/ Includes grants.