NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/154

10:00 a.m., October 21, 1985

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	A. R. Ismael
	M. Lundsager, Temporary
	H. G. Schneider
	S. de Forges
	A. H. Mustafa, Temporary
H. Fujino	
	B. Goos
J. E. Ismael	
	L. Leonard
	G. D. Hodgson, Temporary
	G. Hospedales, Temporary
T. P. Lankester	
H. Lundstrom	
	A. Abdallah
	B. Jensen
	J. E. Suraisry
	J. E. Rodríguez, Temporary
	J. de Beaufort Wijnholds
C. R. Rye	
	H. Alaoui-Abdallaoui, Temporary
A. K. Sengupta	
	I. Angeloni, Temporary
Zhang Z.	Jiang H.

L. Van Houtven, Secretary
B. W. A. Ames, Assistant

Also Present

IBRD: A. Kingsley, Eastern and Southern Africa Regional Office. African Department: A. D. Ouattara, Director; R. J. Bhatia, Deputy Director; J. Artus, N. Calika, A. G. A. Faria, W. Huyser, J. M. Jiménez, D. J. Scheuer, J. D. Simpson, G. B. Taplin. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; M. Nowak. Fiscal Affairs Department: W. R. Mahler. IMF Institute: A. J. Okoth, Participant. Legal Department: Ph. Lachman. Research Department: D. Andrews. Secretary's Department: A. P. Bhagwat. Personal Assistants to the Managing Director: R. M. G. Brown, S. P. Collins. Advisors to Executive Directors: S. M. Hassan, G. W. K. Pickering. Assistants to Executive Directors: W.-R. Bengs, M. B. Chatah, S. Geadah, V. Govindarajan, L. Hubloue, O. Isleifsson, J. M. Jones, S. King, H. Kobayashi, J. Reddy, V. Rousset, C. A. Salinas, M. Sarenac, A. A. Scholten, B. D. White.

1. REPORT BY MANAGING DIRECTOR

The Chairman remarked that following the Annual Meeting, he had traveled to Paris where he had met various people in the official and banking communities. Those meetings had enhanced his understanding of how the European banks saw the debt situation and had followed up developments at the Annual Meeting, particularly the U.S. debt initiative. On the whole, the reaction of European bankers to the debt initiative had been positive and cooperative, although a great deal of uncertainty existed as to the modalities. It would be vital for the banks to overcome their hesitation to contribute to the formulation and development of simple working procedures, which might be different from those followed in the past. For its part, the staff had begun to work hard, in close liaison with the staff of the World Bank as well as with Executive Directors, in order to make progress on the issue.

2. KENYA - 1985 ARTICLE IV CONSULTATION AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1985 Article IV consultation with Kenya and review under the stand-by arrangement (EBS/85/217, 9/13/85; and Cor. 1, 9/27/85). They also had before them a report on recent economic developments in Kenya (SM/85/260, 9/24/85).

Mr. Abdallah made the following statement:

> The hallmark of economic management in Kenya in the past few years has been the Government's enduring commitment to the adjustment process, and last year was no exception. The Board will note that the program agreed with the Fund in connection with the present stand-by arrangement remains on track and that all quantitative performance criteria for the first and second quarters of 1985 were met. This has been made possible in large part by the flexible manner in which adjustment policies have been implemented, enabling the authorities to respond quickly to unforeseen circumstances.
>
> The burden of adjustment has been heavy, with the economy having to cope with external shocks generated by the recession in the early years of this decade and, more recently, with the disastrous effects of a most severe drought that afflicted the country in 1984. Despite these unfavorable developments, my authorities are pleased that their stabilization measures, which were undertaken with active international support, have produced visible progress on a number of fronts, notably with respect to the strengthening of the Government's financial position and the reduction of inflation. The budget deficit in 1985, estimated at the equivalent of 5 percent of GDP, is about one half of the level of 1981, and the inflation rate is about 8 percentage points lower. Kenya's external payments position has also

improved considerably. Prior to the drought, the current account deficit had been reduced to the equivalent of 3 percent of GDP from about 11 percent in 1981, and overall balance of payments surpluses were recorded in 1983 and 1984. Gross reserves are expected to be equivalent to almost three months of imports at the end of 1985, compared with one and a half months in 1981/82.

The economy virtually stagnated in 1984 after growing by almost 4 percent in 1983. The main reason was the severe drought. In 1982 the rate of growth was also low, and the average rate of growth during the last three years was only 1.7 percent, which translates into a drop in per capita income given the high rate of Kenya's population increase. This explains why the Government attaches priority to the implementation of policies aimed at promoting more rational and efficient use of resources with a view to attaining higher rates of growth.

Preliminary data indicate that the economy will recover in 1985. The growth of real GDP is projected at 3.8 percent, similar to the rate of increase of the population. Agriculture is expected to be the main engine of growth in the wake of improved weather conditions. The outlook for the manufacturing sector is also good, based on, among other things, the expansion of regional markets, the increased supply of agricultural inputs, and the likelihood of an expansion in the demand for manufactured goods as agricultural income rises.

Three important factors influenced the framing of the budget for 1985/86. The first was the Government's continuing objective of bringing expenditures down in relation to GDP so as to leave a higher share of domestic savings to the private sector. The second was the urgent need to build up the country's strategic grain reserves and to provide for adequate maintenance of public infrastructure. The third influence was the persistent decline in development outlays which was reflected in falling receipts of foreign aid other than drought relief.

Total expenditure and net lending is expected to increase in 1985/86 by about 15.9 percent, which is about the same rate of increase as projected for nominal GDP. Recurrent expenditures are expected to rise by about 15 percent, mainly on account of increased outlays for maintenance purposes, and development expenditures by 17 percent. Despite the reduction in some import duties in an attempt to stimulate economic growth, the budget deficit is projected to decline from the equivalent of 5 percent of GDP in 1984/85 to about 4 percent in 1985/86. Excluding the nonrecurring allocation for building up the country's strategic grain reserve, the deficit would decline to the equivalent of 3.7 percent of GDP.

A special effort is being made in the current fiscal year to rationalize the Government's investment program so as to maximize benefits to the nation. Resources are being redirected to projects that have already been started and that promise a high rate of return. To be effective, however, this process will need the cooperation of donors who must consent to the transfer of resources that are already committed to certain projects to those that now command higher priority. Some donors have already responded positively with regard to the use of counterpart funds generated from the commodity import program for which my authorities are most grateful.

The strategy for strengthening the Government's financial position continues to involve measures designed to improve the monitoring and control of the public corporations' financial operations. In the past few years there has been a substantial reduction in transfers from the budget. To further improve monitoring procedures, it was announced last June that the Government intends to propose the establishment of an office of Auditor General of Parastatals. Meanwhile, more uniform accounting procedures have been set up including a computerized internal debt reporting system, and steps are being taken to integrate the major public corporations into the forward budget process.

The last three programs show clearly that the authorities are committed to a cautious credit policy. They intend to continue along this path, while making a conscious effort to channel resources to productive investment in the private sector. Domestic financing in 1985/86 is programmed at the equivalent of 3.4 percent of GDP compared with 4.0 percent in 1984/85. Keeping within this ceiling will require a tight control over expenditures, and, accordingly, government agencies have been advised that this year's supplementary budget will not allow for an increase in net expenditure.

Interest rates have remained unchanged during the first part of 1985, ranging from 14 percent to 19 percent on loans and advances and from 11 percent to 14.8 percent on deposit rates. The recent rise in inflation has turned some real deposit rates negative; but this is expected to be a temporary phenomenon, reflecting the sharp decline in the production of food brought about by the drought and the further liberalization of administered prices for a number of consumer goods early in 1985. The rate of inflation is projected to decline next year from 12 percent to about 9 percent which will make all prevailing rates positive again in real terms.

The vulnerability of Kenya's economy to developments in the international economy is evident from the primary character of her exports and the fluctuations that have reflected them both in terms of price and volume. Thus the favorable outlook that

is envisaged for exports up to the end of the decade have properly been made on highly conservative assumptions. The current account deficit is projected to decline from the equivalent of 4.5 percent of GDP in 1985 to 3.1 percent by 1989.

Export earnings in 1985 are projected to be lower than those of last year mainly because of a drop in the price of tea and coffee. Imports are expected to increase slightly after rising by 16 percent in terms of SDRs in 1984. Nevertheless, the real level of imports projected for 1985 is still below the level of 1981. The external current account is expected to deteriorate in 1985, owing mainly to the emergency food imports which had to be made at the beginning of the calendar year, and does not reflect a fundamental change in the country's external payments position.

The Government is moving ahead with its import liberalization scheme, despite the difficult balance of payments situation. At present 42 percent of all items are included in schedule IA, which means that license applications for these commodities are approved automatically. Further action is expected to be taken in this direction in the context of the ongoing effort to make the economy more responsive to market forces. The quickening of the pace of liberalization would be helped considerably by increased financial assistance from donor countries, since the major problem all along has been the constraint imposed by the shortage of foreign exchange. At the same time, the level of tariff protection is being lowered. In the 1985/86 budget, duty has been reduced by an average of 12 percent on items such as raw materials, industrial inputs, and capital goods that had been dutiable at rates in excess of 25 percent. A liberal posture has been taken with regard to transfers for dividends and profits.

The Government will continue to manage the exchange rate in a flexible manner. The recent appreciation of the shilling which occurred from December 1984 has been reversed and the real effective rate is back to what it was in December 1982.

The level of external debt is being monitored carefully and the projected reduction in the rate of growth of external borrowing should help to contain debt service within prudent limits.

Mr. J. E. Ismael commended the Kenyan authorities for their courage and dedication in implementing the stabilization program, as exemplified in their pursuit of a tight incomes policy and their decision to reduce government expenditures, measures which very few countries had been able to implement. All the targets and performance criteria under the current stabilization program had been met. Future success would depend on the

continuation of present policies and on the speed and determination with which the authorities responded to adverse internal and external developments.

He agreed with the staff that the progress attained remained fragile and that the situation could deteriorate further unless policies were reinforced, Mr. Ismael stated. Public sector finances were the major area in which additional policy action was necessary, and in at least four respects. First, the central government budget deficit needed to be reduced to about 4 percent of GDP, as noted by Mr. Abdallah. Second, deficit reduction efforts should focus on expenditure reduction and control. Third, the share of capital programs in the budget should be increased and the quality of public investments should be upgraded. Finally, public enterprises' efficiency should be improved and, in some cases their privatization should be pursued. As noted in the staff report, the Government was proposing to set up an office of Auditor General for Parastatals. It should move swiftly to create such an office and, if requested, the Fund should grant technical assistance to establish an effective system of monitoring and control over the state enterprise sector.

He had some difficulty in understanding the evolution of Kenya's monetary policy and the staff's assessment of it, Mr. Ismael remarked. While domestic credit creation in 1984 and 1985 had been below the progam level, the growth in the money supply had been higher, indicating that monetary conditions had not been as tight as the staff seemed to have suggested. The staff paper stated that private sector credit had been kept well below the program ceiling and that monetary policy had therefore been much tighter than necessary. He did not know the extent to which private sector activities had been constrained by inadequate credit nor whether the staff was advocating some easing in credit. Further comment would be helpful, and he also asked the staff to elaborate on its statement that "credit to the private sector had been difficult to program, because it had been hard to gauge the margin of overperformance by the Government."

The authorities' import liberalization and flexible exchange rate policies were welcome and should be continued, Mr. Ismael stated. The staff projection of a 10 percent annual growth in export values between 1985 and 1990 seemed optimistic and would depend on the maintenance of adequate producer incentives, on an improved agricultural infrastructure, and on a flexible exchange rate policy. As regards the external debt situation, Kenya should increase its domestic savings, reduce its reliance on foreign commercial sources of finance, and gradually decrease its debt service ratio.

Two points needed to be stressed with respect to the design of the Kenyan program, Mr. Ismael considered. First, it was commendable that the program took into account Kenya's special difficulties as a result of drought, allowing for an increase in the overall budget deficit and the external current account deficit. Such understanding and pragmatism was appropriate and should be shown in similar cases. Second, Kenya's next

purchase of SDR 17 million was subject to the end-June performance criteria and to the completion of the present review by the Board. Those criteria had been met but the purchase was being delayed because the review had not been completed. In his view, a member should be allowed to make purchases as soon as the performance criteria had been satisfied; to make purchases subject to the completion of the review process implied that new performance criteria could be introduced at a later stage and introduced a considerable element of uncertainty for the member. He supported the proposed decision and also supported Kenya's intention to make a purchase under the decision on the compensatory finances of export fluctuations in the near future.

Mr. Goos commended the Kenyan authorities for persevering in their adjustment effort under the current Fund program, despite the hardships inflicted by the recent drought and by declining per capita income. That effort, combined with external assistance, had been instrumental in averting a domestic supply crisis while preserving the progress made so far in stabilizing the economy. Despite that excellent performance, the adjustment effort clearly needed to be maintained, and the authorities' commitment in that respect was reassuring. Particular attention would need to be given to agriculture and the budget. Better harvests should improve agricultural supply conditions but the extremely high rate of population growth would require a continued increase in food production. The Government's emphasis on promoting agriculture, therefore, seemed highly appropriate, and the effort should concentrate on the adequate provision of agricultural inputs, on expanding the area under cultivation, which was currently restricted to some 18 percent of arable land, and on increasing producer prices as an incentive for expanded production. The extraordinarily high rate of population growth also constituted an enormous challenge to create sufficient employment opportunities in order to absorb the rapidly expanding labor force. The measures being taken were in the right direction, but he wondered whether they would be sufficient to accommodate the one million people entering the job market each year. He asked the staff for its view, on the issue, including the appropriateness of more direct population control measures.

In mentioning in its assessment that the progress achieved so far remained fragile, the staff was presumably referring to budgetary policy, Mr. Goos remarked. The laudable and successful efforts to contain the budget deficit, under difficult and changing circumstances, seemed to have been unduly biased toward expenditure cuts. The cuts had affected not only the country's growth potential as a result of the sharp curtailment of development outlays but had threatened administrative efficiency. The Government's efforts to rationalize the budget deserved donor support. However, he concurred with the staff that public revenues should be increased in order to consolidate the progress gained and to further reduce the size of the budget deficit. Such a reduction, supported by continued, or even more, decisive progress in the rehabilitation of public enterprises, would help to meet the authorities' stated objective of increasing the share of investment financed by domestic savings, which would ease the pressure on the external accounts. The projected decline

in the gross domestic savings ratio in 1985/86 indicated the need for stronger incentives to private domestic savings. Thus, he endorsed the staff's recommendation that positive real interest rates be maintained.

He encouraged the authorities to continue to liberalize the import system, to maintain an appropriate exchange rate regime, and to reduce existing export subsidies with the aim of securing the efficiency and international competitiveness of domestic production, Mr. Goos stated.

Recalling critical comments on Fund policies made during the Annual Meetings, Mr. Goos considered that contrary to what some Governors had said in their speeches, Kenya's program demonstrated the Fund's ability to respond flexibly to the particular circumstances of a country. Both the overall budget deficit and the current account deficit had been allowed to surpass those of the previous year to allow for the adverse impact of the recent drought. All recent Fund-supported programs in Kenya had made provision for significantly positive rates of real economic growth. Hence, the reproach that the Fund was hostile to growth and unduly dogmatic or inflexible in prescribing adjustment measures seemed to have little justification. He supported the proposed decisions.

The Chairman said that he fully shared Mr. Goos's closing remarks.

Mr. Lundstrom noted that Kenya had met all targets and performance criteria under its current economic program, which was supported by the Fund. The Kenyan authorities had been able to avert a major crisis arising from the drought of 1984 through judicious planning and increased assistance from abroad. In fact, Kenya had been singled out by donors for the timeliness and efficiency with which it had distributed food during the drought.

Important gains had been made under the stabilization program in spite of the difficult economic and political environment, Mr. Lundstrom remarked. Growth rates, however, were unsatisfactory, particularly in the light of Kenya's high rate of population growth. The comparatively high growth of GDP projected for 1985 would merely prevent a further drop in per capita income. Additional comments on that fundamental issue, perhaps by the staff representative from the World Bank, would be helpful.

The current account deficit had been reduced to 3 percent of GDP and the overall balance of payments had recorded a surplus in 1983 and 1984, Mr. Lundstrom observed. The budget deficit had been reduced to about 5 percent of GDP and a continuation of cautious financial policies had been the correct path to follow. In particular, that implied tight expenditure restraint, rationalization of public enterprises, and the ranking of public investment projects according to their yield. He concurred with the staff that the authorities must be prepared to discontinue projects that had been approved for political reasons and were being implemented but did not warrant a high priority from an economic viewpoint.

The Government's commitment to import liberalization was commendable, Mr. Lundstrom stated. Improving the export orientation of industry was of vital importance. The Kenyan authorities should pursue a flexible and competitive exchange rate policy in order to provide export industries with the incentives necessary for sustained growth.

The Kenyan authorities needed to expand their previous efforts to increase the efficiency of the financial system, Mr. Lundstrom indicated. He endorsed the staff's view on the need for positive real interest rates and requested further staff comment on developments in price determination in general.

He welcomed the World Bank's undertaking with respect to sectoral loans in connection with the revised Five-Year Development Plan, Mr. Lundstrom remarked. It was of the greatest importance that the plan prove to be adequate and comprehensive enough to deal successfully with the structural constraints characterizing some sectors of the Kenyan economy. An account of the way the Fund and Bank assessments and programs were coordinated in Kenya would have been of great interest, especially since Kenya was one of the few countries in sub-Saharan Africa that could claim success in its recent economic policies. The desirability of closer Fund-Bank collaboration had been emphasized by the Interim Committee, the Development Committee, and Governors at the Annual Meetings in Seoul. It would seem only natural to incorporate, as a matter of routine, a short paragraph on that issue in staff reports for Article IV consultations, particularly with countries that were potential beneficiaries of Trust Fund reflows. He supported the proposed decisions.

Mr. Hodgson said that he was in agreement that the Kenyan authorities were to be praised for the successful management of the economy during the past year. The recent serious drought could have caused a major setback in the adjustment process and probably would have done so in many other countries. However, the combination of previous planning measures to build up food reserves, timely foreign assistance, and an efficient food distribution system had helped to mitigate the drought's damage. The Government had shown courage and considerable flexibility in reviewing and adjusting economic policy as needed.

With improved weather conditions expected in 1985, growth was likely to be restored and the development momentum regained, Mr. Hodgson remarked. All the performance criteria under the current stand-by arrangement had been met and the financial and incomes policies were realistic. The recovery, however, remained fragile. The authorities should concentrate on structural measures to strengthen the economy's supply capacity to ensure that growth was well founded and that the balance of payments position was sustainable over the medium term.

Fiscal policy continued to be a key element in the current program, Mr. Hodgson believed. He was encouraged that the authorities intended to rationalize government expenditure further to make government operations and the investment program more efficient. Success in reshaping public

investment priorities based on efficiency criteria might well influence donors' decisions to allocate previously committed aid resources. The Central Government's improved control of public enterprises was gratifying, although no significant revenue-increasing measures had been taken in recent years to complement the strong steps to control expenditures, Mr. Hodgson observed. Revenue as a share of GDP had continued to fall, and no new measures were envisaged to replace declining revenues from import duties. A great deal of faith was being placed in a supply-side revenue response to tax reductions contained in the 1985/86 budget. Yet experience with tax cuts elsewhere suggested that such faith might be misplaced and that overall revenue might not increase. Emphasis should be shifted away from further expenditure reduction, especially if maintenance outlays had already been reduced too much, to improving the mobilization of domestic resources and fiscal revenue. He asked for the staff's view on what revenue-enhancing measures might be taken.

Credit growth was well within the program's ceilings and suggested a firm commitment to the adjustment path, Mr. Hodgson commented. However, private sector credit had been relatively restrictive, and although it was difficult to program, the quantitative performance criteria relative to credit expansion should not be met at the expense of the private sector; future adjustments in credit expansion should be directed at the public sector credit, alongside measures to improve revenue. Deposit interest rates should be kept at positive real levels, both to mobilize domestic savings and to attract external resources. Measures to improve the efficiency of the financial system, beginning with the present amendments to the Banking Act, would also be required.

Kenya would continue to be burdened by a heavy debt service over the medium term, Mr. Hodgson commented. A sustained expansion of exports and strong economic growth would be necessary to ease that burden and to eliminate the balance of payments financing gaps. With the terms of trade projected to remain stable over the next decade, it was important that Kenya's competitiveness be maintained. He welcomed the recent reversal in the upward trend in the real value of the shilling, which had restored the target value established at end-1982. The exchange rate should be managed flexibly. The recent increase in the schedule of freely importable items was an important step in the process of import liberalization and should also improve the export orientation of the industry.

The general thrust of the authorities' development plan seemed to be well conceived, Mr. Hodgson suggested. As Mr. Abdallah had emphasized, there was an immediate need to rebuild emergency grain reserves. Once sufficient progress had been made in that respect, the authorities' emphasis on stronger agricultural production, increased self-sufficiency, more efficient and productive investment, and a more externally oriented economy seemed to be well placed. The darkest cloud on the horizon came not from the growth and development plans, but from the extremely rapid rate of population growth which, at 3.8 percent per annum, threatened the gains already attained. He encouraged the authorities to explore and to

use the full range of measures at their disposal to address the problem in concert with the World Bank and other appropriate agencies. He supported the proposed decisions.

Mr. Schneider observed that the stabilization efforts carried out by Kenya since 1980 had been impressive. The Kenyan authorities were to be commended for their continuous implementation of policies that had allowed the country to make considerable progress toward a sustainable balance of payments position.

Political commitment to the adjustment process and the ability to adapt to changing circumstances had allowed Kenya to cope successfully with the recent drought and to avert a major crisis, Mr. Schneider remarked. The authorities' prompt adaptation of financial policies to the precarious situation in 1984 had allowed them to re-emphasize structural reform as soon as the economic situation improved. The removal of the remaining structural constraints to development would be crucial if Kenya were to achieve stable economic growth. The authorities' structural policy targets seemed to be well chosen and had placed emphasis on increased productivity of investment, increased coverage of investment by domestic savings, and the further expansion of agriculture as the leading economic sector. The external situation should be further enhanced by the reallocation of resources in the manufacturing sector, fostered by import liberalization and supported by the adoption of a flexible exchange rate regime. The successful implementation of those structural adjustments would depend on the adoption of cautious and sound financial and external policies and on the provision of appropriate multilateral and bilateral support.

The authorities' fiscal policy was strongly influenced by their efforts to observe the credit ceilings under the stand-by arrangement, Mr. Schneider commented. However, the failure to reconcile the need for fiscal restraint with the need for supply-side adjustments generated by development projects and private initiatives had various drawbacks on which the staff had focused in its discussions with the authorities. The observance of the credit ceilings had sharply curtailed development outlays, leading in turn, to a slowdown in disbursement of previously committed foreign aid and in the negotiation of new aid packages. Credit to the private sector had tended to be tighter than necessary. The Government's intention to improve the situation through a rationalization and a better programming of public expenditures was welcome. However, the staff had suggested that in order to mobilize sufficient resources for development purposes without relaxing budgetary discipline, additional tax revenue might be needed. Therefore, further information on future tax policies would be helpful. The speedy restructuring of public enterprises would probably be an additional way of generating resources for development and for productive purposes, Mr. Schneider believed. More concrete measures should be taken, and he asked whether the World Bank was likely to play a role in that connection.

Improvements of Kenya's domestic financial policies should help to consolidate external adjustment and gradually to diminish the external debt service burden, Mr. Schneider stated. He shared the staff's concerns regarding the recent increase in foreign commercial borrowing as a result of large government borrowing operations over the past months; he hoped that those operations would remain exceptional.

The policies pursued by the Kenyan authorities were broadly in line with the goal of achieving a reasonable growth rate and a viable external situation, Mr. Schneider concluded. The international donor community should therefore be ready to adopt a more positive attitude toward its support of the country's adjustment process. That could be achieved through a prompt response to Kenya's efforts to rationalize its development plan and priorities and through the continuous provision of concessional financial support in appropriate amounts. He supported the proposed decisions.

Mr. Suraisry considered that Kenya had made substantial progress in reducing imbalances and that the program was on track. All performance criteria and targets had been met and real output was expected to increase, thanks to proper policies and a return to normal weather conditions. A continuation of cautious financial policies, a firm tackling of the remaining weaknesses, and additional help from the World Bank were needed to reinforce those achievements and to bolster Kenya's development program.

Specifically, additional efforts were needed in the fiscal area, Mr. Suraisry remarked. The fiscal deficit remained relatively high, despite its reduction. Furthermore, revenue as a share of GDP had declined despite new tax measures. Tax administration therefore needed to be strengthened in order to improve public finances. The planned increase in maintenance expenditures was essential to improve public sector efficiency; in the past, improvements in the country's fiscal position had been achieved primarily by sharply curtailing expenditures, resulting in administrative inefficiencies. If that policy were to be continued, it could have a negative effect on the adjustment process. In reducing the fiscal deficit, it was therefore important to tackle the problem of administrative inefficiencies, and avoid tradeoff with the fiscal deficit. He asked the staff to comment on that point.

The parastatal sector also needed to be strengthened, Mr. Suraisry commented. The decline in budget transfers to public enterprises was a good first step, but there had been no increase in those enterprises' contribution to budget revenues, which suggested that some of the public enterprises needed to be rehabilitated. The authorities recognized the need to improve the efficiency of some of those enterprises, and he encouraged the authorities to pursue reforms to that end; World Bank assistance in that area would be very helpful, and it would also be needed to lessen the severity of structural problems which inhibited

sustainable growth. The successful and early conclusion of the discussions between the authorities and the World Bank on sectoral loans would be of great help to Kenya.

Monetary policy in Kenya had generally supported the adjustment process, although it might have been unduly restrictive, Mr. Suraisry stated. Overperformance by the Government, coupled with credit to the private sector below program ceilings, had unnecessarily restricted credit. Credit to the private sector might need to be more accommodative in view of the expected improvement in the agricultural and manufacturing sectors. However, care would have to be taken not to endanger the fight against inflation.

He commended the authorities for liberalizing foreign trade and payments and welcomed their intention to continue the process, Mr. Suaraisry said. The recent depreciation of the exchange rate seemed to have restored Kenya's external competitiveness, as evidenced by the recent increase in nontraditional exports. The authorities' commitment to a flexible exchange rate strategy was welcome.

The program provided a good basis for tackling Kenya's remaining structural weaknesses, Mr. Suraisry suggested. He commended the authorities for their determination to tackle their economic difficulties and to lay the foundation for sustainable growth. He agreed with the staff's main analysis and supported the proposed decisions.

Mr. Lankester observed that in the light of the severe drought of 1984 the Kenyan authorities had made considerable progress in correcting the imbalances in the economy, in particular the improvement in the external position. The Fund-supported program appeared to have gone well, the various quantitative ceilings having been fully met. The outlook was better, partly due to the improved weather but also because of the policy measures that had been taken. However, the adjustment effort needed to be continued and strengthened. The authorities faced a major task in improving the living standards of the people due to the rapid population growth rate. Fortunately, the World Bank Group was planning another population project in Kenya in fiscal year 1987.

The expenditure restraint exercised by the Kenyan authorities was commendable, Mr. Lankester noted. Expenditures were being rationalized with greater emphasis being placed on achieving higher rates of return on public sector projects and on rehabilitating existing infrastructure. He urged the donor community in general to give special emphasis to those important policies in aid programs, as the United Kingdom had in its own aid program.

The Kenyan authorities were planning to spend a considerable amount of money in rebuilding their grain reserve, Mr. Lankester noted. But unless they took the measures mentioned in the staff report, inter alia, to raise consumer grain prices and export surplus yellow maize, the budgetary cost of rebuilding the reserve might be extremely large. The

authorities should also increase revenue collection, because too much of the improvement in the fiscal situation had been borne by the expenditure side, possibly with adverse results on development spending.

Efforts to improve parastatal performance should be continued, Mr. Lankester said. The authorities themselves recognized that the public enterprises were inefficient and a cause for concern. The creation of an Office of Auditor-General for Parastatals should help to secure the improvement in performance. The conclusions of the Task Force on Divestiture would be of interest.

Notwithstanding the improvements that had taken place, the fiscal position remained relatively weak, Mr. Lankester commented. The underlying deficit as a share of GDP in 1984/85 was approximately the same as it had been in the previous year. The authorities would have to continue their cautious approach and consider possible contingency measures in case the economy did not grow as projected, to forestall the adverse effects on revenue.

The public sector deficit had been financed by nonbank financing to a greater extent than had been forecast, thereby helping to meet the credit ceilings and the monetary targets, Mr. Lankester noted, although private sector nonbank financing might have been squeezed as a result. He asked how the staff assessed the switch from bank financing to nonbank financing and in particular what its effects had been on the private sector.

After making allowance for emergency imports, the current account deficit had been cut dramatically from 11 percent of GDP in 1981 to just 3 percent in 1983-84, Mr. Lankester remarked. The exchange rate adjustment had helped to maintain the Kenyan economy's competitiveness and private sector inflows had picked up substantially. Although the staff believed that the medium-term prospects of the balance of payments were viable and sustainable, the outcome would depend upon a measure of good fortune and upon continued donor support. He therefore asked whether the authorities would request further assistance from the Fund after the current program expired. The sustained improvement in the external position would also depend upon continued sound policies, including a sustained effort on the structural side. The Development Plan was being revised and the authorities' plans appeared to be adequate and comprehensive enough to meet their medium-term development goals. Discussions were under way with the World Bank Group on the possibility of various sectoral loans, and he hoped that they would be successful. He supported the proposed decisions.

Ms. Lundsager said that the first review under Kenya's stand-by arrangement indicated that the adjustment process was progressing as scheduled. The fiscal target established for 1984/85 had brought the program back to the adjustment pace that had been slowed by the severe drought. The current account deficit was manageable, and in fact had declined since 1981. Nonetheless, Kenya was one of the countries that should take bold steps to deal with the structural rigidities which presently hindered its return to a faster, more stable growth path.

Her authorities wanted to emphasize that financial adjustment would be most successful over the longer term if accompanied by policies that stimulated production and growth, Ms. Lundsager said. Kenya had successfully reduced its recent financial imbalances and was one of the few debtor countries that had not sought official debt relief. Although the Kenyan authorities were to be commended for tackling payments and budgetary problems, stronger structural action was required if the country was to effect the reallocation of resources needed to expand and improve the efficiency of its productive base.

The additional fiscal measures taken during the past fiscal year to ensure the attainment of the fiscal targets indicated Kenya's strong commitment to the adjustment effort, Ms. Lundsager added. A reduction in the deficit was expected in the current year, together with a welcome reduction in government expenditures as a share of GDP. The adjustment in the tax rate schedules to compensate for inflation was also appropriate and demonstrated an undertaking to strengthen further private sector incentives. She understood that the Government was making an effort to retain highly skilled workers in the civil service but wondered if across-the-board wage increases might not make it more difficult to attain the goal of an overall slowing down in the growth of the civil service. She would be interested in the staff's views on that point and on the effect of the wage increase on the overall deficit.

While the authorities had expressed a commitment to broadening the role of the private sector, Ms. Lundsager said that she was concerned that restrictive monetary policy had limited unduly the provision of private sector credit. However, the impact on private sector activity was unclear. With the authorities' commitment to stimulate national savings, continued adjustment in interest rates might be desirable.

The lack of progress in reforming the public enterprises was disappointing, Ms. Lundsager remarked, all the more so since a strong structural adjustment effort was essential if Kenya was to return to a strong growth path with equilibrium on the external accounts. The authorities had indicated that the enterprises were inefficient and remained an area of concern, yet the report of the Task Force on Divestiture had still not been reviewed by the Government. The staff report on recent economic developments provided a history of attempted reforms since 1982, few of which had been implemented. She urged the authorities to carry out those reforms, especially the divestiture of those enterprises which could function as private entities and the liquidation of those which caused a permanent drain on resources.

Kenya could be one of the more attractive locales for foreign investment given its more advanced stage of development, Ms. Lundsager declared. Yet, investor interest might be slow to respond because the Government retained control over a large sphere of economic activity. Private capital inflows had increased during the past year, although they remained below 1981 levels. Political factors had played a role in the decline of such inflows, and their recovery no doubt would be influenced by

additional economic liberalization. Besides providing an open environment for foreign investment, liberalization could strengthen domestic producer incentives, particularly in the area of marketing. For instance, if farmers were allowed to engage more actively in marketing, they would be more likely to receive adequate returns, thus enhancing farmer incentives.

Import liberalization had continued as planned, with additional products having been moved to categories eligible for rapid license approval, Ms. Lundsager observed. Nonetheless, a high degree of protection remained for a number of products. Such extensive protection might have hindered the development of new areas of productive activity that could have diversified the economy and provided faster growth in employment. If excessive protection prevented scarce resources from moving to more competitive manufacturing activities, the economy as a whole, especially agriculture, could not be expected to grow. More extensive import liberalization should go hand in hand with a retrenchment of public enterprises.

The recent additional adjustment in the exchange rate should aid the process of reallocating resources, Ms. Lundsager remarked. Given the need to stimulate and to diversify exports, as well as for continued import liberalization, additional exchange rate adjustment might be required. Nontraditional exports had returned to 1981 levels after falling in 1982 and 1983; it would be interesting to know why and to have some indication of future export prospects in that important sector.

Her authorities hoped that future Fund and Bank activities in Kenya could be more strongly integrated, Ms. Lundsager commented. The Bank was concentrating on sectoral loans as opposed to structural adjustment loans (SALs). More broadly based World Bank assistance would be more appropriate, given Kenya's interest in reducing the role of government and in increasing that of the private sector.

The emphasis on structural adjustment was related to the medium-term outlook, Ms. Lundsager noted. The mobilization of domestic resources for development would require both continued vigilance over fiscal spending and further decontrol of the economy. Financing gaps were projected for the remainder of the decade, although those gaps could be narrowed and eliminated more quickly if incentives for export growth were strengthened. The linking of purchases to program reviews, as well as to performance criteria, was appropriate since reviews were necessary to ensure that future policies would sustain the adjustment effort. She supported the proposed decisions.

Mr. Fujino believed that it was opportune for the Executive Board to discuss Kenya as its first agenda item after the Annual Meeting because it was a good example of the effective implementation of appropriate and timely adjustment policies, and the adequate response of the Fund. It was for that reason that his authorities were commenting on that country for the first time.

Kenya had recorded low but continued positive economic growth under extremely adverse circumstances, Mr. Fujino remarked. The average rate of growth for the period 1982 to 1984 had been only 1.7 percent, or about one half of the growth rate of the population. Inflation had remained relatively low, and the budget and current account deficits had declined to 5 percent and 4 percent of GDP, respectively, after rising to 10 percent in 1981.

The authorities' cautious financial policies had proved effective in bringing down imbalances to a more sustainable level, Mr. Fujino said. Government expenditures had been reduced dramatically, and budgetary outlays had decreased to 28.6 percent of GDP in 1983/84, after having risen to 35 percent in 1980/81. The adjustments had been made not only in the investment program but also in current expenditures which had declined by 10 percent in real terms. It might be said that adjustment had done no more than reverse the substantial increases in expenditure in previous years, but it had nevertheless called for a difficult, major decision by the authorities. The progress made in correcting the external imbalances was also noteworthy, considering that external transactions accounted for over half of GDP. In spite of the increased food import requirement caused by the severe drought, the current account deficit had been contained at 3 percent of GDP in 1984. The Kenyan authorities were to be commended for their achievements.

Disciplined financial policies, flexible exchange rate policies, and pricing policies that provided incentives to producers had been instrumental in restoring equilibrium to the economy and in laying the groundwork for noninflationary growth, Mr. Fujino considered. In view of the continued unstable circumstances, such cautious policies should be maintained.

With adequate rainfall and an expected bumper grain harvest, the country would be better placed to pursue its Development Plan, Mr. Fujino stated. Close cooperation with the World Bank would be essential, and it was encouraging that the Bank was engaged actively in the discussion of various sectoral loans to tackle constraints in the economy. The authorities were concerned primarily with the immediate productive effect of their investment program through the lowering of the capital output ratio. There might be some areas, such as agriculture or tourism, where a relatively small amount of investment might yield a higher return. However, he doubted how far the policy of lowering the capital output ratio could go unless the authorities simultaneously secured the investment to finance the necessary social infrastructure. Staff comment on that matter would be helpful.

One of the major causes of government deficits was the inefficiency of public enterprises, Mr. Fujino noted. Kenya, with more than 300 parastatals or government-controlled companies, was no exception. However, it was gratifying to note that the net outflow from the central government budget to the public sector enterprises--over K Sh 1 billion in 1980/81--had become a net inflow of K Sh 100 million in 1982/83 within two years.

Loans and transfers had accounted for the greatest changes, which might not represent a real improvement in enterprise operations; he wondered whether they did not reflect a switch to another form of indirect transfer not shown in the figures he had cited. The authorities' efforts to strengthen the monitoring of those financial flows and, if necessary, to divest enterprises would be important. Their move in that direction was welcome.

With continued adherence to appropriate adjustment policies, there was a prospect of a sustainable balance of payments in the medium term, Mr. Fujino commented. The current account deficit would be held to 3-4 percent of GDP through 1989, depending upon an increase in nontraditional exports of 10 percent. Efforts to diversify the productive base and to strengthen the competitive position would also be important.

The program's targets and performance criteria had been met and the authorities were committed to the continued implementation of cautious financial policies, Mr. Fujino observed. He supported the proposed decisions.

Mr. A. R. Ismael said that he was encouraged by the recovery in economic activity in Kenya in 1985, from the adverse effect of the drought on the country's economic and financial performance in 1984. Better weather conditions, and the establishment of a system of attractive producer incentives had contributed to that recovery. The favorable effects on inflationary pressures could not be overemphasized; those pressures should eventually ease with inflation declining to 9 percent in 1986 compared to the average rate of 11 percent for 1984 and 1985.

The Kenyan authorities were to be commended for maintaining their commitment to adjustment and for meeting the program's targets and performance criteria, Mr. A. R. Ismael remarked. Their prudent and cautious approach to economic and financial management had been impressive. That was especially true of their flexible fiscal policies with expenditures having been adjusted to offset the unexpected shortfall in domestic revenues and foreign grants. The fiscal adjustment had not been easy because the paucity of domestic revenue had required cutbacks in the Government's investment program.

He supported the authorities' intention to redirect their efforts toward strengthening the foundations for economic growth under the Five-Year Development Plan, Mr. A. R. Ismael commented. The continued emphasis on the development of the agricultural sector was a step in the right direction. The potential existed for expanding food crop production, introducing new industrial raw materials, and expanding export output. He welcomed the World Bank's active involvement in the authorities' efforts to carry out the necessary structural reform in various sectors of the economy. The authorities had emphasized the important role that the government budget was to play in reorienting their development effort. They had appealed for donor support for projects that had been reclassified as high priority. While such support was obviously needed, it

should be supplemented by domestic resources. He encouraged the authorities to examine and implement measures for raising additional revenue, as well as for generating much needed domestic savings.

The progress being made in liberalizing imports and invisible payments, as well as in allowing the repatriation of profits and dividends, was also commendable, Mr. A. R. Ismael said. He urged the authorities not to relax efforts in that area. The medium-term prospects for the balance of payments appeared encouraging. In view of the uncertainties regarding prompt donor support for Kenya's development efforts, however, the authorities should monitor developments closely and exercise prudence in their external borrowing policy. He supported the proposed decisions.

Mr. Sengupta commended the authorities for implementing the adjustment program in accordance with the stand-by arrangement despite the severe drought of 1984 and the adverse international environment for primary producing countries. Although it was not surprising, it was unfortunate that that successful adjustment had not been accompanied by a higher rate of growth. Faltering or stagnant per capita income was inimitable to viable adjustment in the long run. The authorities were doing everything to reduce the budget deficit, to contain public expenditure in the face of growing maintenance costs, and to limit the current account deficit in spite of falling export prices of primary products like tea and coffee. He agreed with Mr. Abdallah that the decline in development outlays reflected a reduction in foreign aid receipts, other than drought relief. Governments that believed that adjustment was not viable without economic growth might want to help create an environment that would facilitate the increased transfer of real resources from abroad to low-income countries like Kenya.

Kenya was continuing to liberalize its import regime, Mr. Sengupta commented, yet the level of imports projected for 1985 was still below that for 1981. Thus, the most important variable was the rate of economic growth. He joined Mr. Abdallah and the Kenyan authorities in calling for a substantial expansion of foreign aid inflows into Kenya. He supported the proposed decisions.

The staff representative from the African Department considered that the Kenyan economy's ability to create the number of jobs needed in the medium term was problematic, as the staff had mentioned in its appraisal and in other recent papers on Kenya. The authorities were in a race against time to generate the needed growth and employment levels. The continuation of the adjustment process should further that objective.

Without wishing to venture into a discussion of the pros and cons of the observation that the present employment level was already dictated by previous population growth rates, it was true that direct control measures would only improve employment levels in the next century. There was in fact an extensive direct population control program in Kenya which had

been supported by the authorities over the past five or six years. However, Kenya was one of the largest Catholic countries in Africa, and the people in general opposed such programs.

There was a need for additional revenue measures, the staff representative stressed. Kenya was unlikely to be able to improve its development efforts and carry out the maintenance of its capital stock without reversing the decline in revenue as a share of GDP.

There were large quarterly seasonal shifts in monetary variables in Kenya that made it difficult for the authorities to target reductions from one quarter to the next, the staff representative observed. Similar difficulties had been encountered with Fund programs in the early 1980s, and the authorities' policy was to stay well within the ceilings and to try to maintain credit to the private sector at a level that was consistent with the overall ceiling. That had not been difficult in past years when the economy had been sluggish; the problem had emerged in 1985 when the economy picked up and the demand for credit had increased. The authorities had had to impose a credit ceiling which limited private sector activity; they were not advocating a loosening of that ceiling, but were calling attention to the administrative difficulties of implementing the program. Their statement that "monetary policy tended to be somewhat tighter" was correct with regard to the overall credit actually available in each year of the programs.

Growth in the money supply had come largely from the balance of payments side, the staff representative stressed. The balance of payments surpluses generated in 1983 and 1984 had not been programmed and the recent balance of payments deficit had been below the programmed target.

There had been a considerable reduction in price interference by the Government in the past five or six years, the staff representative mentioned. Only 31 industrial and agricultural items remained under price control, and the Government's policy had been to review those prices frequently and to grant adjustments when necessary. Producer prices were reviewed annually and were providing considerable incentives to producers. Despite the bumper harvest, the authorities believed that it was important to maintain those incentives and to purchase grain, even if it meant a larger than planned grain reserve. If price reductions were made, the authorities feared that the incentives would be removed and that the surpluses would soon disappear.

There were various possibilities for generating additional revenue, including improved tax administration, the staff representative remarked. The Kenyan authorities had been reducing import duties and trying to recoup lost revenues through sales taxes. Unfortunately, the sales tax administration was not as efficient as the customs administration, and potential revenue might have been lost. Improvement in that respect was also needed. The reduction in the excise tax on petroleum products in 1984 had been unfortunate and should be reviewed in the forthcoming

budget. At times when prices of various traditional exports had been extremely high, the staff had recommended a review of the coffee and tea tax to enable the Government to share in the windfall profits. Although that would not be a continuing revenue source, it would permit the authorities intermittently to recoup considerable amounts of revenues. There was a need for an increase in fees and cost sharing for the various services provided by the Government. For example, fees could be charged for education and health services, which comprised a considerable percentage of budgetary expenditures.

The Kenyan authorities had been concerned about the problems in the public enterprise sector for a number of years, the staff representative commented. Budgetary transfers to public enterprises had been reduced substantially, as had government guarantees for external and other borrowing by enterprises. The level of public enterprises' credit utilization had also been cut back; recently, only one or two enterprises had been allowed to make use of bank credit. More frequent price increases had been granted to parastatals. The Task Force on Divestiture had recently selected candidates for divestiture and closure. The authorities currently faced two difficulties in that regard. First, a selling price needed to be determined for a divested company. Second, in the open Kenyan political system any decision on the sale of an enterprise was subject to close scrutiny in Parliament. Considerable work had been done to reconstruct the accounts of many of those enterprises to counter the criticism expected from Parliament. It was those two problems that had delayed the actual divestiture of some enterprises, but the authorities were hopeful that progress would soon be made.

While an actual decision on the public wage increase still had to be made, the amount was likely to be no more than 4-7 percent of the current wage bill, the staff representative explained. The increase was not large considering the length of time since the last wage increase and the rate of inflation during that interval. Although wages for civil servants in the higher ranks should be increased more than the across-the-board increase, the authorities had found that difficult to do because the lower paid government workers had had difficulty in paying their living expenses in the past few years.

Foreign private investment was no longer a major source of investment for Kenya, the staff representative noted. In the past, foreign investment had not financed domestic production but that of the existing East African Community. Kenya had been the community member providing the best support facilities for such investment, but with the collapse of the East African Community, that source of investment had declined. Consequently, firms had found themselves with excess capacity for some time. The Government had recently opened an Office of Investment Promotion in the Ministry of Commerce to resolve the legal problems encountered previously with foreign investment and to facilitate the procedure for new investment. However, foreign private investment was unlikely to generate a large flow of resources in the near future.

Private sector incentives could also be aided by further liberalization in agricultural marketing, the staff representative confirmed. The Government would like the National Cereals and Produce Board to be primarily the buyer of last resort and the keeper of the strategic grain reserve. The private sector had been unwilling to assume many of that enterprise's functions, however, because of the high level of working capital necessary for marketing and the need for transportation. The Government's policy had been to liberalize step by step so as not to hinder the marketing of agricultural commodities. The authorities had found it difficult to carry out a large-scale liberalization of agricultural marketing under the drought conditions prevailing from 1984 to 1985. Kenya was in a competitive position to expand nontraditional exports, as long as the international economy and the market for those products continued to expand, the staff representative considered. Data for the past two years supported that conclusion. However, many of the firms engaged in those activities had experienced difficulties in finding working capital in rediscounting their export bills, and in transportation to some markets.

The capital output ratio of the public sector had increased markedly over the past four years, for two reasons, the staff representative said. First, the implementation of investment projects had slowed down due to the adjustment process. Hence, a project that should have been built and been producing after two years was taking four to five years to reach the production stage. Second, reduced maintenance in many of those facilities had damaged their productive capacity. The authorities expected to improve the productivity of the public sector capital stock and thereby aid the growth process by improving the selection of projects--which would then be given priority so that they could be implemented quickly--and by improving maintenance.

The increase in public sector nonbank financing had reduced the financing available to the private sector in 1984/85 when domestic financing of the government budget had been higher than programmed, the staff representative noted. Although nonbank financing had increased in earlier years, it had merely offset a lower level of bank financing, so that domestic financing had remained generally on target. In 1984/85, the authorities had been trying to regularize the sale of securities to the insurance sector, particularly the National Social Security Fund, and had captured a larger than expected amount of the resources generated by that sector. The authorities had also gained some margin for maneuver in financing the budget deficit as a result of recent expenditure reductions. Difficulties had been experienced in estimating the flow of foreign resources, and at the same time, the authorities had found it difficult to target accurately bank financing. Nonbank financing gave the Government some leeway to maintain the thrust of the program while overcoming those difficulties.

A staff mission would be visiting Nairobi in the second half of November to discuss the possibility of a new program with the authorities,

the staff representative said. If the authorities so wished and if a strong program was drawn up, it might qualify for support under an extended arrangement.

The adjustment process was not the cause of the decline in per capita income from 1980-85, the staff representative remarked. In fact, in the absence of adjustment, growth would have been even lower. The adjustment process had not only provided necessary private sector incentives, but it had forced the Government to deal with public sector resource allocation problems. The country had faced two droughts and one coup attempt during that period, events that had had a considerable impact on investment and on growth. The fact that there was a successful adjustment program in place had helped the authorities to overcome the negative expectations remaining after the coup attempt.

Imports in 1985 had been smaller in real terms compared with previous years, the staff representative from the African Department acknowledged. But the program's objective was to shift import demand to domestic production in order to provide some relief to the balance of payments. Recent statistics revealed that the shift had been successfully carried out. Although real growth of 3 percent a year and a decline in imports was not desirable, it reflected the important structural adjustments that had been carried out in Kenya.

Mr. Sengupta explained that he had not meant to create the impression that the low growth of per capita income was due to the adjustment program. As he had noted, the program had been generally successful, in spite of the difficult external environment. The fall in the development outlays had been due to the decline in foreign aid and the corresponding decline in real resource transfers. An adjustment program must be supported by a sustained flow or transfer of resources from the developed countries to the developing countries.

Mr. Zhang remarked that the Kenyan Government's adjustment efforts had been commendable. However, the staff representative had left the Board a false sense of complacency regarding the development and prospects of the real sector. The implementation of the current program did not guarantee successful adjustment. In fact, no basis for growth had been provided. Growth could come only from the expansion of exports and higher investment in a country like Kenya. The volume of exports had stagnated, yet the staff estimated an annual increase of more than 4 percent for the second half of the decade. Moreover, there had been a drastic reduction in the ratio of investment to GDP since 1982, but the staff gave no clear indication of how investment would increase in the medium term in order to increase GDP.

The staff apparently proposed that the problem of a persistent decline in per capita income should be solved by reducing the rate of population increase, Mr. Zhang remarked. The rate of population increase needed to be planned, but so did an increase in GDP. The factors affecting both the numerator and the denominator of that ratio should be explored.

The staff representative from the African Department said that Kenya's future outlook was fragile and needed to be strengthened, particularly with additional donor assistance. If the authorities continued to reinforce their policies and at the same time receive a commensurate level of donor support, growth levels of 5-6 percent per year would be attainable. Stronger performance in the agricultural sector also needed to be generated, as did higher levels of growth in nontraditional exports.

The staff had tried to be pessimistic in reviewing medium-term growth prospects for nontraditional exports, the staff representative indicated. The staff had deliberately provided estimates that were lower than recently recorded figures because of the possibility of slippages in policy implementation. The staff had also recognized that because the authorities were in a race against time, their efforts would have to be continued and strengthened. The medium-term outlook in the staff report was on the whole a conservative one. Enough additional capital resources would probably be generated to permit the implementation of a strengthened development plan while allowing the Government to continue its stabilization efforts.

Kenya could continue to take advantage of its position in regional markets with respect to nontraditional exports, the staff representative remarked, provided neighboring countries made commensurate progress in adjusting their own economies. That factor had to be taken into consideration in the staff's estimates.

Because an important portion of Kenya's nontraditional exports were generated in the agricultural sector and were profitable, agriculture must be a key area for growth, the staff representative from the African Department said. Foreign markets existed but certain limitations would have to be removed. For example, Kenya was ideally situated to provide vegetables and flowers to Europe during the European winter. However, air freight capacity out of Nairobi had not been adequate to take full advantage of that opportunity. In addition, certain European countries had placed limitations on imports of vegetables and flowers from Kenya. Hopefully, those limitations would be reduced because many European countries could not compete with Kenya's output during the winter months.

The Deputy Director of the Exchange and Trade Relations Department noted that the review was related to monetary and fiscal policy, exchange rate policy, and import policy. Some of the policy objectives were not subject to quantification and hence the review supplemented the quantified performance tests. The delay in bringing the review to the Board was related to the question of exchange rate policy and fiscal policy for 1985/86. It had been necessary to reverse the appreciation of the Kenyan shilling that had occurred in the early part of 1985 before the discussions with the authorities could be finalized. In addition, the 1985/86 budget had not been considered consistent with the continuing need for fiscal adjustment. Until those difficulties had been resolved, it had not been possible to establish the quantified performance tests for September 1985 that were necessary for the program to continue. The delay in completing

the review had been useful in the sense that it had permitted midcourse adjustments in Kenyan policy which should make the program stronger and more successful.

Attempts had been made in recent staff reports to cover Bank-Fund collaboration in an appendix, the Deputy Director said. The appendices provided a way of highlighting any points of difference between the Fund staff and the Bank staff. In the case of Kenya, he recalled that the most important issue that had been raised in the appendix in the staff paper on Kenya's request for the stand-by arrangement (EBS/84/261, 12/12/84, and Sup. 1, 1/8/85; EBM/85/2 and EBM/85/3, 1/9/85) concerned the pace of import liberalization and the pace of the depreciation of the Kenyan shilling. The Bank had not been ready to come forward with a quantified view of an appropriate exchange rate. Hence, the Fund staff had not known whether the Bank felt that there should be a small or a large exchange rate adjustment. A Bank study on the competitiveness of the industrial sector, which was nearing completion, would help the Fund and the Bank approach the question of exchange rate policy.

There had been no real difference of view between the Fund staff and the Bank staff on the pace of import liberalization, which they both considered to be too gradual, the Deputy Director remarked. However, the staff had been cognizant of Kenya's foreign exchange shortage following the coup attempt and the droughts. The staff had also been conscious that both the present and the previous program were underfinanced; special efforts had been necessary to find additional donor support to fill the financing gaps. The Fund staff had perhaps been less dogmatic about a faster pace of import liberalization because that would have required even greater donor support. Serious efforts had been made by both the Bank and the Fund staffs to achieve a greater meshing of policies. In the spring, Kenya had been one of the countries discussed at a joint Fund-Bank staff seminar. Finally, the statement in Attachment III to the staff report that during the past year the Bank staff had been pleased to observe significant progress in a number of areas of the structural adjustment program, including import liberalization, could not have been made 12 months previously.

The staff representative from the IBRD observed that Kenya's population growth of almost 4 percent per annum was one of the highest in the world and was a matter of great concern. The provision of family planning services had been limited, and educational information programs had also not been very effective, owing to social, economic, and political factors. The Government believed that the problem was important, and the President of Kenya himself had recently expressed great concern at the high rate of population growth, emphasizing the need for efficient family planning. The President had also stated publicly that the Government would consider introducing disincentives to large families. The Bank had financed two population projects in Kenya based on a strategy of strengthening the availability and quality of family planning services and programs. A third project would be financed during the next fiscal year which would try to continue the progress made in the last few years. The Government's

emphasis on population control should provide a better environment within which to develop a more effective program. The third population program would tackle the issues of better information services and more contraceptives, especially for the urban population. Most donors had also expressed concern over the high rate of population growth; the Kenyan Government had been trying to coordinate their efforts, as revealed by a recent Bank mission to Kenya which had been joined by representatives of four or five major donors.

The Bank strongly endorsed the Government's efforts to increase the efficiencies of resource use in the public sector because it was critical for donor support and higher growth, the staff representative said. The Government had begun a process of budget rationalization in the Ministry of Agriculture. Technical assistance had been provided in the past in setting up task forces on budget and financial management which had reviewed the portfolio of projects and the efficiency of the implementation of ongoing activities. In some cases, the Bank had encouraged the Government to reduce or to cut programs that had not been effective and to shift funds from low-priority to high-priority projects. The Government had indicated that it intended to extend that effort to other ministries and was currently establishing a budget task force in the Ministry of Finance. It had requested Bank support for that exercise. A cabinet paper had been prepared on the appropriate budget ceilings to be placed on the various ministries, and a Bank mission would be sent to Kenya as soon as the Government had taken a decision in that respect. Another meeting of the Consultative Group on Kenya was expected to take place in April 1986.

Mr. Suraisry recalled that he had referred to the importance of reducing administrative inefficiencies in order to avoid undermining the Government's efforts to increase the economy's efficiency. He asked if the staff had discussed that issue with the authorities or made any recommendations, for instance, to increasing the wages of high-level government employees or reorganizing some ministries and departments.

The staff representative from the African Department replied that increasing administrative efficiency was one of the issues the staff had raised in discussing the shift from import taxation to the sales tax. Kenya had not only received technical assistance from the Bank and from donors, but it had also received assistance on tax administration from the Fund's Fiscal Affairs Department. He hoped that the benefits of that assistance would be visible in the near term. One of the solutions to such administrative problems was to hire additional qualified technical persons to administer some of the taxes. That solution was not readily available to the Government, which had been attempting to keep current expenditures at a certain level, and had been unable to hire or retain the necessary number of employees. Both the Government and the staff were aware of the problems.

Mr. Sengupta said that he was disturbed by the reference to administrative inefficiency. If in discussing the implementation of policies by a

member, the Executive Board began to question the efficiency of a government's administrative system, it would be entering a completely new area, one in which it was very difficult to reach conclusions. In his opinion, the Executive Board should limit itself to reviewing policies.

The Chairman commented that it was difficult to assess administrative efficiency with any precision, but the quality of a country's administration served as the backdrop for the assessment of its policies. If a country was in need of technical assistance to eliminate administrative inefficiencies, the Fund should try to provide it. Of course, judgments of overall efficiency or inefficiency should be made with great hesitancy.

Mr. Suraisry remarked that the sharp reduction in government expenditures might have created inefficiencies. The deficit should not be reduced further, for instance, by limiting hiring at the expense of increasing administrative inefficiency.

The Chairman noted that there was a tendency in some countries to overstaff their administrations and to underpay civil servants. Interregional comparisons had been made which indicated the level of efficiency or productivity of various administrations. Many countries were willing to collaborate with the Fund and the Bank to curtail public sector employment, but the consequence was often an increase in salaries either during or after the curtailment. It was a complex matter that should be dealt with with the greatest discretion.

Mr. Lankester said that although assessment of administrative efficiency is inevitably subjective, he did not think that efficiency should be ignored. It was an important element in both the fiscal situation and the development effort of a country.

The staff representative's assessment of Kenya's technical and political constraints was a little pessimistic, Mr. Lankester considered. The United Kingdom had carried out a major privatization program under which it had managed to overcome technical problems. In privatizing enterprises, the major factor was one of political will, and he hoped that the Kenyan authorities would carry out divestiture where there was a good economic case for doing so.

Mr. Abdallah remarked that despite differences on policy issues between the Fund and the Bank, the Fund had not hesitated to go forward with extending assistance to Kenya. A number of Executive Directors had alluded to those differences at the Executive Board meeting in January 1984, when Kenya's request for the current stand-by arrangement had been considered. He regretted the "coldness" that had developed between the country and the World Bank and had undertaken to do everything possible to promote closer understanding and cooperation between them. Relations between Kenya and the World Bank had improved considerably and constructive exchanges had been taking place. The helpful contribution by the staff representative from the World Bank was evidence of the revived relationship.

At the donors' conference held in Nairobi in March, some participants had remarked that Kenya was probably the only country that appeared to have good relations with the Fund but not with the World Bank, Mr. Abdallah recalled. One reason for that unusual phenomenon was the caliber of the staff leading recent Fund missions to Kenya who had established good rapport with the representatives of the Government and thus had been able to discuss policy matters frankly with persons in key positions. Wherever the Fund staff could establish such a rapport, serious misunderstandings which could spill over into the press were most unlikely to arise.

The limit on expenditure cutbacks might have been reached in Kenya, Mr. Abdallah said. Further retrenchment would have adverse effects on economic growth and on the effectiveness of the civil service. The only alternative was therefore to concentrate efforts on increasing revenues; he assured the Executive Board that the authorities had recognized that revenue enhancement was imperative but that they had refrained from taking action in the current budget because the repercussions of the 1984 drought had not fully worked themselved through the economy. Appropriate measures would be taken in the 1986/87 budget and Fund advice regarding the size and form of those measures would be appreciated.

The fiscal effort in Kenya had been focused on indirect taxation with the main instrument being the sales tax, Mr. Abdallah indicated. As Table IX in SM/85/260 showed, during the past five years, the yield from the sales tax had been fluctuating and the proceeds had been rather insignificant. More efficient administration would undoubtedly reduce the fluctuations and enhance the yield. Offers of technical assistance were likely to be well received by the authorities.

External agencies and donor countries had not given full credit to the authorities for what they had been doing to control population growth, Mr. Abdallah said. However, he was glad to learn that additional assistance would be forthcoming from the World Bank. Resistance to family planning programs was inevitable since the idea as well as the tools being employed were alien to the traditions and norms of the people. Good progress had been made, however, because of the very strong leadership that the Head of State was giving to the campaign.

The Government had appealed to donor countries whose counterpart funds for drought relief were still undisbursed to allow their release "to help the rationalization program," Mr. Abdallah said. He urged the Directors to endorse the appeal and to recommend a prompt response.

The Chairman made the following summing up:

> Directors commended the Kenyan authorities for successfully handling the problems which arose from the country's severe drought in 1984. Improved weather conditions in 1985 contributed to that outcome, but Directors believed that timely drought relief efforts also had been effective and had not compromised the Government's domestic financial policy stance. Consequently,

progress had been preserved in Kenya's stabilization efforts, which had begun in 1980/81 and which had received continued Fund support. During that period, Kenya had implemented meaningful reductions in the overall budget deficit and had succeeded in sharply reducing the balance of payments current account deficit.

Directors observed, however, that the progress attained remained fragile and would require reinforcement in several areas. The 1985/86 budget reflected postdrought difficulties and Directors stressed the need to reduce the overall deficit and the domestic financing requirement in future years. While emphasis should continue to be placed on controlling the growth of current expenditures, a number of Directors were concerned that the current budget contemplated a further slackening in the revenue effort. If the development effort was to be strengthened in the context of financial stability, the tax system would need to be strengthened and revenue measures for the 1986/87 budget would need to be prepared.

Several Directors stressed the need for more meaningful and effective progress in improving the public sector enterprises' financial position. The intended appointment of an Auditor General for Public Enterprises was welcomed as a useful step to improve the monitoring and control of the public sector enterprises.

Directors noted that the medium-term outlook for the balance of payments remained fragile and that its viability depended on a number of factors, particularly the continuation of prudent financial policies accompanied by export promotion policies. They felt that the continuation of a flexible exchange rate policy was essential to external adjustment and they encouraged the authorities to continue import liberalization. Several Directors cautioned that great prudence should be exercised in borrowing decisions so that the debt service ratio could be kept at a manageable level. Directors believed that continued and active donor support would be essential to that end. They also urged the authorities to raise the domestic savings rate. The maintenance of positive real interest rates was seen to be important in that regard.

While progress had been made in tackling the country's structural problems, Directors encouraged Kenya to move forcefully to strengthen its development effort. Directors felt that additional efforts were urgently needed if Kenya was to attain a growth rate consistent with meaningful increases in per capita income, given the rapid growth in population. Directors encouraged the authorities to rationalize their development efforts by concentrating on high-priority areas and urged donor support to that end. The priority attached to agriculture in Kenya's development was considered to be appropriate.

Several Directors stressed that the financing of a strategic grain reserve would require careful monitoring. Directors further stressed that a more active World Bank involvement would aid Kenya in overcoming its structural problems and in meeting its growth objectives more quickly, particularly by controlling population growth, improving investment priorities, and rehabilitating public sector enterprises.

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

The Executive Board then took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision relating to Kenya's exchange measures subject to Article VIII, Section 2, 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 is earlier.

Decision No. 8105-(85/154), adopted
October 21, 1985

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, Sup. 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 dated September 6, 1985.

3. Accordingly, and pursuant to Decision No. 7908-(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 set forth in Attachment IV of EBS/85/217.

Decision No. 8106-(85/154), adopted
October 21, 1985

3. BANGLADESH - 1985 ARTICLE IV CONSULTATION - POSTPONEMENT

Mr. Sengupta noted that the Bangladesh authorities had been discussing with the Fund staff and management a program to be supported by a stand-by arrangement. The Government had already begun to implement certain policies, but they required the Fund's financial support. Agreement on the major elements of the program had almost been reached, and a staff paper on the request for a stand-by arrangement would be issued within two to three weeks. Executive Directors had already received the staff report for the 1985 Article IV consultation, which had been scheduled for discussion on October 23. He requested a postponement of the period for completing the Article IV consultation, to enable the request for use of Fund resources to be considered together.

The Chairman responded that because agreement had been reached on the elements of the program, it would make more sense to discuss the two matters at the same time. If the Fund had not reached agreement on all issues, it would have been useful for the Board to have an opportunity to discuss the staff report for the Article IV consultation first. However, a decision by the Board to combine the discussion of the two sets of staff papers should not be seen as a precedent.

The Executive Board then took the following decision:

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1985 Article IV consultation with Bangladesh to not later than December 6, 1985.

Decision No. 8107-(85/154), adopted
October 21, 1985

4. ZAMBIA - 1985 ARTICLE IV CONSULTATION - POSTPONEMENT

The Chairman noted that the Executive Board's consideration of the staff report for the 1985 Article IV consultation with Zambia had been rescheduled from October 23 to October 30 in order to allow for the normal four-week circulation period for the staff report. In that connection, it was also necessary to extend the period for completing the Article IV consultation with Zambia.

The Executive Board then took the following decision:

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1985 Article IV consultation with Zambia to not later than October 30, 1985.

Decision No. 8108-(85/154), adopted
October 21, 1985

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/153 (10/10/85) and EBM/85/154 (10/21/85).

5. BOLIVIA - TECHNICAL ASSISTANCE

In response to a request from the Bolivian authorities for technical assistance in establishing budgeting systems, the Executive Board approves the proposal set forth in EBD/85/269 (10/11/85).

Adopted October 18, 1985

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/249, Correction ¿ (10/11/85) and EBAP/85/250 (10/17/85) and by an Advisor to Executive Director as set forth in EBAP/85/250 (10/17/85) is approved.

APPROVED: June 5, 1986

JOSEPH W. LANG, JR.
Acting Secretary