FOR AGENDA

EBS/85/217

CONFIDENTIAL

September 13, 1985

To: *Members of the Executive Board*

From: The Secretary

Subject: Kenya - Staff Report for the 1985 Article IV Consultation and Review Under Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with Kenya and a review under its stand-by arrangement. Draft decisions appear on pages 31 and 32.

It is proposed to bring this subject to the agenda for discussion on Monday, October 21, 1985.

Mr. Jimenez (ext. 6952) or Mr. Simpson (ext. 6939) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

KENYA

Staff Report for the 1985 Article IV Consultation and Review under Stand-By Arrangement

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

Approved by A.D. Ouattara and W.A. Beveridge

September 10, 1985

I. Introduction

The 1985 Article IV consultation discussions with Kenya, together with the review of the stand-by arrangement, were held in Nairobi during the periods June 26-July 10, 1985, and August 13-20, 1985. 1/ The missions carried out the review called for under the present stand-by arrangement, which covered fiscal, monetary, import, and exchange and interest rates policies, and negotiated credit ceilings for the remainder of the program period. The Kenyan representatives included the Minister of Finance and Planning, the Governor of the Central Bank, the Minister of Energy and other officials from ministries and the Central Bank dealing with economic and financial matters.

On February 8, 1985, a stand-by arrangement equivalent to SDR 85.2 million (60 percent of quota) became effective after having been approved in principle by the Executive Board in January 1985. To date SDR 51.1 million has been purchased under the arrangement. The next scheduled drawing of SDR 17.0 million is subject to the observance of the end of June performance criteria and the present review and the last purchase of SDR 17.1 million is subject to the observance of the end of September performance criteria. At the end of August 1985 holdings of Kenya shillings subject to repurchase were SDR 409 million or 288 percent of quota. Kenya is expected to request a drawing under the CFF shortly, estimated at about SDR 30 million or 21 percent of quota. Full use of the resources available under the stand-by arrangement and the expected CFF purchase, taking into account scheduled repurchases, will raise Fund holdings of Kenya shillings subject to repurchase to an estimated

1/ The first mission comprised Messrs. J.M. Jiménez (head-AFR), J.D. Simpson (AFR), W.R. Mahler (FAD), M. Nowak (ETR), Ms. W. Huyser (EP-AFR), and Ms. L. Valencia (secretary-ETR), while the second mission included Messrs. J.M. Jiménez (head-AFR), J.D. Simpson (AFR), Ms. W. Huyser (EP-AFR) and Ms. G. Hinds (secretary-RES).

305 percent of quota or 252 percent of quota excluding special facilities on December 31, 1985 (Table 1).

The last Article IV consultation with Kenya was discussed by the Executive Board on May 16, 1984. At that time, Directors commended the authorities for their determined implementation of the adjustment program. They broadly endorsed the authorities' policy stance for 1984. They noted the substantial reduction in the overall deficit which had taken place, but encouraged the authorities to reduce bank financing of the budget and public enterprises in order to shift additional credit resources to the private sector.

Directors welcomed the progress made in the external sector, as reflected in increased import authorizations. They encouraged further measures in this area, together with the rationalization of the tariff system, and continued flexibility of the exchange rate.

Directors observed that the adjustment undertaken had improved the medium-term outlook of the economy and underscored the importance of successfully implementing the 1984-88 Development Plan in order to further structural reform and invigorate the economy. In this respect, they underscored the need to strengthen supply-side policies, including the maintenance of incentives to producers.

Summaries of Kenyan relations with the Fund and the World Bank are found in Attachments II and III respectively.

II. Performance Under Stand-By Arrangement and Review of Recent Economic Developments

1. Performance under Arrangement

As detailed in Table 2, the Government of Kenya has met the quantitative performance criteria established for December 1984, and March and June 1985.

With the support of Fund programs, Kenya has carried out a major stabilization effort since 1980, with impressive reductions in the budgetary and balance of payments deficits, domestic credit expansion and inflationary pressures. The current program seeks to minimize the disturbance on economic activity arising from the recent drought and its relief, within a framework designed to maintain the underlying budgetary and balance of payments deficits at sustainable levels in the medium term. The implementation of the program has been aided by the return of normal rainfall patterns in 1985. Although the current program will expire in February 1986, the present review was carried out in the context of policies for the whole of 1985/86 (July-June) that are consistent with a sustainable medium-term outlook.

Table 1. Kenya: Fund Position During Period of Arrangement, December 1984 - December 1985

	Outstanding at beginning of arrangement December 31, 1984	1985 Jan.-Mar.	Apr.-June	July-Sept.	Oct.-Dec.
		(In millions of SDRs)			
Transactions under tranche policies (net) 1/		22.1	8.1	-16.9	17.1
Purchases		29.8	21.3	--	34.0
Ordinary resources		(14.9)	(10.6)	--	17.0
Enlarged access resources		(14.9)	(10.6)	--	17.0
Repurchases		7.7	13.2	16.9	16.9
Ordinary resources		(5.7)	(9.0)	(11.3)	(10.6)
Other		(2.0)	(4.2)	(5.6)	(6.3)
Transactions under special facilities (net) 2/		--	--	-7.5	22.5
Purchases		--	--	--	30.0
Repurchases		--	--	-7.5	-7.5
Total Fund credit outstanding (end of period)	387.6	410.4	418.5	394.1	433.7
Under tranche policies 1/	327.2	350.0	358.1	341.2	358.3
Under special facilities 2/	60.4	60.4	60.4	52.9	75.4
		(As percent of quota)			
Total Fund credit outstanding (end of period)	273.0	289.0	294.7	277.5	305.4
Under tranche policies 1/	230.5	246.5	252.2	240.3	252.3
Under special facilities 2/	42.5	42.5	42.5	37.2	53.1

Source: Staff estimates.

1/ Ordinary and enlarged access resources.
2/ Compensatory financing facility.

Table 2. Kenya: Quantitative Performance Criteria

	1984	1985	
	Dec.	March	June
	(In millions of Kenya shillings)		
Total domestic bank credit			
Ceiling	28,365	27,913	29,527
Actual	28,094	26,687	28,113
Net bank credit to Government			
Ceiling	9,245	8,754	8,638
Banking system	9,890	9,399	9,283
Eurocurrency	--	--	--
CSFC	-645	-645	-645
Actual	8,315	6,392	7,278
Banking system	9,037	7,122	8,108
Eurocurrency	--	--	--
CSFC	-722	-730	-830
New external borrowing contracted or guaranteed by the Government (cumulative)	(In millions of U.S. dollars)		
1-12 years' maturity			
Ceiling	150	150	150
Actual	--	--	24
1-5 years' maturity			
Ceiling	100	100	100
Actual	--	--	--

Source: Central Bank of Kenya; and staff estimates.

Because of the drought difficulties, the current program allowed both the overall budgetary deficit and the external current account deficit to increase during 1985, temporarily interrupting the downward trend of these variables. Preliminary data indicate that both of these variables did not expand by as much as had been allowed under the program.

The policies included in the program for 1985/86 are consistent with an improvement in economic growth and a reduction in price pressures. The program relies on the maintenance of incentives to producers and an incomes policy which will limit wage increases. Financial policy will continue to be cautious with the overall budgetary deficit expected to fall to about 4.1 percent of GDP in 1985/86. Thus the deficit will be reduced to the approximate level recorded in 1983/84. Domestic financing of the budget is expected to be 3.4 percent of GDP, down from the 4.0 percent recorded in the previous fiscal year.

Overall, domestic credit expansion is targeted below the program target in the previous fiscal year. About 60 percent of the growth in domestic credit will be for non-budgetary purposes, while money and quasi-money are expected to expand below the growth rate of nominal GDP, involving a further slight increase in velocity.

The balance of payments for 1986 targets a small overall surplus but contains a small unfinanced gap, even after the commercial borrowing required for budgetary purposes. It is expected that Kenya will receive increased concessional assistance from the levels presently included in the budget during the year, which will reduce this level of commercial borrowing.

2. Background

In 1984 Kenya suffered a drought of serious consequences. Inadequate rainfall during the short rains (September-November) in 1983 and during the long rains (April-July) in 1984 led to a massive fall in food production. It is estimated that in 1984 grain output fell by about 40 percent below normal levels leading to an import requirement of about 600 thousand metric tons of maize, 322 thousand metric tons of wheat in 1984-85, and quantities of other foodstuffs, such as milk powders. There were considerable livestock losses and some agricultural exports were negatively affected.

Although Kenya received food aid, about 70 percent of import requirements of about SDR 160 million were met from Kenya's own resources and from loans. Donors also provided assistance in transportation and logistics, while various nongovernmental agencies were active in providing direct relief. Kenya has been singled out by donors for the timeliness and efficiency of food distribution during the drought.

Adequate short rains in 1984 provided much needed relief to the livestock sector and assured a major upturn in grain and other food production. More recently the long rains in 1985 were better than normal and a large grain crop is now expected beginning in October, sharply reducing the amount of food imports in 1985. The drought had a negative impact on growth, price developments, and government finance. However, with the improving weather conditions, a rapid turnaround is now foreseen, allowing the Government to reorient its emphasis on structural economic reform.

In 1984 real GDP is estimated to have grown 0.5 percent, compared to initial estimates which indicated little or negative growth (Table 3). Thus, since 1981 real per capita income has fallen. There is a rebound in economic activity in 1985, largely led by a resurgence in the agricultural sector, which on the basis of good rains is expected to grow by 4.5 percent. Overall real GDP is projected to rise by about 3.8 percent or the same rate as population. Additional growth gains are expected in the medium term, with the rate projected at under 5.0 percent in 1986.

Food preferences and sporadic shortages have stimulated inflationary pressures, but these are expected to moderate as the main harvest comes to market. The rate of increase in the cost-of-living index fell from 20 percent in 1981 to 10 percent in 1983, but rose to about 11 percent in 1984 and is likely to reach 12 percent in 1985. Most of the emerging pressures are traceable to the food sector. An important element in price developments has been the fact that most of the imported maize has been of the yellow variety, not well liked by Kenyan consumers, whose preference for the local white maize has put pressure on its price, and created a greater demand on grain substitutes. The adjustments of some controlled prices early in 1985 added to the price pressures. The price increase in 1986 is projected to fall to about 9 percent. The wage guidelines in effect have allowed for salary adjustments of up to 75 percent of the cost-of-living increases.

In June 1984 the Government launched the fifth Five-Year Development Plan. However, the requirements of the drought emergency did not permit the Government to implement the Plan as expected. With the drought emergency over, a reassessment and adjustment of the Plan is taking place to permit its reinstatement in the very near future.

2. Financial developments

Since 1981 substantial progress has been made by the Government in adjusting domestic financial imbalances. The overall budgetary deficit (including grants) which had reached the equivalent of 9.5 percent of GDP in fiscal year 1980/81 (July-June) was reduced to 4.2 percent of GDP in 1983/84 (Table 4). The budgetary adjustment fell largely on expenditures, which fell from 34.8 percent of GDP in 1980/81 to 28.6 percent of GDP in 1983/84 and declined in real terms by 18 percent. The

Table 3. Kenya: Selected Economic and Financial Indicators, 1981-86

	1981	1982	1983	1984		1985		1986
				Program	Estimate	Prog.	Estimate	Prog.
			(Annual percent changes, unless otherwise specified)					
National income and prices								
GDP at constant prices	4.1	0.8	3.9	4.0	0.5	4.0	3.8	4.8
GDP deflator	10.4	10.7	10.4	8.2	10.3	8.0	11.0	10.0
Consumer prices	20.2	14.4	10.1	8.0	10.8	9.0	12.0	9.0
External sector (on the basis of SDRs)								
Exports, f.o.b.	-5.6	-7.5	2.2	9.3	16.6	-1.6	-2.8	8.4
Imports, c.i.f.	-9.7	-15.7	-16.2	9.9	15.7	8.1	2.9	8.2
Non-oil imports, c.i.f.	-16.0	-17.1	-15.7	13.6	25.1	11.1	4.7	11.4
Export volume	-5.2	-2.9	-4.0	2.9	0.8	4.0	5.9	4.0
Import volume	-21.8	-15.3	-21.0	5.1	15.2	5.4	0.7	4.5
Terms of trade (deterioration -)	-13.4	-4.8	-6.0	2.1	17.0	-8.1	-10.2	0.2
Nominal effective exchange rate (depreciation -) 1/	-18.2	-11.0	-3.5	...	-2.4	...	...	--
Real effective exchange rate (depreciation -) 1/	-10.5	-3.7	1.7	...	-3.6	-2.5	...	--
Government budget 2/								
Revenue and grants	20.3	12.4	7.6	10.9	9.8	17.3	12.1	14.2
Total expenditure	24.9	8.4	-3.6	12.2	13.2	18.1	10.4	15.5
Money and credit 2/								
Domestic credit	20.0	26.9	6.4	14.0	8.9	18.0	12.3	14.0
Government	74.6	55.1	-0.8	17.6	3.4	29.0	12.7	19.7
Other sectors	7.7	16.7	9.9	12.0	11.4	13.5	12.2	11.7
Money and quasi-money (M_2)	7.1	8.8	11.3	9.8	11.4	8.1	9.7	12.0
Velocity (GDP relative to M_2)	3.2	3.2	3.4	3.98	3.3	3.52	3.58	3.68
Interest rate (annual rate) 3/								
Savings deposit (min.)	10.00	12.50	12.50	12.50	11.00	10.50	11.1	11.0
Average time deposit	11.0	13.18	13.07	13.75	11.54	11.75	11.75	11.75
Maximum lending rate	14.00	16.00	15.00	15.00	14.00	14.00	14.00	14.00
				(In percent of GDP)				
Government budget 2/								
Revenue and grants	26.2	26.0	24.7	22.4	24.1	26.2	23.8	24.0
Total expenditure and net lending	34.8	33.4	28.4	26.5	28.6	31.4	27.9	28.0
Current expenditure	24.7	23.4	22.3	19.8	21.0	23.6	20.7	20.7
Development expenditure and net lending	10.1	9.9	6.2	6.7	7.6	7.9	7.2	7.3
Overall deficit 4/								
Including grants	9.5	6.7	3.1	4.1	4.2	5.1	5.0	4.1
Excluding grants	10.3	8.1	4.6	5.8	5.4	7.7	6.7	6.2
Domestic bank financing	2.8	2.6	-0.2	1.4	0.8	2.4	0.8	1.5
Foreign financing	4.9	1.7	1.7	1.2	0.9	1.6	1.0	0.7
Gross domestic investment	28.4	22.6	20.9	20.0	21.6	21.5	22.4	22.3
Gross domestic savings	19.4	17.9	19.9	16.2	19.7	18.2	19.9	19.0
External current account deficit 5/								
Including grants	11.1	7.7*	2.3	3.6	3.0	5.6*	4.5*	5.5
Excluding grants	12.3	8.9*	4.4	5.1	5.4	7.8*	6.5*	6.7
External debt								
External debt inclusive of Fund credit (beginning of period)	40	45	50	36	49	46	47	45
Debt service ratio 6/	18	24	28	29	28	31	30	28
Interest payments 6/	10	13	11	10	11	12	10	10
				(In millions of SDRs, unless otherwise specified)				
Overall balance of payments 7/	-198	-150**	89	-24	45	-202**	-100	25
Gross official reserves (months of imports)	1.4	1.6	3.5	2.0	3.3	2.7	2.8	2.6
External payments arrears	--	--	--	--	--	--	--	--

Source: Data supplied by the Kenyan authorities; and staff estimates.

1/ December to December variations.
2/ Fiscal year ending June 30.
3/ Level in percent.
4/ Figures do not add up because of adjustment to cash basis.
5/ *Reflects severe constraint on foreign exchange availability.
6/ In percent of exports of goods and services.
7/ **Reflects severe constraint on foreign exchange availability.

Table 4. Kenya: Central Government Finance, 1981/82-1985/86

	1981/82	1982/83	1983/84 Prel. Actual	1984/85 Program	1984/85 Prelim.	1985/86 Revised budget
			(In million of Kenya shillings)			
Total revenue and grants	16,623	17,894	19,646	22,929	22,018	25,550
Total revenue	15,737	16,768	18,649	20,692	20,446	23,306
Foreign grants	886	1,126	997	2,237	1,572	2,244
Total expenditure and net lending	21,381	20,620	23,356	27,407	25,783	29,876
Current expenditure	15,031	16,156	17,131	20,500	19,136	22,100
Development expenditure and net lending	6,350	4,464	6,225	6,907	6,647	7,776
Overall deficit (Treasury accounts)	-4,758	-2,726	-3,710	-4,478	-3,765	-4,326
Adjustment to financing basis 1/	469	483	277	--	-873	--
Overall cash deficit	-4,289	-2,243	-3,433	-4,478	-4,638	-4,326
Financing	4,289	2,243	3,433	4,478	4,638	4,326
Foreign financing (net)	1,108	1,236	715	1,389	939	726
Drawings 2/	(2,238)	(2,718)	(2,487)	(3,463)	(3,164)	(3,334)
Repayments	(-1,130)	(-1,482)	(-1,772)	(-2,074)	(-2,225)	(-2,608)
Domestic financing	3,181	1,007	2,718	3,089	3,699	3,600
Bank and CSFC	(1,694)	(-120)	(658)	(2,089)	(729)	(1,600)
Nonbank	(1,487)	(1,127)	(2,060)	(1,000)	(2,970)	(2,000) 3/
Overall cash deficit excluding foreign grants	-5,175	-3,369	-4,430	-6,715	-6,210	-6,570
			(In percent of GDP)			
Memorandum items:						
Total revenue and grants	26.0	24.7	24.1	26.2	23.8 4/	24.0
Total revenue	24.6	23.1	22.8	23.6	22.1	21.9
Of which: tax revenue	(21.5)	(19.7)	(19.9)	(20.5)	(19.1)	18.7
Grants	1.4	1.6	1.2	2.6	1.7	2.1
Total expenditure and net lending	33.4	28.4	28.6	31.3	27.9	28.0
Current expenditure	23.4	22.3	21.0	23.4	20.7	20.7
Capital expenditure and net lending	9.9	6.2	7.6	7.9	7.2	7.3
Overall cash deficit	6.7	3.1	4.2	5.1	5.0	4.1
Overall cash deficit (excluding grants)	8.1	4.6	5.4	7.7	6.7	6.2
Foreign financing	1.7	1.7	0.9	1.6	1.0	0.7
Domestic financing	5.0	1.4	3.3	3.5	4.0	3.4
Of which: bank and CSFC	(2.6)	(-0.2)	(0.8)	(2.4)	(0.8)	(1.5)
nonbank	(2.3)	(1.6)	(2.5)	(1.1)	(3.2)	(1.9)

Sources: Financial Statement, 1985/86: Statistical Abstract, 1984: and data provided by the Kenyan authorities.

1/ The adjustment factor arises because financing data are derived from different sources than revenue and expenditure data. It includes a float element resulting from some checks being issued but not cashed.
2/ Includes PL 480 and defense appropriations-in-aid loans.
3/ Including K Sh 1 billion from NSSF.
4/ Staff estimates for GDP; revised estimate for 1984/85 was higher than the program estimate.

adjustment was difficult because the ratio of revenues to GDP also declined, reflecting the less buoyant economic conditions of this period and a substantial reduction in imports. In order to take account of the budget implications of the drought, the current program was framed around a 1984/85 budget with an overall deficit of 5.1 percent of GDP. The actual outturn is presently estimated at 5.0 percent of GDP. The drought implications for the budget were estimated to have been about 1 percent of GDP; therefore the underlying level of the budgetary deficit at 4.0 percent reflected further adjustment from the 1983/84 level. In order to meet the overall budgetary objective, adjustments of expenditures were necessary during the year, as revenues and foreign grants turned out to be less buoyant than expected when the budget was drafted. Consequently, total expenditures in relation to GDP fell further to about 28 percent compared to a target of about 31 percent. There appears to be continued weaknesses in revenue collection, while the contraction of expenditure in relation to GDP recorded in recent years is being reflected in administrative inefficiencies.

The ratio of total revenues to GDP fell from 24.6 percent in 1981/82 to 22.1 percent in 1984/85, despite new revenue measures averaging 0.6 percent of GDP per year. The large reduction in imports during this period has had a large impact on this trend. The 1985/86 budget was revised shortly after approval to reflect the availability of additional grants and additional expenditure. The original and revised budgets contained almost no new revenue measures on a net basis, as new tax measures were largely offset by tax reductions. Tax collections are also being affected by the reduction of the sales tax on petroleum products carried out in February 1985. Total revenue as a percentage of GDP is expected to decline slightly. Import tariffs on raw materials, intermediate imports to industry, and capital goods were reduced by an average of 12 percent of the existing rate, when they were above 25 percent. There was also some streamlining in the duty rates payable on automobile imports. The tax brackets of the income tax were widened to offset the effects of inflation since 1981. The capital gains tax was abolished. These and other minor changes led to an estimated loss of revenues of K Sh 520 million or 0.5 percent of GDP. These deductions were offset by an increase in the sales tax and in excise duties for cigarettes and beer, and in some miscellaneous taxes and fees, such as the hotel accommodation tax. Total expenditure and net lending in 1985/86 is likely to fall somewhat in relation to GDP from the 1984/85 level, once these accounts are closed and the expenditure presently captured in the adjustment item identified. Emphasis is being given to maintenance outlays in the recurrent budget, which also includes an allocation for a possible salary adjustment. In the development budget priority has been given to projects which are most advanced in completion.

The 1985/86 budget provides for an overall deficit of under 4.1 percent of GDP; thus it has remained almost unchanged since 1983/84 when it was 4.2 percent. Including some foreign borrowing on commercial terms the Government is only expecting net foreign financing of 0.7 percent of GDP, considerably below the levels recorded in all the previous years, largely because of payments to Uganda totalling K Sh 480 million arising from the settlement of the assets and liabilities of the East African Community. Domestic financing is targeted at 3.4 percent of GDP, with bank financing at 1.5 percent of GDP, compared to 4.0 percent and 0.8 percent respectively in 1984/85. In order to keep to the program, government departments have been advised that this year's supplementary budget will not allow for an increase in net expenditure, but only for a reallocation of authorizations.

Monetary policy has sought to further the stabilization objectives of the Government. Concomitant with improvement in the budget, domestic credit expansion has been reduced from 20 percent of the initial broad money stock in 1980/81 to about 12 percent in fiscal 1984/85. During this period, there have also been frequent adjustments in interest rates, with all rates becoming positive in real terms in 1983. The more recent inflationary spurt has reversed this position with only some time deposit and the lending rates remaining positive in real terms.

During the last three programs, the expansion of overall credit fell below the established targets. In 1984/85 the program allowed for an overall expansion equivalent to 18 percent of the initial money stock, 5 percentage points more than the actual outturn. There was again a substantially lower level of net credit to the Government and credit to the private sector also fell below its implied level; credit to public enterprises fell slightly. Credit to the Government at the end of June is estimated to have accounted for about 29 percent of total banking system credit, compared to the 31 percent targeted under the current program. During the current year, the Central Bank actively intervened to limit credit availabilities to the private sector in order to assure that the end of June credit ceilings would be observed. Money and quasi-money expanded by about 10 percent in fiscal 1984/85, compared to about 11 percent in the previous two fiscal years.

The 1985/86 program provides for an overall credit expansion of about 15 percent of the initial broad money, with only about 40 percent of the overall credit expansion going for budgetary purposes. The growth of money and quasi-money is projected at about 12 percent, moderating somewhat the rise in velocity recorded in the previous years. The seasonally consistent credit aggregates for September are performance criteria under the program and the December variables are indicative targets (Table 5).

3. External sector

Since 1981 substantial adjustment has taken place in the balance of payments, with the current account deficit falling from over 11 percent of GDP in 1981 to an average of under 3 percent in 1983-84. Overall

Table 5. Kenya: Quantitative Performance Criteria

	1985		
	June	September Proposed	December Indicative
	(In millions of Kenya shillings)		
Total domestic bank credit			
Ceiling	29,527	31,555	31,983
Actual	28,113		
Net bank credit to Government			
Ceiling	8,638	9,625	9,480
Banking system	9,283	10,455	10,310
Eurocurrency	--	--	--
CSFC	-645	-830	-830
Actual	7,278		
Banking system	8,108		
Eurocurrency	--		
CSFC	-830		
New external borrowing contracted or guaranteed by the Government (cumulative)	(In millions of U.S. dollars)		
1-12 years' maturity			
Ceiling	150	150	150
Actual	24		
1-5 years' maturity			
Ceiling	100	100	100
Actual	--		

Source: Central Bank of Kenya; and staff estimates.

surpluses were recorded in the latter two years, totalling SDR 134 million, raising gross reserves to the equivalent of 3.3 months of imports at the end of 1984, compared to about half that amount in 1981-82 (Table 6). The balance of payments surplus would have been even greater in 1984 had it not been for the grain imports made in the second half of 1984. A recovery in the terms of trade in 1984 was helpful in the positive outturn.

At the start of 1985, it was foreseen that the balance of payments would have an overall deficit of about SDR 200 million, as a result of food imports estimated at the equivalent of over 2 percent of GDP. About half of this amount could be financed by a drawdown of reserves and net purchases from the Fund. This left a financing gap of about SDR 93 million to be arranged. The financing gap was closed early in the year by a combination of unexpected better export performance, a larger drawdown of reserves, and additional assistance, largely in food aid, obtained from donors. As previously explained, the turnaround in weather conditions allowed for a reduction in food imports to an estimated 1.8 percent of GDP. As a result, some of the assistance expected from donors will no longer be necessary. The present projections indicate that the 1985 current account deficit of the balance of payments will total about 4.5 percent of GDP; excluding the emergency food imports, it would have been about 3 percent of GDP or comparable to the levels recorded in 1983-84. The outturn is substantially better than the 5.6 percent projected at the beginning of 1985, the difference being largely a reduction in emergency food imports and petroleum products for electricity generation, which were thought necessary to replace hydroelectric capacity being lost by the drought. The reduction in the current account was matched by reduced capital flows, mainly related to the drought emergency, and the balance of payments overall deficit is expected to remain at about SDR 100 million.

Exports in 1985 are expected to be somewhat below the 1984 level, largely as a result of adverse price developments for tea and coffee. Importantly, nontraditional exports have begun to show an upward trend after several years of contraction, increasing by 12 percent (in SDR terms) in 1984 and by an anticipated additional 16 percent in 1985. Imports, which contracted sharply between 1981 and 1983, have reversed their trend increasing by 16 percent in SDR terms in 1984 and by a further 3 percent in 1985. The earlier contraction had affected all import categories. Government imports fell to nearly one third of their 1981 level by 1983 in line with the sharp contraction of the development program. Savings in energy consumption, in conjunction with reduced activities at the Mombasa Refinery (which also affected oil exports), resulted in a fall of 28 percent in oil imports, while nongovernment non-oil imports fell by 20 percent during this period. Since 1983, largely as a result of drought difficulties there has been a turnaround in government imports, but oil imports contracted further. However, non-oil nongovernment imports rose by 22 percent in 1984 and

Table 6. Kenya: Balance of Payments, 1981-85

	1981	1982	1983	1984	1985 Prog. 1/	1985 Prog. 2/	1985 Rev.
				(In millions of SDRs)			
A. Exports, f.o.b.	915	846	865	1,009	984	997	981
Coffee	205	240	225	276	245	245	258
Tea	115	129	173	256	232	245	195
Oil products	213	151	174	150	130	126	148
Other	382	326	293	327	337	381	380
B. Imports, c.i.f.	-1,850	-1,559	-1,306	-1,511	-1,657	-1,636	-1,555
Government	-289	-148	-108	-160	-253	-232	-201
Food	(-25)	(-26)	(-12)	(-76)	(-149)	(-128)	(-110)
Other	(-264)	(-122)	(-96)	(-84)	(-104)	(-104)	(-91)
Oil	-652	-566	-469	-464	-495	-495	-459
Other	-909	-845	-729	-887	-908	-908	-895
C. Trade balance (A+B)	-935	-713	-441	-502	-673	-639	-574
D. Services (net)	244	218	208	184	196	196	167
E. Private transfers	19	-7	-5	4	-6	-6	4
F. Official transfers	66	70	113	140	137	164	126
G. Current account (C+D+E+F)	-606	-432	-125	-174	-346	-285	-277
H. Capital account	401	282	214	219	144	189	177
Long-term (net)	347	252	212	248	97	142	160
Official	(210)	(145)	(130)	(159)	(32)	(77)	(39)
Private	(137)	(107)	(82)	(89)	(65)	(65)	(121)
Short-term (net)	54	30	2	-29	47	47	17
Financial institutions	(20)	(-15)	(-5)	(-9)	(...)	(...)	(...)
Other	(34)	(45)	(7)	(30)	(...)	(...)	(...)
I. Allocation of SDRs	7	--	--	--	--	--	--
J. Overall balance (G+H+I)	-198	-150	89	45	-202	-96	-100
K. Financing	198	150	-89	-45	202	96	100
Gross reserves	176	5	-169	-37	36	56	58
IMF (net)	23	135	88	-11	73	40	43
Other assets (net)	-1	9	-8	3	--	--	-1
To be secured	--	--	--	--	93	--	--
Memorandum items:							
Gross reserves (end of period)	215	210	379	416	367	347	358
Gross reserves (in months of imports)	1.4	1.6	3.5	3.3	2.7	2.5	2.8
				(In percent of GDP)			
Current account deficit							
Including official grants	11.1	7.7	2.3	3.0	5.6	4.6	4.5
Excluding official grants	12.3	8.9	4.4	5.4	7.8	7.2	6.5
Official net capital inflow plus official grants	5.1	3.8	4.5	4.6	2.7	3.9	2.7

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

1/ Projections presented in EBS/84/261 (12/12/84) when the Board approved the arrangement in principle pending closure of the external financing gap.

2/ Projections contained in program that was approved once the financing gap had been closed (EBS/84/261, Supplement 3, 2/8/85).

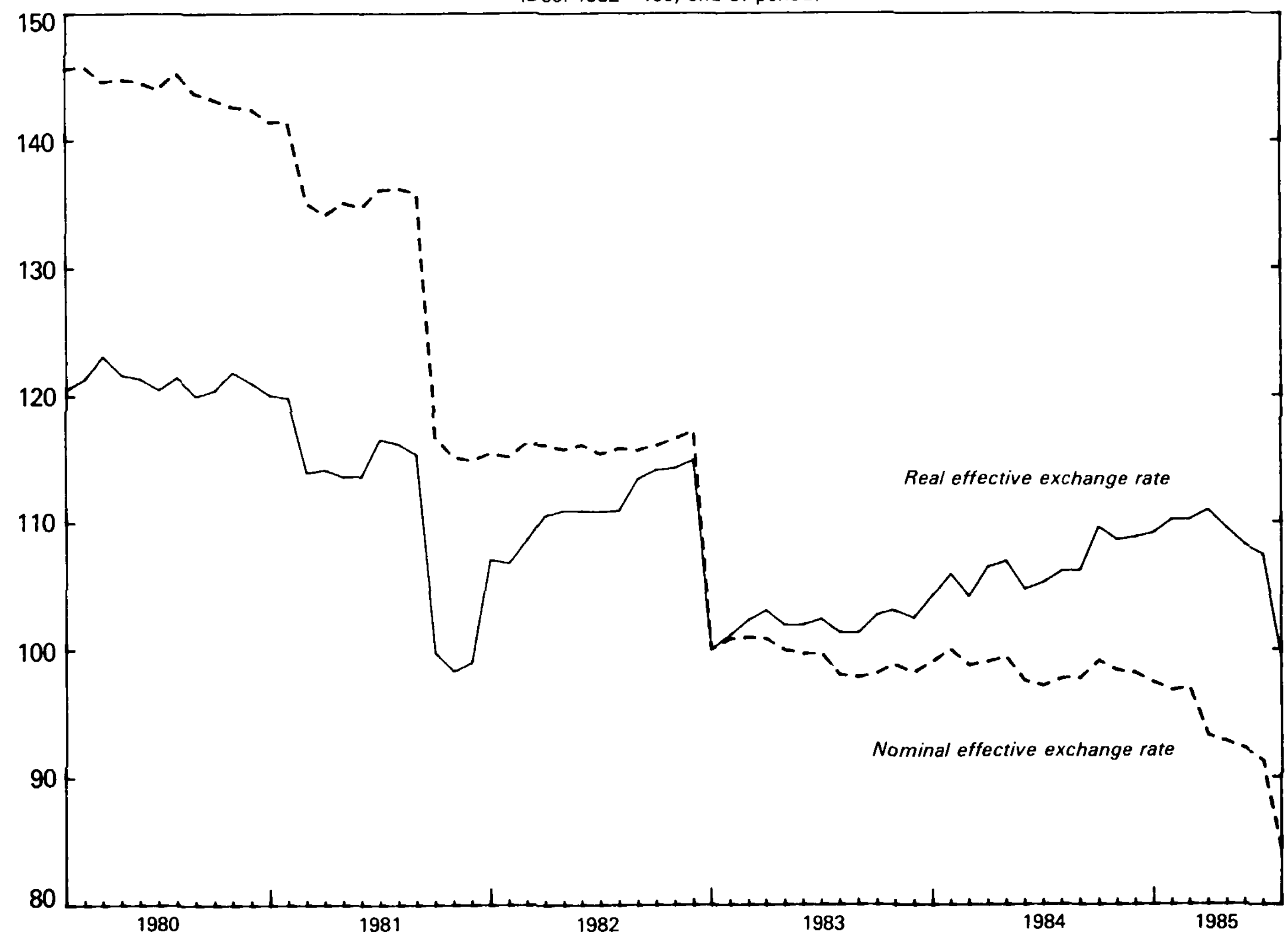
are presently estimated to rise by a further 1 percent in 1985. The rise in this category reflects the implementation of a new import system initiated in 1983 and the two phases of liberalization which it has undergone.

Net capital inflows have fallen rapidly since 1981 from SDR 401 million to a projected level of SDR 177 million in 1985, largely as a result of a contraction in net official capital inflows. In 1985 these were equivalent to less than half of the 1981 level. The fall in net official capital is the result of a sharp reduction in the Government's drawdown of available loans in line with the reduction of the development program and a large increase in debt amortization. However, some of the fall in the capital account has been offset by an increase in official transfers. As the current Five-Year Plan begins to be implemented, net official capital inflows are expected to rise. At the same time, amortization payments in relation to current account receipts are expected to peak in 1985. Private sector capital inflows fell by only 12 percent and have recorded a turnaround since 1984. As private sector activity rises, increased flows of private sector capital are also projected. Nevertheless, in the coming years it does not appear possible that net inflows of capital and official grants will attain the levels recorded in the 1970s, but are likely to be at a more modest average of about 3.0-4.0 percent of GDP.

The Kenya shilling, which is pegged to the SDR, was devalued by 15 percent (in foreign currency terms) in December 1982. Since then, the authorities have tried to follow a flexible exchange rate policy with the aim of maintaining the real value attained after the devaluation. This has resulted in a further depreciation of the exchange rate in nominal terms of 1 percent in 1983, 2 percent in 1984, and 13 percent between April-July 1985. By the end of July, the real effective exchange rate had regained the December 1982 level, after having exceeded this target at end December 1984 and March 1985 by about 9-10 percent (Chart 1). The depreciation of the real rate, together with the import surcharge in effect since December 1982, has had an important impact on relative prices, influencing the import intensity of production and import demand in general. Export profitability has also improved, as the recent growth in non-traditional exports show.

A new import system was introduced in 1983 and liberalized in June 1984 and more recently in June 1985. Last year 306 items, about one quarter of the items in the restricted schedules, were transferred to Schedule 1B, and in June 1985, 317 items were transferred into Schedule 1A. As a result of these changes, Schedule 1A accounts for 42 percent of all import items. Schedule 1A and 1B together account for almost two-thirds of import items. Items in Schedule 1A are licensed virtually automatically while those in Schedule 1B are licensed liberally. Schedule 2 accounts for 35 percent of items and is divided into Schedule 2A Special with 3 percent of items, which includes items such as petro-

CHART
KENYA
NOMINAL AND REAL EFFECTIVE EXCHANGE RATES
(Dec. 1982 = 100; end of period)



Sources: IMF Data Fund; and staff estimates.

leum products and fertilizers, which are freely importable, after specific supervising agencies approve the import, and Schedule 2B items which are restricted, largely for the purpose of industrial protection. On the basis of 1983/84 import values, the items shifted accounted for 9 percent of total imports. Consequently, after the recent shift, Schedule 1A will account for 39 percent of 1983/84 imports with Schedule 1B accounting for an additional 9 percent. Schedule 2A Special accounts for 46 percent. Therefore, about 94 percent of 1983/84 import values are liberally licensed. However, the 6 percent of imports in schedule 2B account for about one third of import items and provide an important element of protection for the manufacturing sector.

In addition to the partial liberalization of imports since 1983, considerable progress has been made in liberalizing other exchange restrictions. Since January 1984 transfers for dividends and profits have been made without delay, while foreign exchange allocations for other invisible payments are provided in a liberal manner.

At the end of 1984, about two-thirds of Kenya's external debt was in the form of bilateral and multilateral loans on concessional terms, at well below market rates, with long maturities and grace periods and a significant grant element. Outstanding debt on commercial terms represents only one third of the total. Debt service (including IMF) is estimated at 27 percent of the export of goods and services and private transfers in 1984. The ratio is expected to peak at 30 percent in 1985. On the basis of existing and anticipated borrowing, the debt service ratio is projected to fall to about 20 percent by 1990.

The current program includes a limit on the contracting of public and publicly-guaranteed external borrowing on non-concessional terms in the maturity range of 1-12 years of SDR 150 million, with a subceiling of SDR 100 million in the maturity range of 1-5 years. As of June 30, 1985 SDR 24 million of loans in the range 1-12 years had been contracted and active negotiations were in effect for a further SDR 105 million for the purchase of two airplanes. There had been no borrowing with maturities of 1-5 years nor of 1 year or less.

III. Report on the Discussions

The discussions were held against an improving economic background: the threat of a protracted drought had been removed; a bumper grain harvest was expected; and the medium-term economic outlook continued to be sustainable. In this setting, the authorities were concentrating on the steps necessary to bring the Development Plan back on track, in order to improve the growth prospects of the economy, while maintaining a viable financial framework consistent with a sustainable medium-term outlook. The necessary policy framework consistent with this objective for 1985/86 was discussed in detail.

1. Resource allocation

The Kenyan representatives said that to re-establish the thrust of development policy, efforts were under way to bring the Development Plan back on track, with the aim of improving the growth rate of the economy. The Kenyan representatives explained that the need to lower the capital output ratio through more productive investments was of crucial importance in this endeavor. They were also targeting an increased coverage of investment by domestic savings.

The Kenyan representatives said that agriculture would continue to be the leading sector in Kenya's economic development. In their view, considerable potential existed for expanding food crop production, for introducing new industrial raw material (such as oilseeds), and for expanding export output. Key to harnessing this potential was the need to maintain favorable producer prices, but they felt that improved marketing arrangements for commodities and farm inputs were also needed. Important in maintaining incentives was assuring prompt payment to farmers and an adequate provision of credit.

The Kenyan representatives explained that improvements in efficiency were also expected in the manufacturing sector. This was being fostered by increasing import competition which was also encouraging an export orientation. In this regard, import duties on a wide range of goods had been reduced during the last three budgets, and the import system was being increasingly liberalized. Further measures in this area would be taken.

Tourism has recovered substantially since the fall occasioned by the coup attempt in August 1982. In 1983 the number of visitor days fell by about 15 percent, reflecting the worldwide tourism contraction and in particular the impact of the coup attempt in 1982. In 1984 there was a recovery of a similar magnitude. The Kenyan representatives expressed optimism that under the proper conditions the number of tourist arrivals could be increased significantly, particularly as the tourist markets outside of Europe are developed. For 1985 an increase of about 5 percent was expected, but this was largely being influenced by several large conferences. The Kenyan representatives felt that Kenya had a potential for continuing to attract large multinational conferences.

The Kenyan representatives explained that the Government has been quite concerned with the level of unemployment. While faster economic growth will tend to lessen the problem, the Government was also attempting to target employment creation in the rural areas. It has been following a two-pronged approach. On the one hand, the school programs were being changed to emphasize training and the promotion of skills. On the other hand, the Government was building up the rural infrastructure, by providing medical and other services. These efforts were expected to slow down the migration of young unemployed school-leavers to the urban areas.

The Kenyan representatives explained that on May 1, 1985, the minimum wage was raised by 20 percent. The last increase had been granted in 1982. Minimum wage regulations affect all those workers not covered by collective agreements, or about 60 percent of the work force, but many of them are already earning above the minimum wage. The wages of workers covered by collective agreements are regulated by the wage guidelines, which were first issued in 1982. The guidelines limit annual wage revisions to a maximum of 75 percent of the ongoing inflation rate. Because of this regulation, the increase in minimum wage rates will not influence the wages under collective agreements.

2. Financial policies

The Kenyan representatives said that the Government had vigorously sought to adjust the budget to a sustainable level. The adjustment had been particularly difficult because it took place at a time when the economy was going through a recessionary period which negatively affected revenue yields. Consequently, despite the introduction of additional revenue measures with each budget, the ratio of revenues to GDP had declined continuously since 1980/81, and in order to reduce the deficit, a major contraction of expenditures had been required. The adjustment was compounded by the need to adjust expenditure levels frequently, in view of changing circumstances in order to meet the objectives set out at the start of the fiscal year. Thus the 1983/84 budget needed to be revised several times during the fiscal year. Such frequent adjustments did not permit the simultaneous correction of the medium-term investment program, negatively affecting the forward budget procedures. Importantly, the sharp curtailment in development outlays led to a slowdown in the use of previously committed foreign aid and in the negotiation of new aid packages. Moreover, the reduction in expenditure also resulted in inadequate maintenance outlays and the running down of various government assets. To ameliorate this situation, starting with the 1985/86 budget, the Government has embarked on a program of rationalizing government expenditure, aimed at improving the efficiency of Government, lowering the capital output ratio in government investments, and improving the forward budget procedures, while linking them more closely to the Development Plan. The Kenyan representatives said that in order to give effect to these objectives, the budget's development outlay was concentrated on projects which were already under way and which had a high rate of return. With respect to current outlays, the Government sought to slow down the growth of employment in the civil service and to increase the amount of outlays available for maintenance purposes. The Kenyan representatives emphasized that to be effective, the new strategy required support from donor governments to reallocate previously committed resources to higher priority projects and allow some of these funds to be used for maintenance. The Kenyan representatives reported that some donors were already permitting the use of counterpart funds generated from the commodity import program for this purpose. The Kenyan representatives expressed hope that more donors would see the benefit of this policy, as the rationalization of the budget would go a long way in improving the growth prospects of the economy.

The Kenyan representatives explained that, together with the rationalization of public expenditure, the Government intended to continue with the adjustment program. The fiscal program for 1985/86 needed to be considered as a transitional budget still reflecting the drought difficulties. It contained an allocation (K Sh 400 million) to help finance a strategic grain reserve and tax measures to help promote the private sector recovery from the drought difficulties. The remainder of the necessary resources for the strategic grain reserve would be generated by the National Cereals and Produce Board from increased consumer prices for maize and the export of some surplus grains. An overall deficit of 4.1 percent of GDP was being targeted, but excluding the equivalent of 0.4 percent of GDP for the nonrecurring strategic grain reserve, the adjusted deficit would be 3.7 percent. A further small reduction in the ratio of revenue to GDP was expected because of low tax elasticities and the tax reductions in the budget. However, the authorities feel that the latter should have a positive impact on economic activity and therefore on future revenue collections. The program counted on foreign grants reaching 2.1 percent of GDP, compared to 1.7 percent in 1984/85. The higher level reflected the receipt of the counterpart funds from drought relief assistance expected in 1984/85 only in this fiscal year and the agreement of other donors to release other counterpart funds to help the rationalization program. Despite the high level of grants the overall budget deficit excluding grants would fall to 6.2 percent of GDP from 6.7 percent in the previous year.

The Kenyan representatives explained that the budget counted on about 3.4 percent of GDP in domestic financing, of which about 1.5 percent of GDP was to come from the banking system, representing a downward adjustment from the original budget and the previous year's requirement. The Kenyan representatives said that the forward budget program was targeting additional reductions in the overall deficit and the domestic financing component in the next few years.

The Kenyan representatives said the public enterprises have been characterized as inefficient and remained an area of concern. However, they said that, in the last few years, there has been a substantial reduction in transfers provided from the budget, although apart from the Central Bank, there had not been an increase in revenue contributions by public enterprises. In the last few years, the monitoring of public enterprises has improved, and the Government is proposing the creation of the Office of Auditor-General for Parastatals. It has also begun to clarify how previous transfers are to be classified between loans, equity participation, and grants. In the case of loans, revised loan agreements are being prepared, which will specify an amortization schedule and interest rate. A computerized internal debt reporting system has been put into operation to assist the Government in collecting these contributions. A restructuring of public enterprises involving their closure or sale is also proposed. The Task Force on Divestiture has already reviewed some parastatals, and its report is pending review by the Government.

The Kenyan representatives said that the thrust of monetary policy continued to support the adjustment effort, while trying to provide a minimum level of credit to the private sector. Efforts were also being made to rationalize the financial system, particularly in reducing the competitive bias enjoyed by nonbanks, arising from regulations, while increasing the system's soundness. Credit to the private sector had been difficult to program, because it had been hard to gauge the margin of overperformance by the Government. As a further precaution credit to the private sector has been been held below the ceilings, with the result that monetary policy has tended to be tighter than necessary.

The Kenyan representatives explained that the Central Bank continued to target time deposit rates at a level above the underlying rate of inflation. They viewed the recent increase in inflation pressures to be a temporary spurt, which would be brought down quickly. Data for June and July already indicated an easing of price pressures. Therefore they did not feel that the underlying inflationary rate had shifted. However, as interest rates were under continuous review, if the recent price pressures did not prove temporary, offsetting adjustments would be taken. The Kenyan representatives said that amendments to the Banking Act had been introduced in Parliament. The aim was to augment Central Bank control and improve the solvency of financial systems. The Kenyan representatives noted that, with the increased demand for private sector credit, more careful allocation needed to be given to available credit resources. They added that studies to implement a more active interest rate policy were continuing.

3. External policies and development

The Kenyan representatives explained that in line with their objectives of liberalizing the import system over the medium term, additional measures had been taken in June 1985 to increase the schedule of freely importable items. They stressed, however, that this was a liberalization in a formal sense, as the level of administrative restraint on imports had been considerably eased since 1983. They noted that these actions had been implemented despite the current difficult balance of payments situation. In their view, there has been a structural change in demand for imports. Actual imports in the last two years had also been affected by the slowdown in economic activity, and an increased import inflow would be expected as domestic demand attained a more normal growth rate. They were, however, concerned at the overhang of licenses approved, but not yet utilized. They stressed that import liberalization remained an integral component of government policy and further actions in this area would be expected in the medium term.

The Kenyan representatives noted that in looking at the medium term, the Government was concerned that despite the availability of already negotiated loans and grants, the budget rationalization process was likely to slow down the utilization of these resources, unless donor governments were supportive of the process by allowing a shift of already committed loans. They stressed that the understanding of the donors was essential in making the budget rationalization a successful exercise. They noted that outstanding balances in projects which no longer had priority were leading to smaller aid programs than in the past. These difficulties were likely to result in a small unfinanced gap in the balance of payments for 1986 and 1987, which may have to be met by commercial borrowing. In order to draw the attention of donors to these problems, the Government was hoping that the Consultative Group Meeting for Kenya would be convened as scheduled in the early part of 1986. In their view a current account deficit equivalent to around 4.0 percent of GDP was financeable and consistent with the liberalization of the trade regime, the maintenance of an adequate level of gross foreign assets over the medium term, and a decline in the debt service ratio.

The Kenyan representatives said that the debt service ratio was expected to peak in 1985 and to decline gradually over the next few years. The increase in the debt service ratio over the last few years had been a major constraint on the external sector. The present high debt service ratio was largely the result of Eurocurrency borrowing undertaken in the late 1970s and early 1980s. These loans should be fully repaid shortly, leading to a major reduction in debt service payments (Table 7).

The Kenyan representatives explained that in August 1984 the Government contracted for the purchase of some naval boats, to be delivered in 1987. This was financed by a commercial loan for SDR 85 million with a 10-year maturity, from the first payment in 1988. In addition, the Government has also agreed to purchase two airplanes to be financed by a loan of SDR 105 million. The Kenyan representatives pointed out that these two loans, although on commercial terms, contain long maturities and would only have a relatively limited impact on the debt service ratio over their life. The staff estimate that the maximum impact on the debt service ratio resulting from these purchases will be in 1988, when it will rise by about 1 percentage point. The Kenyan representatives explained that the naval boats were needed for security reasons, the need to protect Kenya's 200-mile economic zone, and to control smuggling. They added that without the airplanes Kenya Airways would have been unable to fly to Europe, as their current aircraft could not meet low noise standards scheduled to go into effect in 1986. They pointed out that the purchases of the airplanes will be net foreign exchange earners and will aid the tourist industry in Kenya, while providing much needed additional cargo capacity. They stressed that these purchases needed to be viewed on their own merits and as exceptions to the Government's objectives of limiting external commercial borrowing. In this regard they pointed out that apart from these loans and SDR 24 million undertaken in the current program no other indebtedness on commercial terms (including short term) had been incurred in the last few years. The Government was observing the ceilings on nonconcessional debt established in the current program.

Table 7. Kenya: External Public Debt Operations, 1983-1990

	1983	1984	1985	1986	1987	1988	1989	1990
				(In millions of SDRs)				
A. External debt	2,725	2,826	2,910	3,087	3,289	3,432	3,551	3,676
Non-IMF 1/2/	2,327	2,438	2,477	2,694	2,928	3,082	3,256	3,449
Disbursed 3/	(2,327)	(2,438)	(2,195)	(1,973)	(1,757)	(1,519)	(1,276)	(1,049)
Projected	(--)	(--)	(282)	(721)	(1,171)	(1,563)	(1,980)	(2,400)
IMF credit tranches	398	388	433	343	259	187	93	25
Disbursed 3/	(398)	(388)	(318)	(228)	(144)	(87)	(40)	(8)
Projected	(--)	(--)	(115)	(115)	(115)	(100)	(53)	(17)
Financing gap	--	--	--	50	102	163	202	202
B. Principal payments 4/	221	262	313	312	310	322	337	295
Non-IMF 2/	178	204	(252)	(215)	(214)	222	223	210
IMF	43	58	70	90	84	72	94	68
C. Interest/charges	158	169	162	169	177	185	189	192
Non-IMF 2/	127	144	150	148	145	137	127	115
IMF	38	43	39	37	29	22	14	6
Financing gap	--	--	--	3	8	13	17	19
D. Total debt service (B+C)	379	441	475	481	487	507	526	487
				(In percent of current account receipts) 5/				
Memorandum items:								
Total debt service	26.4	26.8	29.7	28.2	25.9	24.8	23.5	19.9
IMF debt service	5.5	6.3	6.8	7.4	6.0	4.2	4.8	3.0
Interest/charges	11.0	10.5	10.1	9.9	9.4	9.0	8.4	7.8
				(In percent of GDP)				
Total external debt 6/	50.1	48.6	47.0	45.4	43.6	41.1	38.4	35.9
IMF credit 6/	7.3	6.7	7.0	5.0	3.4	2.2	1.0	0.2

Source: Kenya External Debt Reporting System; and staff estimates.

1/ Includes nonguaranteed debt of public sector in addition to guaranteed and direct government debt.
2/ Includes IMF Trust Fund.
3/ As at end-1984
4/ Covers payments on medium- and long-term debt only.
5/ Excludes official transfers.
6/ Average of beginning and end of period stock of debt.

The Kenyan representatives explained that the balance of payments surpluses in 1983-84 had increased gross foreign assets to the equivalent of 3.2 months of imports. As a result of the drought emergency, a reduction in gross foreign assets was projected for 1985, but it was their objective to maintain gross foreign assets at about 2.5 months of imports in the medium term.

The Kenyan representatives said that the large fluctuation in the exchange rate of major international currencies which had taken place in 1984 and in 1985 had made it difficult to implement a flexible exchange rate policy. They felt that frequent movements of the exchange rate--some of which would be offsetting previous actions--added confusion to the trade decisions of the private sector. Consequently, the authorities tried to interject an element of stability in making decisions on the exchange rate. In 1985 exchange rate decisions were also affected by the need for minimizing their impact on domestic price pressures in order to reduce wage demands resulting in some delay in effecting needed changes. Thus for a period of time the real effective exchange rate of the Kenyan shilling appreciated above the target established after the last major devaluation of the shilling in December 1982. However, the target had been regained by the end of July 1985. They stressed that the fact that the exchange rate had appreciated for a period of time did not reflect a change in the Government's commitment to a flexible exchange rate policy, but only some practical difficulties in implementing the policy.

The index being used for the effective exchange rate calculation contains a higher weight for the U.S. dollar than suggested by trade flows. The Kenyan representatives said that this had been done to take account of the dollar's predominance as a form of payment. However, since December 1982, they also tracked other indexes which gave the dollar a lower weight. By and large, all the indexes moved in a similar fashion, and therefore they did not feel it was necessary to change the weighting of their main index. In their view the recent growth of non-traditional exports also reflected an adequate level of competitiveness. Export profitability was also evident from the very rapid growth of tea exports. The decline in 1984 was due to the drought impact on output. The Kenyan representativers pointed out that the prices paid to producers reflected export prices and that care was being taken to improve the timeliness of payments.

4. Medium-term outlook

The medium-term outlook for Kenya's balance of payments (Table 8) remains broadly the same as that presented to the Board in EBS/84/261, if Kenya continues to adhere to the policies and objectives supported by the current stand-by arrangement. This will critically involve the mobilization of additional domestic resources for development purposes. In this regard a further adjustment in the overall budgetary deficit to

Table 8. Kenya: Medium-Term Balance of Payments Projections, 1984-1989 1/

	1984	1985	1986	1987	1988	1989
			(In millions of SDRs)			
A. Exports, f.o.b.	1,009	981	1,080	1,168	1,279	1,410
Coffee	276	258	274	295	317	341
Tea	256	195	214	241	272	307
Oil products	150	148	148	157	167	177
Other	327	380	442	475	523	585
B. Imports, c.i.f.	-1,511	-1,555	-1,702	-1,810	-1,888	-2,033
Government	-160	-201	-126	-217	-125	-132
Food	(-76)	(-110)	(-21)	(-11)	(-12)	(-13)
Other	(-84)	(-91)	(-105)	(-206) 2/	(-113)	(-119)
Oil	-464	-459	-461	-489	-524	-561
Other	-887	-895	-1,115 3/	-1,104	-1,239	-1,340
C. Trade balance (A+B)	-502	-574	-622	-642	-609	-623
D. Services (net)	184	167	162	185	199	230
E. Private transfers	4	4	4	4	5	5
F. Official transfers	140	126	80	86	94	104
G. Current account (C+D+E+F)	-174	-277	-376	-367	-311	-284
H. Capital account	219	177	401	414	346	374
Long-term (net) 4/	248	160	342	364	296	324
Official	(159)	(39)	(217) 5/	(234) 6/	(154)	(174)
Private	(89)	(121)	(125)	(130)	(142)	(150)
Short-term (net)	-29	17	59	50	50	50
I. Overall balance (G+H)	45	-100	25	47	35	90
J. Financing	-45	100	-25	-47	-35	-90
Gross reserves	-37	58	15	-15	-27	-35
IMF (net)	-11	43	-90	-84	-72	-94
Other assets (net)	3	-1	--	--	--	--
To be secured	--	--	50	52	61	39
Memorandum items:						
Gross reserves (end of period)	416	358	343	358	385	420
Gross reserves (in months of imports)	3.3	2.8	2.6 7/	2.5 8/	2.4	2.5
			(In percent of GDP)			
Current account deficit						
Including official grants	3.0	4.5	5.5 9/	4.9 10/	3.7	3.1
Excluding official grants	5.4	6.5	6.7	6.0	4.8	4.2
Official net capital inflow plus official grants	4.0	2.7	4.2	4.2	3.0	3.0

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

1/ Projections based on price and volume assumptions contained in Table 6.
2/ Includes purchase of naval boats, equivalent to SDR 100 million.
3/ Includes purchase of two airplanes, equivalent to SDR 135 million.
4/ It has been assumed that long-term net inflows between 1986 and 1989 will be the equivalent of around 3.5 percent of GDP, of which between 1.5-2.0 percent will comprise net borrowing by the official sector.
5/ Includes a loan of SDR 105 million to finance special import described in footnote 3 and SDR 50 million of commercial borrowing for budget.
6/ Includes a loan of SDR 85 million to finance special import described in footnote 2.
7/ Calculation based on imports excluding airplane purchases.
8/ Calculation based on imports excluding naval boat purchases.
9/ Deficit equivalent to 3.5 percent of GDP, excluding airplane purchases.
10/ Deficit equivalent to 3.5 percent of GDP, excluding naval boat purchases.

under 4 percent of GDP will be necessary, unless a greater flow of concessionary foreign resources than presently estimated in the balance of payments projections become available. The maintenance of real positive interest rates would also be necessary to generate additional financial savings and provide the resources for the higher level of investment in the private sector which would be necessary to generate increases in real per capita income. The continued strengthening of demand management policies, as detailed above, will be important in gradually reducing price pressures and setting the stage for more rapid noninflationary growth. The maintenance of incentives in the agriculture sector will continue to play a key role. Further, liberalization of import restrictions, which provide undue protection in the industrial sector, will give an impetus for export sales. Export growth is expected to average 10 percent a year in value terms between 1985 and 1990 or 5 percent in volume terms (Table 9). This projection is based on the conservative assumption that increases in Kenya's coffee quota under the ICO agreement will constrain the increase in export shipments to less than 2.5 percent per year, even though Kenya has the capacity to export coffee at a rate well in excess of this. Tea exports are expected to grow by around 7.5 percent per year in real terms, although because of the considerable new planting that has taken place in recent years, shipments could grow by as much as 10 percent per year.

Kenya's import bill will be inflated in 1986 by the purchase of two airplanes at a cost of SDR 135 million and again in 1987 by the purchase of naval boats at a cost of SDR 100 million; these imports, which are largely being financed by credit, had not been built into the previous projections and largely explain the differences in the present estimates for imports and the current account deficits from the earlier figures. Other non-oil imports, except those by the Government, are projected to rise at the same rate as GDP between 1985 and 1990. It has been assumed that the terms of trade will remain virtually unchanged through the medium term.

The surplus on services account is projected to decline slightly from just under 3 percent of GDP in 1985 to 2.5 percent by 1989; earnings derived from continued growth in the tourism sector should be offset by the increased interest cost of servicing Kenya's external debt. Official transfers are expected to remain at around 1 percent of GDP through the medium term, a little below the average of 1.5 percent of GDP during the period 1978-83 and well below the drought-related level of over 2 percent of GDP in 1984-85.

The current account deficit is projected to decline from 4.5 percent of GDP in 1985 to 3.1 percent by 1989. In the interim, however, it will be affected by the previously described special import purchases in 1986 and 1987. It has been assumed that the medium-term current account deficits will be financed by long-term net capital inflow equivalent to around 3.5 percent of GDP. This compares with an average

Table 9. Kenya: Export and Import Assumptions for Medium-Term Balance of Payments Projections, 1984-89

	Average Percentage Change Over Previous Year							
	1984	1985	1986	1987-89	1984	1985	1986	1987-89
	(Prices in SDRs) 1/				(Volumes)			
Exports	15.7	-9.2	3.7	5.0	0.8	5.9	4.2	4.7
Coffee	15.4	-7.6	4.0	5.0	7.1	1.2	2.1	2.4
Tea	62.4	-39.7	2.0	5.0	-8.7	26.3	7.6	7.5
Oil products	0.9	-2.3	--	5.0	14.2	1.0	--	1.1
Other	-0.3	2.8	5.0	5.0	-2.7	13.0	5.8	6.2
Imports 2/	-0.9	2.2	3.5	5.0	15.2	0.7	-3.9	4.3
Government	-0.6	6.6	5.0	5.0	49.0	17.8	-40.3	-3.3
Oil	-0.1	-2.3	--	5.0	-1.0	1.3	0.4	1.7
Other	-1.7	3.6	5.0	5.0	19.6	-2.6	2.2	6.4
GDP	6.3	2.5	5.0	5.0	0.5	3.8	4.8	5.5

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

1/ U.S. dollar/SDR rate assumed unchanged from June 1985 level.
2/ Calculations exclude special imports referred to in footnotes 2 and 3 of Table 5.

level of net borrowing, excluding Eurocurrency loans, of 5.3 percent of GDP between 1978 and 1983. After providing for repurchases to the Fund and for an accumulation of reserves necessary to maintain a reserve level equivalent to 2.5 months of imports, there will remain a financing need of about SDR 50-60 million in 1986-88 and SDR 40 million in 1989.

The staff regard the medium-term balance of payments position as viable and sustainable. No difficulties are envisaged in meeting the financing gap largely because of the highly conservative assumptions that have been made with regard to the "normal" (above-the-line) capital flows, and the projections do not take into account additional capital flows that may emerge to support the development program. The current account deficits projected through the medium term are consistent with the maintenance of an adequate level of reserves and an expansion of imports that is commensurate with GDP growth of 5 percent per annum. The current account profile is also consistent with reductions in the debt service ratio from 30 percent in 1985 to 20 percent in 1990 and the interest payments ratio from 10 percent to 8 percent. These calculations are based on the cautious assumption that all borrowing to meet the financing gap is undertaken on commercial terms. The bulk of the two special import purchases will be financed through commercial borrowing already arranged.

Table 10 illustrates the impact on key economic indicators of changes in the assumptions used in the medium-term projections. They should of course be interpreted with a great deal of caution since they have been derived within a partial equilibrium framework. For example, in modifying the GDP growth assumption, the exercise does not take into account the budgetary impact and the resulting feedback effects on the external sector. The staff do, however, regard the exercise as worthwhile, since it shows broadly the degree to which the medium-term balance of payments projections are sensitive to changes in the underlying assumptions used.

Lowering the projected rate of real GDP growth by 1.5 percent to 3.5 percent a year over the medium term has little positive impact on the current account deficit relative to GDP, partly because of interest payments on additional foreign borrowing. However, it would result in lower demand for money growth and therefore an unchanged domestic credit expansion would place greater pressure on the overall balance of payments. To maintain the gross reserve target and provide for repurchases to the Fund, there would have to be less recourse to domestic bank credit and additional external borrowing. As a consequence, the financing gap would increase, and the debt service burden and the stock of debt relative to GDP would rise.

Because about 85 percent of Kenya's external debt has been contracted on fixed rates, movements in foreign interest rates have only a minimal impact on Kenya's debt service burden. The staff estimate that for the debt service ratio to decline by one percentage point, commercial interest rates would have to fall by 4 percentage points.

Table 10. Kenya: Effect of Key Parameter Changes on Medium-Term Balance of Payments Projections

Assumptions modified	Change in 1989 in:			
	Current account (in percentage points of GDP)	Financing gap (in millions of SDRs)	Debt service ratio (in percentage points)	Long-term debt (in percentage points of GDP)
1. Real GDP growth: lowered from 5.0 percent to 3.5 percent a year, 1986-89 1/	-0.3	72	5.7	5.0
2. Export volume growth: lowered from 4.6 percent to 2 percent a year, 1986-89 2/	-1.7	135	2.6	2.1
3. Long-term net capital inflow: raised from 3 1/2 percent of GDP to 5 percent of GDP, 1986-89	-2.1	Eliminated	0.6 3/	3.9
4. Financing gap: covered through official grants and/or import compression rather than commercial borrowing	0.6	Eliminated	-0.7 3/	-2.0

Source: Staff calculations.

1/ Assumed that export growth and import growth of non-oil, nongovernment imports are reduced proportionally.
2/ Assumed that real GDP remains unchanged.
3/ Impact on debt service payments restricted to interest costs; it has been assumed that the grace period on new borrowing extends beyond 1989.

IV. Staff Appraisal

Through a combination of judicious planning and increased assistance from abroad, the Government of Kenya has been able to avert successfully a major crisis arising from the severe drought which affected the country in 1984. Substantial quantities of grain were imported and distributed on a timely basis. The support of donors was crucial in lessening the impact of the crisis on the balance of payments. The improved weather conditions have brought considerable relief, including a possible bumper grain crop in 1985, and lessened the impact of the drought on economic growth. A cautious domestic financial policy stance, which necessitated a major reordering of domestic priorities and budgetary expenditures, permitted the Government to meet the challenge without endangering the substantial progress recorded since 1981 in stabilizing the economy. Kenya has met the targets and performance criteria established under the current program supported by the Fund. Budgetary operations were limited to an overall deficit of 5.0 percent of GDP in 1984/85, below the target in the current program, and domestic bank financing was held below the program ceiling, freeing some bank resources for the private sector. Public enterprises reduced their credit use during the fiscal year. To achieve this outcome, the Government adjusted expenditures during the year to offset a shortfall of domestic revenues and foreign grants. The successful outcome is owed considerably to the Government's ability to continually review economic trends and adjust policy accordingly. Price developments, however, have not been as favorable, as initially projected.

The authorities have rightly begun reorienting their efforts to rebuild the country's development program, including the revision of the current Five-Year Development Plan. Their concern with the lagging trend in economic growth in the present decade is shared by the staff. Kenya should be encouraged to move quickly and forcibly to tackle the remaining structural constraints to development. In this context, the World Bank is engaged in active discussions with the authorities on various sectoral loans which will be addressing those structural constraints in respective sectors. The current Five-Year Development Plan has been viewed as an adequate and comprehensive method of meeting this objective. Increased donor support would greatly facilitate the implementation of a revised plan.

Since 1980/81 Kenya has successfully implemented a major stabilization effort. Prior to the recent drought the external disequilibrium had been reduced to a level which was sustainable in the medium term. In the balance of payments, the current account deficit had been reduced to about 3 percent of GDP and overall balance of payments surpluses were generated in 1983 and 1984. While the budgetary deficit had been reduced to about 4 percent of GDP and the overall domestic credit expansion to about 12 percent of the initial money stock, given the expected foreign financing of the budget, the level of the overall deficit still required some additional adjustment, if the credit needs of the private sector were to be met in an noninflationary manner. The budgetary adjustment attained so far required a substantial reduction of government expenditure, particularly in the development program, and a tight incomes policy. The fall in per capita income, which occurred during this period, affected living standards negatively. Considerable political courage was needed to persevere with the stabilization program under these circumstances. It must be recognized that the progress gained remains fragile, and without reinforcement it can be reversed in a short period of time. Therefore, there is a continuing need for cautious domestic financial policies.

The rationalization objective included in the current budget appears to be a necessary element in improving the quality of Kenya's development effort. It will improve the allocation of resources, raise the efficiency of government operations, and improve the prospects for economic growth. However, the program cannot be successfully implemented without donor support. There are many projects with donor financing whose priority has been considerably reduced. Donors could play a major role in the rationalization process by permitting the transfer of already committed resources to higher priority programs, including for maintenance expenditures. In this exercise the authorities themselves should be prepared to discontinue projects which, for political reasons, have been approved and are being implemented, but which from an economic point of view do not have the appropriate priority.

The fiscal program for 1985/86 is a transitional step from the drought difficulties suffered in the previous fiscal year. Its successful implementation will require very careful monitoring by the authorities and the willingness to adopt timely measures, if they prove necessary. A larger revenue effort in the 1985/86 budget involving less tax reductions would have made the implementation easier. The staff endorse the authorities' objective of reducing the overall deficit and the domestic financing requirement further. In addition, as grants are likely to fall from their present high level, revenue measures will be necessary in 1986/87. The accumulation of the strategic grain reserve is based on a financing plan which requires careful monitoring and is based on the timely implementation of agreed upon measures. The recent increase in consumer grain prices was an important initial step.

The recent proposals to amend the Banking Act are an important first step in improving the efficiency of the financial system and assuring a more sound financial structure. However, additional measures are likely to be needed, as the discrepancy in regulations between banks and nonbanks has not yet been resolved adequately and there is a need for a more competitive means for the setting of interest rates. Meanwhile, care needs to be taken to maintain deposit rates at positive real levels.

The medium-term outlook for the balance of payments remains viable to the extent that domestic financial policies are not allowed to get out of line, and a truly flexible exchange rate policy is implemented.

However, if donors do not respond positively and quickly to Kenya's effort to rationalize its Development Plan, there is also the likelihood that Kenya may need to undertake some commercial borrowing. In this regard, the recent large purchases undertaken by Kenya with commercial borrowing can only be viewed with concern. Kenya can only maintain its prudent record in debt management, by the more careful review of borrowing decisions.

Over the last two years the Government has moved steadily to liberalize the import system. The measures put into place in June 1985 are a continuation of this process. The Government remains committed to this process and it should be encouraged to continue implementation of the present system liberally and to carry out additional liberalizations in the near future, through substantive actions which would reduce the coverage of schedule 2B in order to improve the export orientation of industry. In this regard, continued emphasis needs to be put on the integration of external policies, so as to allow for continued liberalization in the context of a flexible exchange rate policy, which will maintain the competitive position achieved in the export sector. The staff welcome the progress made so far in liberalizing invisible payments, which has normalized the payment of dividends and profits. Kenya maintains restrictions on the availability of foreign exchange for certain categories of imports and rental income that are subject to Fund approval under Article VIII. The staff note the authorities' intention to remove these restrictions and encourages them to make early progress towards this end. In the meantime, the staff recommend that the Executive Board grant approval for the retention of the exchange restrictions.

It is expected that the next consultation discussions will take place on the basis of a 12-month cycle.

V. Proposed Decisions

The following draft decisions are proposed for adoption by the Executive Board:

1985 Consultation

1. The Fund takes this decision relating to Kenya's exchange measures subject to Article VIII, Section 2 and in concluding the 1985 Article XIV consultation with Kenya, in the light of the 1985 Article IV consultation with Kenya, conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (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, arising from limitations on foreign exchange for certain imports and rental income remittances. In the circumstances of Kenya, the Fund grants approval for their retention until October 31, 1986, or the next Article IV consultation with Kenya, whichever earlier.

Review Under Stand-By Arrangement

1. Kenya has consulted with the Fund in accordance with paragraph 4 of the stand-by arrangement for Kenya (EBS/84/261, Supplement 2, 1/10/85) and paragraph 19 of the letter of the Minister of Finance and the Governor of the Central Bank of Kenya dated November 21, 1984 annexed thereto, in order to review policies and establish performance criteria for the remaining period of the arrangement.

2. The letter dated September 6, 1985 from the Minister of Finance and the Governor of the Central Bank of Kenya shall be annexed to the stand-by

arrangement for Kenya and the letter of November 21, 1984, shall read as supplemented by the letter of September 6, 1985.

3. Accordingly, and pursuant to decision No. 7918-(85/26) of February 20, 1985 on overdue payments to the Fund, the stand-by arrangement for Kenya shall be replaced by the revised arrangement in Attachment IV of EBS/85/217.

KENYA - Basic Data

Area, population, and GDP per capita

Area	580,000 square kilometers
Population: Total (1984)	19.5 million
Growth rate	3.8 per cent
GDP per capita (1984)	SDR 289

GDP (at 1982 market prices)	1980	1981	1982	1983	1984	1985 Proj.
Total (in billions of Kenya shillings)	64.4	67.0	67.5	70.1	70.5	73.2
Agriculture (percent of total)	26	27	27	27	26	26
Manufacturing (percent of total)	12	11	11	11	11	11
Government (percent of total)	13	13	13	13	13	14
Annual real rate of growth (percent)	4.8	4.1	0.8	3.9	0.5	3.8
Investment as percent of GDP (at current market prices)	30	28	23	21	22	22
Prices (percent change)						
GDP deflator	11	10	11	10	10	11
Cost-of-living index (annual average)	13	12	22	12	10	13
Cost-of-living index (end of period)	13	20	14	10	11	12

	1980/81	1981/82	1982/83	1983/84	1984/85 Prelim. actual	1985/86 Revised budget
Central government finance 1/	(In billions of Kenya shillings)					
Total revenue	14.3	15.7	16.8	18.6	20.4	21.9
Foreign grants	0.5	0.9	1.1	1.0	1.6	2.1
Total expenditure	19.7	21.4	20.6	23.4	25.8	28.0
Recurrent	14.0	15.0	16.2	17.1	19.1	20.7
Development	5.7	6.4	4.5	6.2	6.6	7.3
Adjustment	-0.4	0.5	0.5	0.3	-0.9	--
Overall deficit (-)	-5.4	-4.3	-2.2	-3.4	-4.7	-4.1

1/ Fiscal year July 1-June 30.

KENYA - Basic Data (continued)

Central government finance (continued)	1980/81	1981/82	1982/83	1983/84	1984/85 Prelim. actual	1985/86 Budget
Foreign financing (net)	2.8	1.1	1.2	0.7	0.9	0.7
Domestic borrowing (net)	2.6	3.2	1.0	2.7	3.8	3.4
Of which: from banking system	(1.6)	(1.7)	(-0.1)	(0.7)	(1.0)	(1.5)

	1980	1981	1982	1983	1984	1985
Money and credit			(Percent change)			
Domestic credit	13	25	29	0	11	14
Government	10	79	62	-19	11	11
Private sector	20	11	10	7	11	14
Money and quasi-money	3	13	14	7	13	11

	1980	1981	1982	1983 Prel.	1984 Est.	1985 Proj.
Balance of payments			(In millions of SDRs)			
Exports, f.o.b.	969	915	846	865	1,009	981
Imports, c.i.f.	-2,059	-1,850	-1,559	1,306	1,511	-1,555
Trade balance	-1,090	-935	-713	-441	-502	-574
Services and private transfers (net)	317	263	211	203	188	171
Official transfers (net)	92	66	70	113	140	126
Current account balance	-681	-606	-432	-125	-174	-277
Capital account (net)	531	401	282	214	219	177
Official	317	210	145	130	151	39
Private	214	191	137	84	110	138
Of which: long-term	(84)	(137)	(107)	(82)	(89)	(121)
Allocation of SDRs	7	7	--	--	--	--
Overall surplus or deficit (-)	-143	-198	-150	89	45	-100
Current account deficit as percent of GDP						
Including grants	-12.5	-11.1	-7.7	-2.3	-3.0	-4.5
Excluding grants	-14.2	-12.3	-8.9	-4.4	-5.4	-6.5
Gross official foreign reserves (end of period)	392	215	210	379	416	358
In weeks of imports	10	6	7	15	14	12

KENYA - Basic Data (concluded)

	1980	1981	1982	1983	1984 Prel.	1985 Proj.
External public debt	(In millions of SDRs)					
Disbursed and outstanding (end of period)	1,964	2,221	2,510	2,725	2,826	2,910
Debt service as percent of exports of goods and nonfactor services						
Excluding the Fund	12	17	21	23	22	24
Including the Fund	13	18	24	28	28	31

Kenya: Relations with the Fund

(As of August 31, 1985)

I. Membership Status:

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

A. Financial Relations

II. General Department

(a) Quota		SDR 142.0 million
(b) Total Fund holdings of Kenya's currency		SDR 539.21 million (379.73 percent of quota)
(c) Fund holdings of Kenya's currency subject to repurchase		SDR 409.39 million (288.30 percent of quota)
Of which:	credit tranche	SDR 82.72 million (58.25 percent of quota)
	SFF	SDR 74.54 million (52.49 percent of quota)
	E.A.R.	SDR 191.76 million (135.04 percent of quota)
	C.F.F.-C.	SDR 60.38 million (42.52 percent of quota)

III. Current or previous stand-by arrangements and special facilities

(a) Current stand-by arrangement: became effective for 12 months on February 8, 1985 in the amount of SDR 85.2 million.

(b) Previous arrangements:

1 extended arrangement approved in July 1975, and
5 stand-by arrangements approved, respectively, in November 1978, August 1979, October 1980, January 1982, and March 1983.
Amounts range from SDR 17.25 million to SDR 241.50 million.

Kenya: Relations with the Fund (continued)

(c) Special facilities approved included oil facility, Trust Fund loans, SFF subsidy account and compensatory financing facilities for export shortfalls and cereal imports.

IV. SDR Department

(a) Net cumulative allocation - SDR 36.99 million
(b) Holdings: amount to SDR 1.5 million or 4.06 percent of net cumulative allocation.

V. Administered Accounts

(a) Trust Fund loans:

(i) Disbursed - SDR 46.91 million
(ii) Outstanding - SDR 33.74 million

(b) SFF Subsidy Account:

(i) Payments by Fund - SDR 8.35 million

VI. Overdue Obligations to the Fund: none

B. Nonfinancial Relations

VII. Exchange system: Pegged to the SDR at K Sh 17.74 = 1 SDR (since August 16, 1985), with margins of 2.25 percent of the rate.

Intervention currency and rate - U.S. dollar
K Sh 17.09 = US$1.

VIII. Last Article IV Consultation

Article IV consultation, January-February 1984 (EBS/84/79) discussed by the Executive Board on May 16, 1984 - (EBM/84/78). The following decisions were adopted:

1984 Consultation

1. The Fund takes this decision relating to Kenya's exchange measures subject to Article VIII, Section 2, and in concluding the 1984 Article XIV consultation with Kenya, in the light of the 1984 consultation with Kenya, conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

Kenya: Relations with the Fund (concluded)

2. Kenya maintains restrictions on payments and transfers for current international transactions subject to approval under Article VIII, Section 2, arising from limitations on foreign exchange for certain imports, and for dividend and rental income remittances. In the circumstances of Kenya, the Fund grants approval for their retention until March 31, 1985, or the next Article IV consultation with Kenya, whichever is the earliest.

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

IX. Technical Assistance

CBD: One expert assigned to Central Bank of Kenya.
Technical assistance missions on Kenya Financial System (March and May-June 1984).

FAD: Technical assistance in fiscal field (1981).

Relations with the World Bank Group

The World Bank has a large ongoing program in Kenya. As of March 31, 1985 it had committed almost SDR 1.8 billion, of which SDR 1,177 million had been fully disbursed.

1. Agriculture

As the dominant sector in the Kenyan economy, agriculture has received about 17 percent of all World Bank group lending and is expected to obtain an even larger share of proposed lending by the Bank (Table I). The main existing projects relate to the extension of development activities to smallholders in the Rift Valley and Coast Province; rural health and family planning; the rehabilitation and expansion of sugar factories and improvement of irrigation and drainage, etc.; and the promotion of institutional strengthening in the areas of financial management, credit training, and data processing of agricultural credit. Proposed projects relate to dairy farming; agricultural research; agricultural training and institutionalization; and parastatal management, private sector marketing and processing.

2. Energy

The Bank's efforts in this sector have thus far concentrated on lessening Kenya's dependence on imported oil and preventing deforestation. The sector has received about 14 percent of the World Bank's total past lending, and the main projects have been the Olkaria Geothermal Power project and petroleum exploration. Proposed energy projects relate to energy management and oil and geothermal exploration.

3. Industry

To date, Kenya's industry has obtained only 4 percent of total World Bank lending. However, it is anticipated to share an increasing amount of the proposed lending. The main existing projects relate to the financing of Kenya's Industrial Development Bank and small scale industry.

4. Transport

In the past, this sector has received close to one fourth of the Bank's total lending. Highway projects and the promotion of railways account for most of the lending.

5. Structural

The World Bank has negotiated and fully disbursed two structural adjustment loans to Kenya. The first one, negotiated in March 1980, was for US$70 million and was fully disbursed by September 1980. The second one, negotiated in July 1982 for SDR 130 million was disbursed in two

Table I. Financial Relations of the World Bank Group with Kenya

(As of March 31, 1985)

Date of Membership: February 3, 1964

Capital subscription: SDR 40.0 million

	World Bank Loans			IDA and Third Window Loans			Total	
	Net committed	Disbursed	Disbursement ratio	Net committed	Disbursed	Disbursement ratio	Committed	Disbursed
Agriculture, livestock, and rural development	151.0	97.5	64.6	207.4	106.1	51.2	358.4	203.6
Population	--	--	--	35.0	17.1	48.9	35.0	17.1
Education	10.0	9.9	99.0	77.7	30.9	39.8	87.7	40.8
Tourism	17.0	13.7	80.6	--	--	--	275.9	161.8
Energy and petroleum exploration	251.4	161.8	64.4	24.5	--	--	275.9	161.8
Industries and development finance institutions	63.2	46.3	73.3	10.0	4.5	45.0	73.2	50.8
Harbours	19.1	19.1	100.0	--	--	--	19.1	19.1
Urban Water Supply	133.3	83.0	62.3	61.0	34.2	56.1	194.3	117.2
Transport	303.8	210.9	69.4	107.1	67.1	62.3	410.9	278.0
Telecommunications	81.1	59.0	72.8	--	--	--	81.1	59.0
Structural adjustment loans	90.9	90.9	100.0	125.0	122.6	98.1	215.9	213.5
Technical assistance	--	--	--	10.5	2.6	24.8	10.5	2.6
Total	1,120.8	792.1	70.7	658.2	385.1	58.5	1,779.0	1,177.2

Repayments	Bank:	97.58	IDA:	6.00	World Bank Group:	103
Debt Outstanding	Bank:	594.30	IDA:	373.11	World Bank Group:	967.
Total undisbursed	Bank:	328.65	IDA:	238.25	World Bank Group:	566.90

IFC operations

Promotion of tourism facilities, capital markets, industrial development (pulp and paper, textiles, cement) and development fianancing. Total net commitments on loans and equity held by IFC amount to US$43.1 million, of which US$36.6 million have been disbursed.

Source: World Bank.

tranches: one in September 1982 and the second in January 1984. The SAL programs have been implemented under adverse external circumstances which negatively affected Kenya's performance. The protracted balance of payments crises of 1981 and 1982, as well as the coup attempt in August 1982, forced adjustments in the Government's policies and led to delays and reversals in policy initiatives included in the SAL programs. The speed of implementation was also affected by a shortage of technical personnel and the preoccupation of the authorities with short-term stabilization efforts. In addition, problems were encountered with the timing of required studies and the role of some technical assistance personnel.

It has been agreed between the Bank and the Government that, for the near future, Bank financial support for the Government's structural adjustment efforts will take the form of sector loans rather than the comprehensive SAL. Sector loans for agriculture, industry, and energy are included in the Bank's future lending program, and are now under preparation. During the past year the Bank staff have been pleased to observe significant progress in a number of areas of the structural adjustment program, including import liberalization; studies to help determine the eventual protective and incentive structure for industry and development of a more effective population program.

The Bank and the Fund share common concerns on the need for Kenya to continue to remove unwarranted import protection through a better integration of tariff and exchange rate policies.

Kenya--Revised Stand-By Arrangement

Attached hereto are a letter dated November 21, 1984, and a supplementary letter dated September 6, 1985, both from the Minister of Finance and the Governor of the Central Bank, requesting a stand-by arrangement and setting forth the objectives and policies which the authories of Kenya intend to pursue for the period of this arrangement.

To support these objectives and policies, the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For the period from February 8, 1985 to February 7, 1986, Kenya will have the right to make purchases from the Fund in an amount equivalent to SDR 85.2 million, subject to paragraphs 2, 3, 4, 5, and 6 below, without further review by the Fund.

2. (a) Purchases under this arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 8.5 million through February 15, 1985, SDR 29.8 million through May 15, 1985, SDR 51.1 million through September 2, 1985, and SDR 68.1 million through December 2, 1985.

(b) None of these limits shall apply to a purchase under the stand-by arrangement that would not increase the Fund's holdings of Kenya's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 percent of quota.

3. Purchases under this arrangement shall be made from ordinary resources and from borrowed resources in the ratio of 1 to 1, provided that any modification by the Fund of the proportions of ordinary and borrowed resources shall apply to amounts that may be purchased after the date of modification.

4. Kenya shall not make purchases under this arrangement that would increase the Fund's holdings of its currency in the credit tranches beyond 25 percent of quota, or increase the Fund holdings of that currency resulting from purchases of borrowed resources beyond 12.5 percent of quota:

(a) during any period in which the data at the end of the preceding period indicate that (i) the limit on net domestic credit of the banking system or (ii) the limit on net credit from the banking system to the Government, described in paragraphs 8 and 9 of the letter of November 21, 1984, and paragraph 11 of the letter of intent of September 6, 1985, is not observed; or

(b) during the entire period of this stand-by arrangement, if Kenya

(i) fails to observe the limit on the contracting of public or publicly guaranteed external debt on commercial terms, described in paragraph 17 of the letter of November 21, 1984, or

(ii) imposes or intensifies restrictions on payments and transfers for current international transactions, or

(iii) introduces or modifies multiple currency practices, or

(iv) concludes bilateral payments agreements which are inconsistent with Article VIII, or

(iv) imposes or intensifies import restrictions for balance of payments reasons.

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

5. Kenya will not make purchases under this stand-by arrangement during any period of the arrangement in which the member has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation pursuant to the Guidelines on Corrective Action in respect of a non-complying purchase.

6. Kenya's right to engage in the transactions covered by this arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Kenya. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 6, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Kenya and understandings have been reached regarding the circumstances in which such purchases can be resumed.

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

8. The value date of a purchase under this stand-by arrangement involving borrowed resources will be determined in accordance with Rule G-4(b) of the Fund's Rules and Regulations. Kenya will consult the Fund on the timing of purchases involving borrowed resources in accordance with Rule G-4(d).

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

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

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

(c) The value date of a repurchase in respect of a purchase financed with borrowed resources under this stand-by arrangement will be normally either the 6th day or the 22nd day of the month, or the next business day if the selected day is not a business day, provided that repurchase will be completed not later than seven years from the date of purchase.

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

12. In accordance with paragraph 20 of the letter of November 21, 1984, Kenya will consult with the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria in paragraph 4 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Kenya has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Kenya's balance of payments policies.

Nairobi, Kenya
September 6, 1985

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

Dear Mr. de Larosière:

1. The arrival of adequate rainfall this year has prevented the 1984 drought from turning into a major national disaster. The Government of Kenya was able to surmount the grave difficulties arising from the drought by moving swiftly in mounting a relief effort and adopting the necessary economic and financial policies which facilitated the purchase and distribution of grains. This limited the drought's effect on economic activity and allowed for the continuing adjustment of the economy. In these endeavors, the Government was greatly assisted by many friendly donors. On the basis of the price incentives established over several years, farmers have responded with renewed energy and a large grain crop is now expected in the current year. The short-term economic outlook has improved considerably, as a result of the favorable developments in weather and farm production.

2. The economic policy objectives for the 1985/86 fiscal year seek to further an increased tempo of economic activity within a framework designed to reach a sustainable balance of payments position in the medium term and help reduce domestic price pressures. The growth of real GDP is estimated to rise to 3.8 percent in 1985 from the drought-reduced level of 0.9 percent in 1984. The drought dislocations and the continued increase in administered prices have led to a temporary strengthening of inflationary pressures, from 10 percent in 1984 to 12 percent in 1985. A fall to about 9 percent is expected in 1986 as the food situation improves. The Government is conscious of the need to provide an environment which will lead to a positive real per capita income growth in the medium term to alleviate unemployment and increase the welfare of the population.

3. Since 1980/81 the Government has made substantial progress in reducing the internal and external imbalances which have encumbered the economy. The overall fiscal deficit was reduced from 9.5 percent of GDP in 1980/81 to 4.2 percent of GDP in 1983/84. Drought relief in 1984/85 resulted in a temporary rise in the deficit to 5.0 percent of GDP, but the underlying deficit (excluding drought-related expenditures) recorded a furhter reduction to 4.1 percent of GDP. The rise in net domestic credit was adjusted downward during this period, while price inflation fell from 22 percent in 1981 to 10 percent in 1984. At the same time, the external current account deficit was reduced from 11 percent of GDP in 1981 to 3 percent of GDP in 1984. Overall balance of payments surpluses were recorded in

1983 and 1984. These developments allowed for a debt service ratio which will decline rapidly after 1985. So far in 1985, all of the performance criteria established under the program have been observed. The adjustment of the economy was difficult to attain because it occurred in a period characterized by a deep and protracted recession in the world economy, considerable exchange rate volatility, excessively high real interest rates, and declining external assistance. The rapid budgetary adjustment impeded the Government's development effort and rapid cutbacks in real expenditure resulted in administrative inefficiencies. The drought emergency added to the difficulties and delayed the redress of the resource allocation problems. Real per capita GDP has fallen since 1980.

4. The outlook during the 1985/86 fiscal year continues to be affected by the drought. Expected revenue yields will be depressed from the losses sustained by the private sector, relief operations are still continuing in some parts of the country pending the harvest, which begins in October, and reconstruction and increased maintenance of some assets, such as irrigation works, is needed. The 1985/86 budget included a reduction in the income tax, which offsets some of the inflationary impact of the last few years on tax brackets, to encourage private sector activity. A reduction in import duties, for the third year in a row, was also implemented to encourage export promotion and reduce domestic industrial protection. Although increases in sales and other taxes and fees were put into effect to recoup the revenue loss of the above measures, total revenue is expected to fall in relation to GDP. However, the thrust of tax policy is likely to help promote a more rapid recovery of the private sector economy, improving revenue yields in the medium term.

5. On the expenditure side, the 1985/86 budget includes a program to rationalize budgetary expenditure and to set the framework for a renewed development effort based on improved resources allocation. This requires an increase in recurrent expenditure to provide for the delayed maintenance of government assets to improve their productivity. These expenditures are foreseen to have an important impact in improving services and the growth performance of the economy. In this regard, a special appeal has been made to donors for assistance in covering the recurrent costs of development programs. Negotiations have begun with the World Bank on a sector loan for budget rationalization. In the development budget, priority has been given to speed up the completion of projects which are in an advanced stage of implementation, cancelling projects with low priority, and limiting the initiation of new projects to those that have a high priority. The process of rationalization will improve the capital output ratio in the public sector, but will need the strong support of donors not only to channel assistance toward recurrent expenditures, but to accept the cancellation or redesign of some of their favored projects.

6. A major statement of economic policy that will incorporate the budget rationalization program to the current five-year development plan and recast the plan's objectives, given the delayed implementation resulting from the drought emergency, is being prepared and will be submitted to Parliament shortly.

7. The magnitude of the costs necessary for the importation and distribution of grains during the drought emergency required the Government to incorporate in the budget the financing of grain importation and drought relief by the National Cereals and Produce Board (NCPB). Some additional outlays will be neccessary in the current fiscal year as the crop will not be harvested until October. The recent drought experience has highlighted the need for a strategic grain reserve. Its accumulation is being facilitated by the expected bumper grain harvest, but will increase NCPB's financial requirements during the fiscal year, with an impact on the budget. A financing requirement of K Sh 1,100 million is projected, after allowing for private sector participation in grain marketing. Consumer grain prices have been increased and will reduce the financing requirement by K Sh 200 million, while the export of the stocks of yellow maize are expected to yield a minimum of K Sh 300 million, leaving a residual of K Sh 600 million, which will be provided by the budget, in keeping with the principle established last year of meeting NCPB's requirements from the budget, other than purely seasonal needs, which are met through a revolving overdraft with the banking system.

8. The 1985/86 revised budget is a transitional budget still reflecting the drought difficulties, as it contains special expenditures related to food security as well as tax measures, aimed at promoting a quicker recovery in the private sector. It includes an allocation for the wage increase recommended by the Public Sector Wage Review Commission. The last wage adjustment was carried out in 1981 and the erosion in pay scales since then has been a grave disincentive in the civil service. The revised budget has been framed on an overall deficit equivalent to 4.1 percent of GDP. Excluding the outlays for the strategic grain reserve, the underlying budgetary deficit would be 3.7 percent of GDP. The target compares to an overall deficit of 5.0 percent of GDP in 1984/85, including drought-relief expenditures, and 4.1 percent of GDP, excluding these outlays, and is facilitated only because of an extraordinarily large inflow of foreign grants, equivalent to 2.1 percent of GDP. This will be the result of the counterpart of donor assistance for drought relief being deposited in the Government's accounts only this fiscal year. This also explains the shortfall in grant receipts in the previous fiscal year. New procedures introduced this year will speed up the payment to the Treasury of resources arising from commodity assistance, providing a one-time gain. Government departments have been advised early that in the current year the supplementary budget will not allow a net increase in expenditure, but only reallocations of expenditure authorizations.

9. The special circumstances faced by the economy since 1983/84 has not permitted the reduction in the overall deficit and particularly the domestic financing component of the budget considered desirable by the Government. The forward budget review to start in November will aim to implement such an adjustment. The Government hopes that the Fund will be able to help in this endeavour. This work is given a high priority because of the difficulties foreseen in maintaining a high level of grants in the future, thus requiring new revenue measures in the 1986/87 budget.

10. Budgetary outlays in terms of GDP will be reduced further in 1985/86, and the rationalization of the development projects will result in a slowdown in the use of previously contracted external loans. The Government is hopeful that during the year some donors will permit the reallocation of their commitments toward recurrent costs or to other projects with a higher priority. This request is already being discussed with donors. At the present time, net foreign borrowing is expected at 0.7 percent of GDP and domestic financing at 3.4 percent, compared to 1 percent of GDP and 4.0 percent, respectively, in the previous year. Any additional concessionary borrowing which may emerge during the fiscal year will be utilized to reduce the amount of external commercial borrowing presently foreseen.

11. Monetary policy in 1985/86 aims to generate an increase in financial savings while providing adequate finance to promote a rise in economic activity by limiting net credit to the Government. Domestic credit and broad money are programmed to expand by less than nominal GDP in order to help reduce inflationary pressures. About 60 percent of the growth in domestic credit will be allocated to the private sector; little growth in credit to public enterprises is expected, as NCPB's financing needs are being met through the budget. Consistent with these objectives, domestic credit which was K Sh 28,113 million on June 30, 1985 will not be allowed to exceed K Sh 31,555 million on September 30, 1985, with an indicative target of K Sh 31,983 million for December 31, 1985. Within these totals, net credit to the Government, net of the deposits with the Treasury of the Cereals and Sugar Finance Corporation (CSFC), which was K Sh 7,278 million on June 30, 1985 will be limited to K Sh 9,625 million on September 30, 1985 with an indicative target of K Sh 9,480 million for December 31, 1985. Interest rates are being kept under review to assure that they remain positive in real terms when compared to the underlying rate of inflation.

12. The current account deficit of the balance of payments is presently projected at 4.5 percent of GDP for 1985 and 5.5 percent for 1986 (3.5 percent, excluding the purchase of airplanes). A further reduction is expected in the medium term. For 1985, a balance of payments deficit of SDR 100 million is presently projected and is fully financed. In order to meet the Government's objective of rebuilding the net reserve position of the banking system in 1986, additional financing presently foreseen at

about SDR 60 million will need to be arranged in 1986. The Government also hopes that a new arrangement from the Fund can be put in place during 1986. The additional financing for 1986 now foreseen is smaller than what was projected when the current program was negotiated, despite the budget rationalization.

13. With the 1985/86 budget, the import system was liberalized further, 317 items (12 percent of all items) were transferred to schedule 1A (freely importable items). After this adjustment, schedule 1 accounts for 42 percent of all items, schedule 1B (liberally licensed items) for a further 23 percent, while schedule 2AS (items freely licensed once approved by supervising agencies, i.e., mainly petroleum products and fertilizers), has 3 percent of items. Thus, 68 percent of items are liberally licensed, while the restricted category only retains 32 percent of items. A further liberalization of the import system through additional shifts of items is expected in 1986. Meanwhile, the implementation of the system will continue in a liberal manner, as characterized in recent years.

14. The Government gives a high priority to the maintenance of an adequate exchange rate, through a flexible exchange rate policy. Actions in July and August have reduced the real effective exchange rate to below the target level of December 1982.

15. In 1985, Kenya's debt service ratio (including IMF) is estimated at 30 percent of exports of goods and services. The ratio is projected to fall rapidly during the rest of the decade, including the debt service arising from the financing of the projected current account deficit. The Government gives high priority at maintaining an adequate debt service ratio and will make every effort to remain in compliance with the limits established in the program for the contracting of public and publicly-guaranteed external debt.

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

Yours sincerely,

/s/

P. Ndegwa
Governor of the Central
Bank of Kenya

/s/

Professor George Saitoti
Minister of Finance