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615-0227

KENYA

PROGRAM GRANT

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PAAD

DEPARTMENT OF STATE
AGENCY FOR
INTERNATIONAL DEVELOPME

PROGRAM ASSISTANCE APPROVAL DOCUMENT

1. PAAD NO. 615-K-603
Proj. No 615-0227
2. COUNTRY: Kenya
3. CATEGORY: Program Grant
4. DATE: September 28, 1982
5. TO: Allison B. Herrick
Director, USAID/Kenya
6. OYB CHANGE NO.
7. FROM: Satish P. Shah
Chief, Projects Division
8. OYB INCREASE
TO BE TAKEN FROM:
9. APPROVAL REQUESTED FOR COMMITMENT OF: $ 10,714,000
10. APPROPRIATION - ALLOTMENT: ESF
11. TYPE FUNDING: ☐ LOAN ☒ GRANT
12. LOCAL CURRENCY ARRANGEMENT: ☒ INFORMAL ☐ FORMAL ☐ NONE
13. ESTIMATED DELIVERY PERIOD: October 30, 1982
14. TRANSACTION ELIGIBILITY DATE: October 1, 1982
15. COMMODITIES FINANCED

Not applicable

16. PERMITTED SOURCE
U.S. only:
Limited F.W.:
Free World:
Cash: $10,714,000

17. ESTIMATED SOURCE
U.S.:
Industrialized Countries:
Local: $10,714,000 equivalent
Other:

18. SUMMARY DESCRIPTION

The purpose of the cash grant is to provide the Government of Kenya critical balance of payments support to help it succeed in the economic structural adjustment program it has undertaken. The Kenya shillings generated by the grant will be placed in a Special Account and jointly programmed by the GOK and AID for mutually agreed upon purposes. These will include general support of priority items within the GOK Development Budget for 1982/83 and funds for a Central Bank of Kenya discount facility to be available to commercial banks for on-lending to private businesses, who suffered losses during the August 1 civil disturbances.

19. CLEARANCES	DATE
PROG:WLefes	9/28/82
RLA:PScott	9/28/82
D/DIR:CECostello	
PROG:PGreene	9/28/82
RFMC:RHenrich	9/28/82

20. ACTION
☒ APPROVED ☐ DISAPPROVED

Allison B. Herrick 29 Sept 1982
AUTHORIZED SIGNATURE DATE

Director, USAID/Kenya
TITLE

CLASSIFICATION:

ACTION MEMORANDUM FOR THE DIRECTOR, USAID/KENYA

FROM: Satish P. Shah, Chief Projects Division

SUBJ: Kenya Program Grant 615-0227

DATE: 28 September 1982

PROBLEM:

To obtain your approval for a Program Grant of $10,714,000 for the Government of Kenya from FY 82 Economic Support Fund Appropriations.

DISCUSSION:

Kenya, since it achieved independence in 1963, is one of the few countries in Africa which has maintained democratic political institutions and a freely elected civilian government. The economy is largely based on free market principles with a strong private sector. Kenya experienced rapid progress during the first ten years after independence. From 1964 to 1973 real Gross Domestic Product (GDP) grew at an average rate of 6.6 percent per year, and per capita GDP rose at an average rate of nearly 3 percent. GDP growth during the period 1974-81 has averaged only 4.8 percent annually, and the rate for 1982 is also estimated to be under 5 percent. Nearly every major sector of the economy has shared in the general slowdown of activity since the early 1970's. By 1979, foreign exchange shortages and budgetary imbalances had emerged as key constraints limiting Kenya's growth to unacceptable levels and restricting Government's ability to carry out its development program and structural economic reforms. Basic structural changes in both the industrial and agricultural sectors are essential for sound long-term growth. Since 1980, with the support of World Bank, IMF and bilateral donors, Kenya has undertaken the serious task of modifiying certain key policies affecting currency exchange rates, quantitative restrictions on imports, tariff schedules, agricultural prices, debt management, domestic borrowing and fiscal management.

Kenya today faces economic and political difficulties. A coup attempt of August 1 demonstrated cracks in the facade of political stability and will widen the balance of payments gap by a negative impact on tourism and capital account flows. The overall balance of payment deficit for 1982 before the coup attempt was estimated by Government at $287 million, but now after the coup attempt, the deficit is estimated at $407 million. Government's past projections for improvements in 1983 and beyond are now questionable, and additional balance of payments analysis and close cooperation with donors will be required.

The proposed $10,714,000 cash Grant will provide the Government of Kenya with critically needed foreign exchange for balance of payments as the Government continues adjustment of economic policies. The United States and Kenya Government are in agreement that an early announcement of export incentive measures is necessary in support of the structural adjustment program; this is in addition to elements of an export compensation scheme reintroduced recently. The Kenyan shilling generated by the Grant will be placed in a special account and jointly programmed by the GOK and AID for mutually agreed upon purposes. These may include priority items within the Government of Kenya budget and loans to the business community to repair damages or replace losses.

There are no conditions or waivers associated with this Program Grant. However, the Program Grant Agreement will include the following covenants:

1. The Grant will not be utilized for military or luxury goods or any other goods listed in Grantee's Import Licencing Schedule II.B dated November 1981.

2. For the purpose of financing the local currency costs of development programs and recovery from the economic losses suffered in the disturbances of August 1, 1982, the Grantee agrees to establish a special account within sixty (60) days from the date of disbursement of the Grant and to deposit therein currency of Kenya (local currency) equivalent in amount to the United States dollar disbursement made under this Agreement. The highest rate of exchangewhich is not unlawful in Kenya on the date of the United States dollar disbursement shall be used in determining the total amount required to be deposited in the Special Account.

3. A.I.D. and the Grantee agree that the funds deposited in the Special Account shall be used to finance local currency costs of Grantee's development programs and to provide local currency resources to businesses to assist them in recovering from the economic losses suffered in the disturbances of August 1, 1982. In order to be eligible for budgetary assistance from the Special Account, development programs must support increased rural production,

employment and income; be included in the Grantee's five-year development plan; and be included in the Government of Kenya's 1982/83 budget estimates. Within 60 days of the disbursement of the Grant, the Grantee will submit for A.I.D. approval a specific list of development programs which it proposes to support from the Special Account. It is also agreed that not less than the equivalent of $5,114,000 of the local currencies deposited in the Special Account will be made available to the Central Bank of Kenya for a discount facility for local commercial banks providingshort-term loans to businesses which suffered losses as a result of the August 1, 1982, disturbances. The specific conditions under which funds will be made available through the discount facility will be mutually developed and agreed upon by the Grantee and A.I.D. within 60 days of the disbursement of the Grant.

4. Disbursements from the Special Account shall be made in accordance with such procedures and at such times as determined to be appropriate by the Grantee; provided, that all funds deposited in the Special Account shall be disbursed within fourteen (14) months from the date of disbursement of the Grant, except as A.I.D. may otherwise agree in writing.

Congress was notified of the program on September 13, 1982 and the fifteen day waiting period expired on September 27, 1982.

AA/AFR has determined that the Program Grant does not require environmental evaluation as it satisfies criteria set forth in Section 216.2(c) "Categorical Exclusions" of Agency's environmental procedures (State 271134). There are no human rights issues in Kenya.

The Executive Committee for Project Review approved PID equivalent for this Grant per State 248842 of September 3, 1982.

AUTHORITY:

Pursuant to Delegation of Authority No. 140 of June 9, 1982, you have the authority to authorize any project* that does not exceed $20,000,000, does not present significant policy issues,does not require issuance of waiver that may only be approved by the Assistant Administrator for Africa or the Administrator, and does not have a life of project in excess of ten years. This project falls within these limitations.

* includes non-project

RECOMMENDATION:

That you sign the attached PAAD thereby authorizing the proposed Program Grant in the amount of $10,714,000.

Approved Allison B Henrick
Disapproved
Date 29 Sept 1987

Attachment: a/s

Clearances: RLA:PScott Draft Sha
RFMC:RHenrich
PROG:WLefes Draft Sa
PROG:RGreene Draft Sa

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I. Summary and Recommendation:

A. Activity: Kenya Program Grant

B. Terms: Grant

C. Amount: $10,714,000

D. Executing Agency: The Government of Kenya Ministry of Finance

E. Brief Program Description:

By letter dated August 16, 1982 Kenyan President Daniel Arap Moi requested $10 million in emergency balance of payments assistance from the United States to partially meet additional import requirements in 1982 totalling $130 million (see Annex A). Assistance was also requested from several other donors. President Moi cited the substantial damage to property associated with an attempted coup d'etat on August 1 and other economic difficulties as justification for the special request. The program will provide a $10,714,000 cash grant to the Government of Kenya for general balance of payments support as an immediate response to the GOK's request for emergency balance of payments assistance. The Government has taken steps to restore confidence of the business community by reinstituting elements of an export compensation scheme (as noted in President Moi's speech of September 21, 1982), and the Government is preparing to put into place longer term policy changes to provide export incentives. The Kenyan shillings generated by the Grant will be placed in a special account and jointly programmed by the GOK and AID for mutually agreed upon purposes. These may include priority items within the GOK budget and a discount facility in the Central Bank of Kenya for loans from commercial banks to the business community to repair damages or replace losses.

F. Other Donor Activities:

Other donors have been responsive to Kenya's growing need for balance of payments assistance. In 1980 the World Bank provided a structural adjustment credit equivalent of $55 million in conjunction with an EEC special action credit equivalent of $15 million. In July 1982 agreement was reached on a second World Bank/IDA structural adjustment loan and credit equivalent of $135 million in total. The IMF has also provided program assistance. A two year IMF stand-by credit equivalent of $273 million was approved in October 1980, $102 million of which had been drawn by August 1981. Negotiations for a replacement IMF stand-by totalling the equivalent of $165 million became effective on January 8, 1982. Other donors who have responded to Kenyan Government requests for a shift to increased program assistance include the United Kingdom, the Netherlands, West Germany, Japan, Norway and OPEC.

G. Statutory Checklist: Satisfied (See Annex C)

H. Issues: None

I. Recommendation: That a $10,714,000 Program Grant be authorized for Kenya.

J. Project Committee:

J. Wilhelm, Chief, AFR/DP/PPEEA
R. Greene, Economist, USAID/Kenya
W. Lefes, Program Officer, USAID/Keny
S. Shah, Project Development Officer, USAID/Kenya
P. Scott, Regional Legal Advisor, REDSO/EA
D. Butcher, Economic Counselor, Embassy

II. Political and Economic Setting and U.S. Interests

The United States has important political and strategic interests in Kenya. Kenya is one of the few countries in Africa with democratic political institutions and a freel, elected civilian government. The economy is based on free market principles with a strong private sector. The economic and political well being of Kenya is important to the U.S. as a demonstration that progress and stability are possible under a government committed to democratic institutions and a market oriented economy.

In international affairs, Kenya pursues a moderate course and has been a good friend of the United States on numerous issues of importance to us. On international and regional security matters, Kenya provides important support to the U.S. strategic position in this part of the world through access for U.S. forces to its airfields and the Indian Ocean port of Mombasa. This security cooperation is formalized by a facilities access agreement between the United States and Kenya signed in 1980.

Kenya today faces economic and political difficulties much more serious than observers had anticipated earlier this year. A coup attempt on August 1 1982 demonstrated cracks in the facade of political stability and has had a negative impact on tourism, capital account flows and trade balance.

Lack of confidence about the political future is closely related to growing economic pressures on what has generally been perceived as a sound economic system. In recent years, Kenya's poor economic growth performance, its high inflation rate, population explosion and demands on the availability of scarce social services have all contributed to a deterioration of the quality of life for the average Kenyan. Unrest and economic and political frustration are increasingly manifest and the Government has been hard pressed to respond with better performance of the economy.

There is little doubt that world economic conditions contributed to Kenya's poor performance following the 1970s. However, the Government must assume responsibility for policies that tended to exacerbate economic problems. High levels of protection for inefficient, high cost import substitution industries, for example, resulted in a misallocation of scarce capital resources. An untimely decrease in prices paid to maize growers in mid-1979 and a delay until 1981 in adjustment of prices to provide an adequate economic return to farmers resulted in significant cutbacks in plantings and a production deficit.

A serious foreign exchange shortage now threatens Government's strategy for structural readjustment of the economy. Since 1980, with the support of the World Bank, IMF and bilateral donors, Kenya has undertaken the serious task of modifying certain key policies affecting currency exchange rates, quantitative restrictions on imports, tariff schedules, agricultural prices, energy prices, debt management and domestic borrowing.

The U.S. firmly supports the democratic institutions and the private enterprise system in Kenya, both currently under a great deal of stress. In order to give these institutions a greater chance of survival in time of crisis, the Kenya economy will need to be strengthened, the trade balance improved and the quality of life enhanced. In the short run the timely provision of foreign exchange for balance of payments support will help as the Kenya Government continues adjustment of economic policies. The United States and Kenya Governments are in agreement that an early announcement of export incentive measures is necessary in support of the structural adjustment program.

III. Economic Trends and Prospects

A. Background

By 1979 foreign exchange shortages and budgetary imbalances had emerged as key constraints limiting Kenya's growth to unacceptable levels and restricting Government's ability to carry out its development program and structural economic reforms. During 1979-81 foreign exchange and budgetary constraints acted interdependently to lower the growth rate of the Kenyan economy. Strict measures to control balance of payments deficits also resulted in reduced use of industrial capacity and shortfalls in tax revenues. Reductions in revenue were felt most heavily in the development budget. The Government's ability to implement its long-range policies in both the industrial and agricultural sectors was therefore limited. Basic structural changes in both sectors are essential to achievement of long-range improvements in the foreign exchange and budgetary situations and for creation of the basis for sound long-term growth.

At the Consultative Group meetings of 1979 and 1981, the Government of Kenya asked donors to put increased emphasis on program assistance relative to project assistance. Kenya made it clear that a difficult balance of payments position, a growing development assistance pipeline, and a need to control the growth of recurrent expenditure all support the need for program assistance in the short-term. Kenya's requests drew an initial response in 1980 in the form of a World Bank/IDA Structural Adjustment Credit equivalent to $55 million, combined with an EEC Special Action Credit equivalent to $15 million. Agreement was reached in July 1982 on a second World Bank Structural Adjustment at a proposed level of 124 million SDR's ($135 million) with emphasis on the agricultural sector. The International Monetrary Fund (IMF) also provided program assistance. A two-year Stand-By Credit equivalent to $273 million was approved in October 1980, but only $102 million had been drawn by August 1981 when the credit was suspended. Difficult negotiations for a replacement Stand-By totaling 152 million Special Drawing Rights (SDR), equivalent to $165 million, continued through December 1981 and the Arrangement became effective on January 8, 1982. Other donors who have responded to the request for a shift to increased program assistance include the United States, the United Kingdom, the Netherlands, West Germany, Japan, Norway and OPEC.

B) Macro-Economic Trends

Despite a continued high level of commitment to development, Kenya has faced increasing diffuculty in matching the rapid progress experienced during the first ten years after Independence in 1963. From 1964 to 1973 real Gross Domestic Product (GDP) grew at an average rate of 6.6 percent per year, and per capita GDP rose at an average rate of nearly 3 percent. More recent developments are less promising reflecting both internal problems and Kenya's vulnerability to external events: the collapse of the East African Community in 1977, the end of the coffee boom in 1978, international recessions (1974/75, 1979/80); continuing increases in petroleum and other import prices (especially 1974, 1975, 1979, 1980), and periodic drought (1974/75, 1979/80).

GDP growth during the period 1974-81 has averaged only 4.8 percent annually, and the rate for 1982 has been estimated to be under 5 percent. Per capita GDP at market prices stood at $393 in 1981 based on a realistic mid-year population estimate of 17.0 million. The level for 1982 would be somewhat higher if calculated at the 1981 exchange rate. However, the Kenya shilling was devalued against the SDR on two occasions in 1981 for a cumulative adjustment of 23.7 percent. When the average exchange rate of the shilling for 1982 as calculated by the IMF is applied to final GDP data for the year, estimates of Kenya's per capita GDP may be reduced by as much as 20 percent.

Government and donor analysts agree that Kenya will be unable to meet the original economic targets of the 1979-83 Development Plan. According to recent Government estimates, growth rates (which were to have averaged 6.3 percent year over the 1979-1983 Plan period) have been revised downward to an average 4.3 percent per year. Moreover, even if the country's terms of trade halt their recent decline, the growth rate of real resources over the period will average only 2.2 percent annually, well below the 4 percent rate of population increase. On average, people will be less well off in Kenya in 1983 than in 1973. (See Table 1.)

Nearly every major sector of the economy has shared in the general slowdown of activity since the early 1970's. Some sectors have performed better than others, however, and the economy has undergone a slow but steady structural transformation.

The manufacturing sector in Kenya has performed consistently better than the economy as a whole, growing at an average rate of 8.4 percent per year in the first decade of independence and at a slower but still impressive rate of 6.4 percent since 1974. However, despite its rapid growth the manufacturing sector remains relatively small accounting for 14 percent of wage employment and 13.3 percent of GDP in 1981. Nearly 80 percent of GDP in manufacturing is accounted for by private sector activity and the remainder by majority-owned government corporations or parastatal organizations.

Since Independence, Kenya has fostered the growth of its manufacturing sector primarily by means of a policy of import substitution based on quantitative trade controls and foreign exchange restrictions. Relatively capital-intensive manufacturing has been encouraged and protected. Industry operates with heavy dependence on imported inputs and is therefore vulnerable to limitations on availability of foreign exchange. Most of the easy investments of the import-substitution variety have already been made. High levels of protection, including an overvalued exchange rate, have in the past resulted in an anti-export bias reducing the availability of foreign exchange. At the same time, the net contribution to foreign exchange savings of many past investments is open to question. The capital-intensive nature of many import-substitution industries has contributed to the relatively slow growth of industrial employment while the poor quality and high prices of many manufactured goods represent an implicit tax on the agricultural sector.

Table 1

Annual Rates of Growth of GDP
(at Factor Cost) 1979-83

	1979	1980	1981	1982	1983
Development Plan	4.5	7.0	6.5	6.7	6.9
Sessional Paper No. 4 of 1981	3.5	5.8	5.9	5.9	6.0
GOK: June 1982	4.2	3.0	4.8	4.5	4.8
Per Capita GDP Growth	0.2	-1.0	0.8	0.5	0.8
(Adjusted for Terms of Trade)	-2.9)	(-3.4)	(-4.0)	(0.5)	(0.8)

The growth of the agricultural sector has declined from an average annual rate of 4.7 percent during 1964-73 to 3.9 percent during 1974-81. Despite a rate of growth since independence below that of the general economy, the agricultural sector still provides Kenya with 34 percent of inputs into manufacturing, 67 percent of non-petroleum exports and approximately 65 percent of total employment. Agriculture remains overwhelmingly in private hands with 99 percent of total output accounted for by the private sector. Kenya's agriculture is characterized by a wide variety of production systems reflecting different ecological zones, population densities and land holding patterns. Farms of twenty hectares or more cover 3.7 million hectares or just over half of Kenya's recorded farmland. Included in this total are 2.7 million hectares of so-called "large farms" in the former scheduled areas once reserved for European settlers and 1.0 million hectares of "gap farms" (i.e. farms outside the scheduled areas but too large to be included in the Integrated Rural Survey of small farms). During most of the 1970's, large farms and gap farms together provided approximately 25 percent of the value-added in agriculture and 45 percent of recorded marketed production. When coffee and tea prices were at their highest in 1977, large and gap farms increased their share of agricultural value-added to just over one-third of the total. Kenya's large ranches and open grazing lands in pastoral areas provided an additional 2 percent of agricultural value-added on average during the 1970's. The small farm, however, remains the dominant mode of agricultural production in Kenya accounting for 49 percent of recorded farmland, 55 percent of marketed production, 70 percent of value-added in agriculture, and more than 80 percent of agricultural employment.

Problems in Kenya's key agricultural sector were outlined in Kenya's National Food Policy Paper published early in 1981. Producer prices in the past have been inadequate (maize, beef and milk prices in particular), credit services inefficient (late disbursements, unsatisfactory collection programs), and provision of input supplies inadequate and untimely. Marketing services have been poor with parastatal bodies and cooperatives taking an increasing share of sale proceeds at the expense of the producer. Recently, the Government of Kenya has introduced large increases in producer prices on a number of important agricultural products including maize (44 percent), wheat (21 percent), rice (53 percent), sugar (13 percent), beef (20 percent to 30 percent), and milk (16 percent). Kenya's program of structural adjustment is now being extended to the agricultural sector under the new $135 million agreement with the World Bank. The Bank, USAID and

other donors are continuing to discuss necessary actions with the Kenyan Government relating to agricultural pricing, marketing, storage, credit, and financial planning and management. Donor support at the current stage of Kenya's agricultural development will be important both to help finance the costs implicit in implementing some key policy measures, as well as to lend support to policy-makers faced with difficult economic and political decisions during a time of increasingly scarce resources.

C) Public Sector and Budget

The contribution of the public sector to total output has grown only marginally since Independence from 24 percent of GDP in 1964 to 27 percent in 1981. During the same period, Government's share of wage employment rose from 31 percent to 47 percent of the total, and the Government budget rose from 20 percent of GDP to 37 percent. The development account has generally maintained its share of the rapidly increasing budget levels. Although the exact percentage has varied from year to year, the development budget in 1981 accounted for 29 percent of total expenditures, the same level as in 1964. Although an expansion of development spending may have seemed desirable, it is now apparent that the number of donor initiatives has exceeded the Government's ability to manage projects. The requirement to match development expenditures with additional expenditures in the recurrent budget, especially for managerial and administrative personnel, is so great that project implementation has been damaged - seriously in some cases.

The share of Central Government expenditures covered by deficit financing has never exceeded the 27 percent recorded in the first year of Independence. By 1969, this deficit had been reduced to 19 percent. Since then the deficit has generally averaged over 20 percent with a level of 20.4 percent in 1979/80 and a peak level of 24.4 percent in 1980/81, the first year of the structural adjustment. The preliminary data contained in the June 1982 Budget Speech suggest a reduction in the deficit for 1981/82 to less than 22 percent. The deficit for 1982/83 is currently budgeted at just under 17 percent. Such an improvement will require significant additional effort and will be difficult to obtain.

The peak deficit of 1980/81 (10.6 percent of GDP) far exceeded the level foreseen under the IMF program of that year (6.0 percent of GDP). (See Table 2.) Budget deficit levels (like balance of payments targets), are not themselves IMF performance criteria but failure to achieve program objectives

often results in a co-ordinate failure to meet quantitative performance criteria with regard to total domestic bank credit, net bank credit to Government, and new external borrowing contracted or guaranteed by Government.

Government's first attempt to prepare a forward budget for 1980/81-82/83 as part of its Structural Adjustment program was not completed satisfactorily. This was due in part to a reorganization of Government and in part to a deterioration in the external terms of trade which caused the macroeconomic planning frame to become rapidly outdated.

During 1980/81 budget deficit targets were exceeded entirely because of a sharp increase in expenditures. Revenue in fact, increased from 30 percent of GDP in 1979/80 to 31.5 percent in 1980/81. Expenditures increased for a variety of reasons including: supplementary allocations to finance Government wage increases of 23-30 percent; increased costs for defense and internal security; accelerated development expenditures; and the chronic breakdown of fiscal controls which results in a large volume of unauthorized and extrabudgetary expenditure.

Expansion of the budget deficit prevented Kenya from meeting the IMF ceiling on net bank credit to Government at the end of June 1981, though previous ceilings had been observed. Net bank credit to Government as of June 30, 1981 stood at some 4.9 billion Kenya shillings versus an agreed performance criterion level of 3.7 billion shillings. Compliance with the performance criterion for total net domestic bank credit was narrowly missed as well (17.7 billion shillings actual, versus 17.5 billion shillings agreed upon). The ceiling on new external government borrowing which had been set at $600 million was not exceeded. Given Government's inability to comply sufficiently with agreed upon criteria, drawings under the Stand-By were suspended in August 1981 after the equivalent of $102 million of the total Stand-By credit of $273 million had been drawn.

Protracted negotiations between the IMF and Government continued through December 1981, and a replacement Stand-By Arrangement was approved by the Executive Board of the IMF on January 8, 1982. The Arrangement provides Kenya with the right to draw up to 151.5 million SDR's ($165.8 million) in four tranches through November 1982 upon compliance with certain performance criteria to be periodically reviewed. Import, exchange rate, and interest rate criteria are discussed separately in the section on Government policy reforms below.

With regard specifically to budget and fiscal policy the main program objective was a reduction in the Central Government deficit from 10.6 percent of GDP in the fiscal year ending June 30, 1981 to 7.5 percent of GDP in fiscal year 1981/82. Based on preliminary data for 1981/82 contained in the June 1982 Budget Speech, Kenya may have achieved its desired program target especially if estimates of GDP growth rates approaching 5 percent are confirmed when final data are available*. Unless data on the overall budget deficit are significantly revised, or estimates of the GDP growth rate last year prove highly inaccurate, Kenya is unlikely to have approached anything like the budget disaster of 1980/81 during fiscal year 1981/82.

Kenya met its performance criteria ceilings for January 1982 by narrow margins and was able to proceed with the first two scheduled drawings under the new Stand-By (90 million SDR's by June 1982). By January 1982 total domestic bank credit stood at 98.8 percent of the agreed ceiling, and net bank credit to Government was at 87.1 percent of the agreed level. New external borrowing contracted or guaranteed by Government (1-12 years maturity) stood at $145 million as against a ceiling of $160 million. Government was able to meet its targets in part due to extraordinary budget practices (delayed payment of January salaries to some Government workers; non-payment of suppliers credits). Supplementary tax measures voted in April 1982, and severe restrictions on expenditures in the final quarter of the fiscal year, were undertaken to assist in meeting the June targets. A continued shift toward utilization of non-bank financial intermediaries to fund the debt of the Central Government has assisted in meeting bank credit ceilings as well. Although utilization of such non-bank intermediaries should expand in line with their overall growth, it will become increasingly necessary to take such a shift into account in setting bank credit ceilings in the future in order to avoid over expansion in the money supply. As of the first week of September 1982, Kenya had not drawn the third tranche of the current Stand-By, the IMF assessment of Kenya's performance for the period ending June 30 was incomplete and the final November 1982 drawdown was uncertain. USAID's current assessment is that Kenya will meet or come close to its targets as agreed.

* IMF might question GOK's computations for GDP.

Table 2

Kenya: Central Government Finance, 1978/79-1981/82

	1979/80	1980/81 Program Outturn	1980/81 Estimated	1981/82 Budget	1981/82 Program	1981/82 Projected Outturn
	(In millions of Kenya Shillings)					
Total revenue and grants	12,193	14,411	14,892	16,244	16,832	16,403
Recurrent revenue	11,884	13,819	14,234	15,610	16,054	15,861
Foreign Grants	309	592	658	634	778	542
Total expenditure	15,543	16,779	19,618	19,106	20,784	20,575
Recurrent expenditure	10,684	11,692	12,940	13,468	14,220	14,230
Development expenditure	4,859	5,087	6,254	5,638	6,164	6,345 1/
Suspense and other 2/	--	--	424	--	400	--
Adjustment (- expenditure) 3/	179	--	62	--	--	--
Overall deficit (-)	-3,171	-2,368	- 4,788	- 2,862	- 3,952	- 4,172
Financing	3,171	2,368	4,788	2,862	3,952	4,172
Foreign (net)	2,198	1,278	2,202	2,026	2,798	1,667
Gross borrowing	(2,602)	(1,875)	(3,144)	(3,160)	(4,082)	(2,963)
Repayments	(-404)	(-597)	(-942)	(-1,134)	(-1,284)	- 1,296)
Domestic (net)	973	1,090	2,586	836	1,154	2,505
Nonbank (net)	(811)	(412)	(1,026)	(782)	(800)	(1,476)
Bank and CSFC	(162)	(678)	(1,560)	(54)	(354)	(1,029)
Bank, CSFC, and Eurocurrency financing	906	678 to 1,000	2,294	54	1,413	2,053
Of which: Eurocurrency financing	744	...	735	--	1,059	1,024
	(In percent of GDP)					
Memorandum items:						
Reccurent revenue	30.1	30.4	31.5	30.2	30.6	29.7
Of Which: tax revenue	(26.1)	(26.5)	(26.7)	(26.1)	...	(...)
Total expenditure	39.3	36.9	43.4	36.9	39.6	38.5
Overall deficit	8.0	6.0	10.6	5.5	7.5	7.8
Bank, CSFC, and Eurocurrency financing	2.3	2.2	5.0	0.1	2.7	3.8

Sources: IMF. Economic Survey, 1981; The Appropriation Accounts; Other Public Accounts and the Accounts of the Funds, 1979/80; Financial Statement, 1981/82; and data provided by the Kenyan authorities.

1/ Includes a KSh 400 million loan to Cereals and Sugar Finance Corporation.

2/ For 1980/81 represents expenditure incurred against deposit accounts; for 1981/82 represents a provision for unpaid vouchers from 1980/81.

3/ Reflects the fact that budget is not strictly on a cash basis.

D) External Trade and Balance of Payments

The external sector has become increasingly important to Kenya since Independence. The value of imported goods and services rose from 29 percent of GDP in 1964 to as much as 40 percent in 1980. The level for 1981 is estimated at 35 percent despite substantial restrictions on import licensing. Imported inputs have become important to the growth of Kenyan industry and to a lesser extent of commercial agriculture. Machinery and transport equipment accounted for 26 percent of the value of goods imported in 1981, while industrial supplies represented 25 percent, fuels 39 percent, (two-fifths for re-export), food and beverages 5 percent, and other consumer goods only 5 percent. Kenya's Social Accounting Matrix for 1976 shows that in the overall economy 35 percent of primary and intermediate inputs were accounted for by imports. In the manufacturing sector, imports accounted for 33 percent of gross output. By comparison 3 percent of gross output in agriculture was directly accounted for by imports.

Exports of goods and services have not kept pace with the rapid growth of imports in Kenya. The value of exports has fallen from more than 33 percent of GDP in both 1964 and 1974, to 28 percent in 1980, and to an estimated 26 percent in 1981. The volume of Kenya's worldwide exports was only 12 percent higher in 1981 than in 1972, the year when Kenya's program of industrial protection and import substitution began in earnest. Given a decrease of 35 percent in the external terms of trade, the purchasing power of Kenya's exports was 27 percent lower in 1981 than in 1972. By 1981, the volume of Kenya's manufactured exports had fallen to 70 percent of its 1972 level. Such decreases occurred despite (or perhaps because of) an increase in the price index of Kenya's manufactured exports by about 350 percent during the same 9-year period.

Kenya has attempted to develop new export markets in the Middle East, but little tangible evidence of success can be noted and no major breakthroughs are expected. The 1977 closing of the Tanzanian border resulted in a major market loss for Kenya. Exports to Tanzania fell from 10 percent of total exports in 1976 to 1 percent in 1980 and 1981. The Ugandan export market similarly dropped from 10 percent of total exports in 1976 to 1 percent in 1979. The Ugandan market rebounded to 13 percent of the total in 1980, but fell again in 1981 to only 8 percent, indicating that prospects remain uncertain.

In contrast with the above trends, real GDP has grown by more than 4 percent annually since 1972. The failure of the export sector to expand or diversify has implied increasing relative shortages of imports as overall GDP continues to rise. The current account deficit rose from 3 percent of GDP in 1972 to 13 percent of GDP in 1980, although this was reduced to an estimated 10 percent in 1981. In absolute terms, Kenya's current account deficit (expressed in U.S. dollars) peaked in calendar year 1980 at a level of $873 million. (See Table 3A.) Provisional Government data of September 1982 indicate a reduction in the current account deficit for 1981 to a level of $693 million. The current account deficit for 1982 is now estimated by Government to be on the order of $677 million. As indicated by a comparison between Tables 3A and 3B, Government's current estimation of the 1982 current account deficit now falls $17 million above the level previously projected by the World Bank, and nearly $246 million above the level once projected under the IMF Stand-By program.

Despite the large improvement in Kenya's current account balance between 1980 and 1981, Kenya's overall balance of payments deficit rose from $194 million in 1980 to a level of $302 million in 1981 due to a shortfall in the capital account. Net private long-term capital inflows fell by more than $50 million between the two years. More importantly, net public long-term capital flows decreased by nearly $225 million, and net short-term flows fell by more than $30 million. For 1982 the Government of Kenya had projected a modest reduction in the overall balance of payments deficit with larger improvements for 1983 and beyond as the structural adjustment began to take effect. Following the recent coup attempt, however, Government's estimate is that the overall balance of payments deficit for 1982 will be $407 million rather than the $287 million that was orginally projected (see Table 3A). Embassy and USAID estimates are in the same range. Government's past projections for improvements in 1983 and beyond are now rendered very uncertain as well. Additional analysis balance of payments and subsequent coordination with donors will be called for.

Kenya's immediate requirement (before the end of calendar 1982) is to find additional financing for about KSh. 1,100 (approximately $100 million) to cover the negative impact of the August coup attempt on the overall balance of payments. The increased need due to the coup attempt is estimated as follows:

Table 3A

Kenya: GOK Balance of Payments Projections, 1979-1984
(Millions of U.S. dollars)[a]

	1979 Actual	1980 Actual	1981 Provis.	1982 Est.	1983 Proj.	1984 Proj.	
Exports	1031	1238	1067	1111	1252	1380	Exports
Imports	-1832	-2624	-2200	-2180	-2224	-2375	Imports
Trade Balance	- 801	-1386	-1133	-1069	972	- 995	Trade Balance
n-Factor Services, Net	422	513	540	537	688	779	Non-Factor Services, Net
source Balance	- 379	- 873	- 592	- 532	- 284	- 216	Resource Balance
Factor Services, Net	- 211	- 156	189	- 226	- 252	- 289	Factor Services, Net
Transfers, Net	91	139	89	804	88	98	Transfers, Net
Current Account Balance	- 498	- 889	- 693	- 677	- 448	- 408	Current Account Balance
Private Long Term Cap., Net[b]	207	191	139	121	146	137	Private Long Term Cap., Net [b]
Public Long Term Cap., Net	300	387	164	135	126	126	Public Long Term Cap., Net
Other Capital [c]	180	118	87	14	36	42	Other Public Capital [c]
Capital Account Balance	687	696	391	270	308	304	Capital Account Balance
Overall Balance	189	- 194	- 302	- 407	139	- 103	Overall Balance
Monetary Movements	- 189	194	302	407	139	103	Financing
Transactions with IMF, Net	- 10	147	69	212	...	...	IMF, Net
Other Changes in Assets, Liabilities	- 178	47	-	79	43	...	IBRD, Program
			)	15	...	...	Commercial Loans
			100)	152	...	...	Bilateral Program
			134	51	...	...	Reduction in Reserves

Sources: 1979, 1980. Economic Survey, 1982. 1981-1984. GOK: July, September 1982, (draft documents).

Notes: a/ Final digits may not add due to rounding and exchange conversion. Exchange rates: 1 KSh = $.13376 (1977); 1 KSh = $.13431 (1980); 1 KSh = $.11052 (1981); 1 KSh = $.091324 (1982 ff).

b/ Includes parastatals.

c/ Includes errors and omissions.

Table 3B

Kenya Balance of Payments Projections FY 1982 - 84
(Millions of U.S. dollars)[a]

	IMF (MAY 1982)		IBRD (APRIL 1982)			
	1982 PROG	1982 PROJ	1982	1983	1984	
Export	915	909	1115	1259	1424	Exports
Imports	- 1739	-1714	-2261	-2574	-2910	Imports
Trade Balance	- 824	- 805	-1146	-1314	-1486	Trade Balance
Non-Factor Services	...	...	508	577	655	Non-Factor Services
Resource Balance	...	...	- 638	- 737	- 831	Resource Balance
Factor Services	...	...	- 191	- 209	- 237	Factor Services
Transfers	119	123	169	186	204	Transfers
Current Account Balance	- 397	- 431	- 660	- 761	- 863	Current Account Balance
Private LTC	129	114[b]	73	80	88	Private Direct. Cap.
Public LTC	128	87	553	580	680	Public & Pub. Guar.
Othe Capital	-	-	10	56	60	Short Term Cap.
Capital Account Balance	257	201	...	...	...	
Overall Balance	- 140	- 230	...	...	...	
Financing	140	230[c]	...	...	...	
IMF, Net	124	179	89	85	85	IMF
IBRD, Program	103	64	...	...	...	
Commercial Loans	41	- 20	...	...	...	
Required Bilateral	26	31	...	...	...	
Reduction in Reserves	- 153	- 24	- 65	- 40	- 50	Reduction in Reserves
Gross Reserves	350	221	357	397	447	
Months of Imports	2.4	1.5	1.9	1.9	1.8	

Source: IMF - Review of Standby Arrangements, May 11, 1982.

IBRD - Report - For a Second Structural Adjustment, P - 3322-KE, June 1982.

Notes: a/ Final digits may not add due to rounding and exchange conversion Exchange rates: 11.95 KShs = 1 SDR = 1.09133 US$ (at mid-year July 1, 1982); 1 KSh = $ .091324.

b/ Includes parastatals

c/ Excludes exceptional financing included above the line in original IMF presentation.

PROG:9/6/82

1. Imports - Assume a total import coefficient of 25 percent on the estimated KSh. 1.2 billion losses during the rioting on August 1 (a generous estimate since many of the looted items consisted of foodstuffs, clothing, jewelry, shoes, etc., which were locally made). Even high-cost items such as television sets are often locally assembled and contain locally made components. Total increase in import bill: KShs 300 million.

2. Tourism Earnings - Assume a small shortfall in tourism of 25 percent during August and a decline in earnings of fully one-half in the fourth quarter. Local tour operators, hotel managers and airline executives can provide no better estimate, but most would hold that an estimated total shortfall of KSh 300 million is probably high.

3. Capital Flight - There obviously is no single line item to which illegal capital movement can be attributed. Yet there is little doubt that many entrepreneurs and individuals, will attempt to move liquid assets abroad. Most such transfers take place via under-invoicing of exports and over-invoicing of imports, and through collection of tourism receipts abroad which are not remitted. However, tourism will not present much opportunity for increased outflow in 1982. Neither do many opportunities exist in the export sector which tends to be dominated by big ticket items such as petroleum, coffee, tea, pineapples, etc. Assuming that Kenya's imports already are fully 10 percent over-invoiced by importers attempting to circumvent exchange controls and avoid the overvalued shilling, a maximum of an additional five percent of the value of imports could be removed from the country during the five months of 1982 following the coup attempt. At current values, that total would come to approximately KSh 500 million.

Estimates of a total overall deficit by the Government, Embassy and USAID are all tentative, and are based on very flexible interpretations of the effects of the August events. Resulting estimates are similar. Addition of our estimate of the effect of recent events, to the overall deficit forecast by Government before the coup attempt produces a total overall deficit to be financed of some KSh 4.2 billion ($395 million), as compared with the $400 million suggested in President Moi's letter to President Reagan(see Annex E).

Although estimates of the coup effect encompass considerable margin for error in regard to total imports (especially potential Government imports), analysts are agreed on a reasonable working number. Additional financing of about $100 million must be found from bilateral donors, commercial borrowing abroad, or a further reduction in already limited reserves if the required financing of some $400 millions is to be achieved. The Government could finance approximately $50 million by foregoing an anticipated improvement in gross reserves of KSh 562 million. It is more likely, however, that the Central Bank of Kenya would restrict imports more severely since Central Bank officials become extremely nervous when reserves account for barely five weeks' worth of imports. Additional problems would therefore arise. The official anticipated growth rate of imports in 1982 is approximately 22 percent and the unweighted average increase in prices is about the same. A volume increase in imports of zero would not be consistent with Government's projected growth of real GDP of almost five percent. Given the pressure which the Central Bank is exerting on imports, therefore, it is likely that economic activity which is already being severely restricted in 1982 is in serious danger of being similarly constricted in 1983 as well.

The high level of current account deficits since 1978 has necessitated a major increase in external borrowing resulting in a sharp rise in the debt service level. External debt outstanding and disbursed rose from $701 million at the end of 1977 to $1,744 million at the end of 1980; an increasing portion was contracted on relatively hard commercial terms. (See Table 4.) The debt service ratio has risen from 4.8 percent of exports of goods and services in 1977, to 9.2 percent in 1980. Projected ratios for 1981 and 1982 are 12.2 percent and 14.9 percent respectively. The ratio is expected to continue to rise to a peak of 22 percent by the early 1990s, even assuming a considerable growth in external assistance levels.

Kenya: External Debt and Debt Service 1977-1995
(Millions of U.S. Dollars)

	1977	1978	1979	1980
Undisbursed	780.7	1056.6	1252.8	1304.5
Disbursed	917.2	1083.7	1433.2	1743.8
Debt Service*	74.6	121.6	120.2	183.0
Principal	(35.0)	(69.2)	(49.6)	(78.5)
Interest	(39.6)	(52.4)	(70.6)	(104.5)
Ratio to Exports of Goods, NFS	4.8	7.9	7.6	9.2

		(Projected)			
	1981	1982	1986	1991	1995
Undisbursed	1383.7	1323.0	1584.2	2518.1	3319.7
Disbursed	2336.3	2888.9	5817.3	10873.3	14359.5
Debt Service*	201.8	271.2	531.3	1193.7	1652.1
Principal	(105.8)	(136.9)	(285.4)	(671.4)	983.2
Interest	(96.0)	(134.3)	(245.9)	(522.3)	668.9
Ratio to Exports of Goods, NFS	12.2	14.9 16.9	18.1	21.9	18.3

Note: *Includes Kenya's notional 45 percent share of EAC debt.

Source: World Bank, EAIDA, April 7, 1982.

Although the Government has in the past shown itself willing to apply orthodox methods to reestablish balance in the external accounts, the consistent application of such methods over the next few years would not permit the external trade liberalization and internal structural changes required to achieve either long-term improvements in the balance of payments, or desirable rates of long-term growth. Additional balance of payments support from major bilateral donors will be required to supplement that already being provided by the World Bank and the IMF, especially in light of the coup attempt of August 1982 and its likely aftermath. Government now projects a requirement for program assistance from bilateral donors alone in 1982 of up to $152 million (see Table 3A). All the major bilateral donors have been approached recently including the U.S., U.K, Germany, France, Norway, Japan, Sweden, Denmark, the Netherlands, Saudi Arabia, and Kuwait. Few if any appear to be in a position to respond favorably at least in the short run at levels beyond those already programmed. In addition to the assistance being provided by the IMF and the World Bank, program assistance in the following amounts is currently budgeted during Kenya's 1982/83 fiscal year: Netherlands ($3.7 million); Japan ($3.7 million); U.K. ($900 thousand); Germany ($900 thousand); European Economic Community ($1.6 million) and the World Food Program ($5.4 million). In line with its 10 percent share of Kenya's gross official development assistance in recent years, the U.S. response to Government's request for assistance this year might logically be in the range of $15 million, a major part of which will be provided under the program proposed in this paper. Given the inability of most donors to react to Government's request in time to provide significant help this calendar year, the ability of the U.S. to respond with a contribution of $15 million will be of special significance as a sign of U.S. economic and political support to Kenya.

E. Status of Non-project U.S. Assistance

Kenya has been provided with $20.0 million in ESF for Commodity Import Programs and $30.0 million in PL480 Title I credits in FY 1980 and 1981. These programs are fully disbursed. The PL480 Title I credit of $15.0 million in FY 1982 has also been disbursed.

IV. POLICY OVERVIEW AND STRATEGY

A. Overview

Although external factors such as the price of oil, a deterioration in the terms of trade and a generally soft international marketplace have had a substantial impact upon the Kenyan economy, they cannot be viewed as the root cause of the current economic crisis. They merely contributed to it, and hastened the day of reckoning.

The combination of monetary, fiscal, foreign exchange, trade, industrial, and agricultural policies in Kenya is such that the very structure of the economy and the incentives driving it must be reordered if significant recovery and renewed dynamism are to be hoped for. While the United States agrees with the IBRD that energy and population policies are also essential components of a long-term economic strategy, those issues are beyond the scope of this exercise.

The IMF and IBRD share our view that the Kenyan economy must be restructured and reoriented and are both working with the GOK to find a solution. A concise summary of Kenyan measures to meet the IBRD Structural Loan provisions is attached at Annex D. Kenyan intentions as conveyed to IMF in December 1981 are set forth in Annex E.

The Embassy and USAID Kenya believe that the efforts of the IMF and IBRD are generally well directed and that the Government has embarked upon general economic reform consistent with their efforts. What follows is an examination of the major structural elements of the Kenyan economy, a discussion of reforms already undertaken in association with the IMF and the IBRD, and a strategy for AID which addresses the immediate problem and also looks beyond.

Since 1979 Kenya has reacted to the deterioration of the economy and the balance of payments in a relatively ad hoc fashion by limiting import licenses and borrowing, both external and internal. This resulted in a mounting internal debt, a rising external debt service ratio and an overvalued exchange rate. This over-valued exchange rate together with controlled interest rates encouraged imports, consumption and capital flight and discouraged exports, savings and investment. The IMF has entered into two Stand-By agreements with Kenya in an effort to remedy the problem. The objective has been to begin to redress the fiscal imbalance and correct the balance of payments deficit in the short-term. The IMF Stand-By agreements have been complemented by two IBRD Structural Adjustment Loans.

The first IMF stand-by effort was only partially successful. The GOK exceeded its budget and credit limitations and the foreign exchange reserves continued to erode.

A 15% devaluation in September 1981 in addition to the 5% devaluation which had already taken place in February of the same year was undertaken before approval of the second Stand-By. The agreement included a reform and simplification of the import system, a freeze on public sector wages and hiring except for vacancies in "absolutely necessary" posts, monetary and fiscal limitations, an agreement to raise interest rates and increase credit to the private sector, and limits on external borrowing.

The IBRD structural adjustment loans facilitate a rationalization of the industrial structure and to orient it toward exports; this necessarily includes reform of the import regime. Agriculture is similarly to be restructured. Management of the budget, external debt and internal credit are also covered, as are energy and population.

B. The Import Regime and Exchange Rate

1) Foreign Exchange

Despite the two devaluations and certain reforms in the import regime, the foreign exchange position of the GOK continues to deterioriate and a black market for the currency offering premia of 40% to 100% exists. Overvaluation of the shilling brings all of the economic dislocation and disincentives associated with that condition. An estimate of the degree of overvaluation is beyond the analytical scope of this paper, but knowledgeable sources estimate the degree of overvaluation as high as 100%. While that may be excessive, it is not beyond credibility, given the relatively inelastic demand for imports in Kenya and the current rate of inflation which is in excess of 20% per annum. Although the GOK is nominally committed to keeping the exchange rate realistic, it has resorted to administrative rationing of foreign exchange and delays in payments to defend the current rate of exchange.

The dimensions of the problem are indicated by the rate of issuance of import licenses . For CY 1982, the GOK forecast a demand for KSh. 23 billion and established a target of KSh. 24 billion. Yet at the beginning of the calendar year licences were being issued at a rate of KSh. 32 billion. By mid-year, this had been administratively cut back to the current rate of KSh. 18 billion per annum.

Clearly, such gyrations are damaging to the economy and aggravate an already delicate situation. The absence of a clearer commitment to a realistic exchange rate structure which can accommodate the pressures of inflation and restructuring of the economy is a lamentable defect in the IMF Stand-By agreement which requires remedy in the near future if the efforts of the IBRD and the donors, to include the U.S., to support restructuring of the economy are to be fully successful.

The GOK must be encouraged to cooperate with the IMF and move expeditiously toward a freer foreign exchange and continue the transition from license rationing to tariffs as a means of limiting demand for certain goods.

But here again, the reliance on high tariffs reinforces an overvalued exchange rate. The IMF and the GOK should be strongly encouraged to view the current tariff structure as transitional and establish, as an intermediate term goal, the elimination of as many tariffs as possible. Otherwise the effort to expand and strengthen the export sector could be severely handicapped, and the structural reforms hoped for from the IBRD Structural Adjustment Loans will be impeded.

The reforms in the foreign exchange and import regimes which have been taken to date are to be applauded because they move in the right direction. But they are substantially short of the necessary goals. It will take steadfast dedication on the part of the donors and the IMF to gain and sustain the necessary momentum for genuine reform, the sine qua non of which is an exchange rate and import regime which clearly reflect international market conditions and support exports. In this regard, a resident IMF presence would clearly make a difference and the U.S. should encourage the IMF to move expenditiously to establish one.

It is important to bear in mind that recent pricing reforms in maize and wheat, as well as fertilizer, are laudable only in so far as they are now in line with world markets at the official exchange rate. However, because of the substantial overvaluation of the Kenyan shilling, there is still a de facto subsidy to consumption on these and other commodities, which continues to distort investment and production decisions, and continues to discourage exports.

External borrowing from banks deserves close monitoring. Kenya's debt-service ratios, present and projected, are still manageable provided the appropriate discipline is maintained. But the debt service levels are at the margin of "acceptability". Kenya's "bankability" can be maintained, and that is a great asset. Every effort should be made to keep it.

2) Public Finance

Financing of the budget has become a progressively greater problem. The result has been a substantial "crowding out" of the private sector as government borrowed ever greater amounts, both absolutely and proportionally.

It appears now that the targets of the second Stand-By may be met, and in order to further tighten discipline, the budgets of the parastatals are to be incorporated into the overall budget. Restrictions have also been placed upon external and internal borrowing.

These accomplishments were necessary and the maintenance and enhancement of discipline to continue their enforcement is essential. But they have not been cost free. The burden of recurrent costs problem, already troublesome, has become acute as the GOK has to meet increasing demand for payroll and other non-discretionary expenditures. There have also been substantial delays in certain payments due which cannot be delayed indefinitely.

The Kenya development budget is a particular case in point. The current budget contains 440 active development projects up from 360 last year. This number refers to major projects which contain numerous sub-projects, fifty or more in some cases. Projects in Kenya in the past has been funded at 85%. An IBRD sample compiled last year indicated a 45% funding. Since then the number of projects has increased by more than 20%. Some estimate that in the current year, funding for some projects may be as low as 25%. The internal rates of return on such underfunded projects have plummeted and the viability of many is in question. It is important that the donors and the GOK reach an understanding on project priorities, both existing and planned, and adjust to the funding realities. This implies a discontinuance or delay of some projects. Donors must be prepared to accept that fact if the IMF and IBRD packages are to receive the necessary support.

The inadequacy of the resource base to sustain the level of development activity indicates the urgent requirement for the GOK and donors to place special emphasis upon the rapid expansion of the private sector in order to expand the tax base

Similarly, an all out effort should be made by the GOK to divest itself of parastatals, thereby limiting the fiscal and administrative burdens of the government and expanding the private sector.

Implicit in the sum total of the reforms in the IMF and IBRD packages is a substantial reordering of the tax structure to assure that it supplies adquate revenues without smothering the incentives to production, particularly for export. The GOK should be given technical assistance is this area as a matter of high priority, and progress should be carefully monitored.

3) Credit

The agreement of the GOK to limit public borrowing should contribute significantly to providing liquidity for the private sector. The GOK has also complied with its commitment

to raise interest rates. Lending rates have been raised to 14% which at the time it was done most likely constituted a positive real rate. Now the real rate is again negative in view of the 20% plus inflation rate. There is evidence however that banks and financial institutions are charging commitment and administrative fees and are requiring compensatory balances such that an effective positive real lending rate exists. On the supply side however, there is less opportunity to effectively adjust the interest rates paid, and therefore less incentive to save than should be the case. Interest rates paid to savers appear to still be negative in real terms. A lifting of ceilings on both deposits and loans would eliminate this disincentive without raising effective lending rates. Indeed, it could lower them.

C. Agricultural Marketing

This discussion will concentrate on maize because it is the most important food crop and food staple, and because changes in the handling of this crop eventually would have significant implications for the marketing of other commodities.

The official price of maize is set by the National Cereals and Produce Board. Currently it is approximately at world market levels at the existing exchange rate. The board purchases maize at the established price -- until it runs out of money. Then purchases cease and the market must rely more heavily on private traders.

Only 20 to 25 percent of the maize produced goes through the Board. The majority of the Board's transactions are with large commercial farmers. This structure has curious results. If supplies are tight and official prices are relatively low, the Board is unable to purchase sufficient quantities to meet demand; thus the private market price rises above the official price and the private sector meets demand (unless imports are brought in to depress the price). On the other side, if suppliers are high and official prices are also "high" as they currently are, the board is unable to purchase all that is offered for sale, the surplus goes to the private market, and prices drop below the official price. Exports, if allowed, then become a significant determinant of actual market prices.

The Board, as it now functions, distorts markets, invites corruption and strains GOK administrative capacity. Moreover, because it inhibits the development of a rural commercial infrastructure, it is an impediment to economic development. Moreover, the currently overvalued exchange rate discourages production and favors imports. Studies indicate

that small holders could significantly increase maize output with increased fertilizer use. A real world market price based upon a realistic exchange rate would supply the additional income to purchase the additional fertilizer and still retain a larger profit. And a free market would assure that the producer gets the fertilizer and can sell maize.

D. Strategy

1) The Short Term

USAID's short term objective is to respond to the current crisis by providing immediate resources to stabilize the economic system and allow time to determine with some degree of accuracy what is further needed in terms of resources, policy change and donor assistance to reestablish Kenya's development momentum.

A prompt cash grant of $10 million will underscore U.S. resolve to assist Kenya and provides the foreign exchange resources to assure a continued flow of raw materials and spare parts, and to reassure the private sector of USAID support of the GOK's efforts to assure a prompt recovery from the damage suffered on August 1. By this action we hope to encourage other donors to be similarly forthcoming.

The FY 82 planned U.S. program assistance of $10 million will now be $15 million. $5 million of this total will be applied to assist that segment of the private sector which was damaged during the looting of August 1. The shillings generated will be on deposit with the Central Bank of Kenya to be available for discounting facility to commercial banks whose customers suffered losses. The increased liquidity thus created should facilitate recovery and reassure the private sector. This mechanism carries no subsidies, it simply provides the additional liquidity needed by the private sector, and in doing so, gives the commercial banks an incentive to be more forthcoming in assisting the victims of the civil disturbance that accompanied the coup attempt.

At the same time the U.S. Mission is making a concerted effort to encourage the GOK to adopt and publish the package of export incentives which it has announced are in preparation*.

2) The Intermediate Term

While recognizing that it is imperative to stabilizing the immediate economic and political situation, USAID believes that it is important to use the time afforded by a prompt and

*President Moi, in his speech on September 21, 1982 reinstated the export compensation scheme. However, we expect the Government to publish the package of export incentives by November 1, 1982.

forthcoming response to the needs of the GOK to promote longer term strategies.

a) Policy Objectives Macro:

USAID believes that the general framework of the IMF Stand-By Agreements and the IBRD Structural Adjustment Loans is consistent with the U.S. policy of supporting the evolution of a market based export oriented economy.

To accomplish this, USAID will continue its discussions with other donors to assure that they are aware of our objectives and enlist their support. There is already a good pattern of informal coordination among donors upon which this can be built. Similarly, an enhanced effort will be made to continue to expand the exchange of views with the GOK. Specific points of emphasis will be:

1) USAID believes that reform of the foreign exchange system and tariff structure is essential to the success of the structural adjustment program, particularly if it is to result in increased exports. Specifically, a floating exchange rate (or similar mechanism) accompanied by a low tariff structure and issuance of import licenses on demand is the appropriate objective.

2) A review of commercial and financial laws and institutions to assure their supportiveness of the continued modernization of the private sector is an important ingredient of success.

3) USAID will encourage other donors to cooperate with the GOK in the establishment of development priorities for projects and in the implementation of those priorities both in the rationalization of the existing portfolio and in the introduction of new projects. This activity is essential to solving the burgeoning recurrent cost problem, and in assisting the GOK in its efforts to control its budget.

b) Agriculture and the Private Sector

USAID believes that a strengthening of the private commercial sector role in the marketing of agricultural inputs and products in a free market context is essential to place the agricultural sector on a more productive and rational basis. Accordingly, USAID will be exploring means of using its resources to accomplish the following policy and institutional changes.

1) Assuming that the level of ESF resources requested will be available, USAID will strive to have fertilizer moved to Import Schedule 1; licence available on demand. This would expand fertilizer distribution through the private sector and strenthen its capacity to conduct commerce in the rural areas. An analysis of the fertilizer market indicates that it is now sufficiently large to eliminate the collusive abuses which were possible in the past.

2) To eliminate the current subsidy resulting from delayed counterpart deposits, and to channel credit to the commercial banking sector, USAID will strive for a requirement that counterpart be deposited upon removal of U.S.-supplied fertilizer from customs.

3) In order to strengthen the commercial capabilities of indigenous rural small traders and thereby strengthen the commercial sector, USAID will explore the possibility of placing deposits in commercial banks at favorable rates with the understanding that the banks will provide technical assistance to indigenous small traders in rural areas.

4) USAID will encourage the GOK to lift the restrictions on the movement of maize among districts, thereby facilitating the free flow of maize in the countryside in response to economic incentives.

5) USAID will encourage the GOK to limit the role of National Cereals and Produce Board in direct purchase and sales and redirect it to the establishment and management of security food stocks, and their use for the maintainance of appropriate floor and ceiling prices.

USAID believes that this strategy offers an integrated approach to the use of its program resources. It will enhance donor coordination and effectiveness. It will give an integrated focus to USAID policy dialogue with the GOK on those elements of policy which affect agriculture, our prime sector. It will support reform of the institutions in the agricultural sector, and expand the role and effectiveness of the private sector to enable it to assume the functions implicit in this strategy.

The Kenyan economy is in difficulties and even under the best of circumstances, several years of effort will be required to establish a good development momentum. But the elements necessary for such success are at hand and properly managed and supported, Kenya can reach its goal. USAID believes that the strategy for support outlined above offers the most effective use of U.S. resources in support of Kenya's efforts.

V. Program Implementation

This program is designed to facilitate the flow of financial resources to the Government of Kenya to enable it to meet its immediate foreign exchange shortfalls. The grant will be disbursed to a Goverment of Kenya account in a U.S. bank specified by the Government of Kenya in a Financing Request. The Financing Request will be submitted to A.I.D. within thirty (30) days from the date of execution of the Program Grant Agreement. The Regional Finance Management Center (RFMC) will cable the Financing Request to M/FM, AID/W, who in turn will arrange for transfer of funds electronically into the GOK account.

Because the Government of Kenya's quarterly foreign exchange requirements substantially exceed the full amount of this Grant ($10,714,000) and considering the urgent requirement for foreign exchange to finance the import of critical inputs for agriculture and industrial sectors, A.I.D.'s initial disbursement will cover the full amount of this Grant. The Program Grant will not be utilized for purchase of military or luxury goods, or other goods in the lowest priority category of imports (Import Schedule II.B).

Upon transfer of US dollar funds under this Grant, the Government of Kenya Ministry of Finance will establish a Special Account. Local currency equivalent to the US dollar amount will be deposited in this account within 60 days of the disbursement of the cash dollar grant. Within these 60 days the Government of Kenya and Ministry of Finance will agree on specific activities for which the local currency shall be used.

VI. Use of Local Currency

A. Immediate Local Currency Requirements

In discussions with officials from commercial banks, insurance companies and Government of Kenya Ministry of Finance, the PAAD team has learned that during the August 1 civil disturbances commodities worth approximately $40 million were looted from about 400 business premises consisting of retail shops, wholesale warehouses and factories located in Nairobi. In the majority of cases the retail shops and wholesale warehouses lost all of their inventory. Government's concentrated efforts have resulted in recovery of nearly 1(percent of the looted goods which have been returned to owners. Because the event leading to the looting has been considered a 'civil commotion', the insurance companies maintain that they cannot compensate for the losses.

In Kenya most goods are sold by factories and wholesalers on credit extended for between 120 to 150

days. The demand bills executed by a purchaser in favour of a supplier are normally discounted by local banks. As the retail shops have lost most of their merchandize they are not in a position to pay wholesalers and factories for commodities they had purchased before August 1. If a demand bill is not paid, the party in whose favor the demand bill was drawn is responsible for refunding the money to the bank. Similarly, the wholesaler who purchased goods from a factory is not in a position to pay for those because he/she did not receive payment from the retailer. In the end, the factory owner has to arrange for financing so as to keep operating the manufacturing facility, to pay wages to the staff and to buy raw materials.

With the chain reaction described above, it is very probable that many people in Nairobi and other parts of Kenya who work in industries will soon be unemployed. The estimates of potentially unemployed people vary from 1,000 to 5,000; the PAAD team believes the higher figure to be closer to the mark. The PAAD team estimates that the unmet requirement for local currency is approximately $20 million for a period of three years, the estimated time required for businesses to recover.

B. General Budgetary Constraints

The share of central government expenditures covered by deficit financing runs around 20 percent per annum. It reached a peak level of 24 percent in 1980/81, the first year of the structural adjustment. The deficit is expected to decrease to just under 17 percent by 1983/84, assuming certain improvements in Kenya's financial management procedures. Recognizing that many of its problems stem from a general lack of discipline in its budget process, the GOK has taken some long awaited necessary steps toward restoring the integrity and authority of the budget as the central framework for the allocation of government financial resources. It has imposed a stringent system of prior certification of funds and evaluation criteria for all development projects and is closing loopholes and eliminating tax arrears.

The Kenya Government expects to finance 19 percent of its 1982/83 budget from external grants and concessional loans. Assuming that domestic revenue targets are met the GOK will be able to reduce its budget deficit substantially and decrease the amount it needs to borrow in competition with the private sector. Past performance indicates that its revenue estimates are optimistic and the GOK will, therefore, look to additional external donor resources to make up the shortfall. Its balance of payment deficits and the August 1 civil disturbances, have contributed to a decline in economic activity. The slowdown will adversely affect tax and license revenues suggested in the budget.

C. Areas of Concentration for AID Local Currency Equivalent

As mentioned above, the PAAD team has identified the immediate need for local banks to extend the validity period of short-term credit facilities to businesses which were looted on August 1. The Government's Ministry of Finance concurs that financial assistance to these businesses should have high priority. GOK will establish a discount facility of local currency equivalent to $5,114,000 at the Central Bank of Kenya to which commercial banks will have access for a period of approximately 3 years. Interest and principal paid to the Central Bank of Kenya shall be disbursed to the Ministry of Finance.

Given the need for budgetary support, an amount of local currency representing the shortfall in the anticipated commodity program may be used for programs that support USAID's major assistance objective - increased rural production, employment and income. The eligible programs must be included in the five year Development Plan and in the 1982/83 budget estimates. Details of local currency uses and implementation procedures will be the subject of implementation letters within 60 days following disbursement of the grant. An illustrative list of programs and the amounts which could be supported with the local currency is as follows:

1.	Rural Development Projects Fund	- $1,200,000
2.	Kiboko Research Stattion	- 800,000
3.	Buchuma Research Station	- 400,000
4.	Fodder Bulking Project	- 1,000,000
5.	Sheep and Goats Development	- 800,000
6.	Crop Production	- 3,000,000
7.	Soil Conservation	- 1,000,000
8.	Soil Conserv. and Land Preparation	- 2,000,000
9.	ASAL Development	- 400,000
10.	Agricultural Information Center	- 500,000
11.	Agriculture Education	- 3,500,000
12.	Rural Roads	- 6,000,000
	Total	$20,600,000

VII. Negotiating Status and Govenants

The PAAD team and USAID Director have discussed the purpose of the Program Grant and use of the local currency generated by the Grant with the Permanent Secretary, Ministry of Finance, and there has been a general agreement on implementation procedures described in Section V. No significant issues or problems are, therefore, outstanding. The Program Grant Agreement is being prepared by the REDSO/EA,

RLA. The Agreement will have to be negotiated on an expedited basis with GOK Attorney General's Office and Ministry of Finance so that it is signed by September 30, 1982.

The following covenants will be included in the Program Grant Agreement:

1. The Grant will not be utilized for military or luxury goods or any other goods listed in Grantee's Import Licencing Schedule II.B dated November 1981.

2. For the purpose of financing the local currency costs of development programs and recovery from the economic losses suffered in the disturbances of August 1, 1982, the Grantee agrees to establish a special account within sixty (60) days from the date of disbursement of the Grant and to deposit therein currency of Kenya (local currency) equivalent in amount to the United States dollar disbursement made under this Agreement. The highest rate of exchange which is not unlawful in Kenya on the date of the United States dollar disbursement shall be used in determining the total amount required to be deposited in the Special Account.

3. A.I.D. and the Grantee agree that the funds deposited in the Special Account shall be used to finance local currency costs of Grantee's development programs and to provide local currency resources to businesses to assist them in recovering from the economic losses suffered in the disturbances of August 1, 1982. In order to be eligible for budgetary assistance from the Special Account, development programs must support increased rural production, employment and income; be included in the Grantee's five-year development plan; and be included in the Government of Kenya's 1982/83 budget estimates. Within 60 days of the disbursement of the Grant, the Grantee will submit for A.I.D. approval a specific list of development programs which it proposes to support from the Special Account. It is also agreed that not less than the equivalent of $5,114,000 of the local currencies deposited in the Special Account will be made available to the Central Bank of Kenya for a discount facility for local commercial banks providing short-term loans to businesses which suffered losses as a result of the August 1, 1982, disturbances. The specific conditions under which funds will be made available through the discount facility will be mutually developed and agreed upon by the Grantee and A.I.D. within 60 days of the disbursement of the Grant.

4. Disbursements from the Special Account shall be made in accordance with such procedures and at such times as determined to be appropriate by the Grantee; provided, that all funds deposited in the Special Account shall be disbursed within fourteen (14) months from the date of disbursement of the Grant, except as A.I.D. may otherwise agree in writing.

5. The Grantee agrees to provide to A.I.D. for each six (6) month period following the date of this Agreement until such time as all Special Account funds have been disbursed, a report which shows:

(i) Cumulative deposits to and disbursements from the Special Account of local currency furnished pursuant to this Agreement;

(ii) For each program or activity receiving Special Account funds under this Agreement, the budget amount, disbursements made during the six-month period and cumulative disbursements.

This report certified as correct by an appropriate official within the Ministry of Finance or other Grantee agency, will be submitted to A.I.D. within thirty (30) days after the close of each six-month period, except as A.I.D. may otherwise agree in writing.

6. Grantee agrees to provide such other reports on the disbursement and use of Special Account funds as A.I.D. may from time to time require.

Annex A

STATE HOUSE
P O BOX 10430
NAIROBI, KENYA

Ref. No. ZZ 95/010

16th August, 1982

REQUEST FOR EMERGENCY BALANCE OF PAYMENTS SUPPORT

You are no doubt aware of the disruptive events of 1st August, 1982, during which some misguided elements in the Kenya Air Force caused substantial damage to life and property in Nairobi. Those elements have now been crushed; and peace, law and order restored in the Republic. Unfortunately, however, the damage caused to the economic life of the Nation has inevitably aggravated the general economic difficulties that Kenya has been experiencing in the last few years. Primary amongst these problems is the continued weak balance of payments position facing the economy.

Prior to the events of August the 1st, Kenya had embarked on a rational structural adjustment programme with the support of both the World Bank and the International Monetary Fund. Indeed, the policies persued by my Government in the last few years have sought to restore economic growth within a framework of policies designed to move Kenya's manufacturing sector towards production for exports; a reformed trade and import licensing system; better project preparation and implementation; as well as a comprehensive external debt management system. Besides these policies, my Government has committed itself to a purposeful population policy; and is vigorously pursuing related policies in other sectors. Above all, the Government has been concerned that a proper balance is maintained between the public and private sectors, and to this end, the Government has embarked on a process of

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STATE HOUSE
P O BOX 10430
NAIROBI, KENYA

stringent curbs in public expenditure to ensure that more resources are channelled to the private sector which must continue to bear the main burden of bringing about more rapid growth to the economy.

It was in support of these policies that the International Monetary Fund and the World Bank had pledged support to the Kenya Government in the form of a Stand-by Facility of SDR 151.5 million and a Structural Adjustment Loan of US$ 130.9 million, respectively. These foreign exchange resources, together with normal export earnings and other receipts would have been adequate to see us through to the end of the current financial year.

Unfortunately, these projections have now been undermined by the events of August the 1st, and it is our expectation that the overall balance of payments deficit formerly anticipated will more than double by the end of the year, due to lower tourist receipts in the immediate future and adverse balance in the capital account.

According to our revised projections for the balance of 1982, the overall deficit will increase by at least US$ 130 million over the previous estimate, thus bringing the overall balance of payments deficit to approximately US$ 400 million. Prospects for 1983 and 1984 remain equally uncertain; and in the absence of substantially increased amounts of bilateral financial assistance on a concessional basis, it is clear that many of our current economic policies stand the risk of being aborted. For the moment, however, we face a critical foreign exchange problem as we begin to reconstruct our economy.

In the light of these circumstances, I take this opportunity to make a personal appeal to you, Mr. President,

...../3

STATE HOUSE
P O BOX 40530
NAIROBI, KENYA

and your Government for immediate balance of payments support. In addition, we would urge that consideration be given to accelerated disbursement of funds under existing grants and concessional loan agreements. Consideration should also be given to possiblities of modifying certain of these agreements so as to make the undisbursed amounts immediately available for generalized balance of payments support. It would also seem necessary to negotiate the re-scheduling of certain loans or waiver of interest payments; but separate approaches along these lines will be made to your Government through normal channels.

In the particular case of your Government, the Government of Kenya requests:-

1. That the US$ 10 million commodity aid programme currently at the final stage of negotiations between the Government of Kenya and the United States Agency for International Development be adjusted to permit utilization of such funds for general balance of payments support during the remainder of Calendar Year 1982;

2. New balance of payments support of US$ 100 million on a grant or concessional basis during the next US Fiscal Year, i.e. from October 1982..

The Government of Kenya is prepared to provide assurances that such foreign exchange will be utilized for purchases of US goods and services as well as undertaking any other measures which will enhance the prospects of economic recovery in these difficult times.

...../4

STATE HOUSE
P O BOX 30510
NAIROBI, KENYA

Accept, Mr. President, the assurances of my highest estimation and good wishes.

DANIEL T. ARAP MOI
PRESIDENT

The Hon. Ronald Reagan,
The President,
The Whitehouse,
Washington D.C.,
U.S.A.

Annex B

UNCLASSIFIED
AID 09/08/82
DIR:ABHERRICK
PRJ:SPSHAH:AM
1. PROG:WLefes, 2. RLA:PScott
DIR PRJ-2 RF, PROG RLA CHRON, ECON

AMEMBASSY NAIROBI
SECSTATE WASHDC

AIDAC

E.O. 12356: N/A
Subject: Kenya Program Grant, 615-0227
- Environmental Examination, Reg. 16

1. USAID/Kenya requests AID/W concurrence in quote categorical exclusions unquote as defined in Section 216.2(c)(2) for the subject project. Details are as follows:

A. Project location: Kenya

B. Project Title: - Kenya Program Grant

C. Funding: - - FY 1982 - Dol. 10,000,000

D. Project Description: The Proposed Dols. 10 million cash grant will provide the Government of Kenya critical balance of payments support to help it succeed in the economic structural adjustment program it has undertaken. Until full implementation of newly adopted monetary, trade and industrial policies result in increased exports, additional foreign exchange will be needed for raw materials, industrial and agricultural inputs, capital equipment and spare parts essential to maintenance of acceptable economic growth rates. The funds will be disbursed within ninety days from the date of execution of the Program Grant Agreement. The Kenya shillings generated by the grant will be placed in a special account and jointly programmed by the GOK and AID for mutually agreed upon purposes. These may include general support of priority items within the GOK development budget and providing funds to commercial banks for loans to the business community to repair damages or replace losses as a result of the August 1 civil disturbances.

2. USAID/Kenya believes that the activities to be financed from the Grant and Special Account fall within the criteria established for categorical exclusion. The cash grant itself will not have an effect on the natural or physical environment and the objective of A.I.D. in furnishing assistance as indicated above, does not require A.I.D. to have (and AID will not, in fact, have) knowledge and control of the details of the specific activity that may have an effect on the physical and natural environment, either prior to approval of financing or prior to importation of commodities to be financed from the grant. GOK will determine the nature and mix of commodities and/or raw materials to be financed by the foreign exchange resources provided by the grant and such commodities/materials will be imported and distributed through normal commercial channels. With regard to the utilization of host country-owned funds from the Special Account to be established under the project, USAID and GOK will mutually agree upon their uses, but it is not anticipated at this time that USAID review, approval or control over the details of specific activities that may have an effect on the physical and natural environment will be required, particularly in the case of support to intermediate credit institutions. In the event USAID control over specific activities is deemed necessary, environmental analysis of such activities will be undertaken to the extent required by Reg. 16 at the time of AID approval of such activities for financing from the Special Account.

3. This message has been cleared by RLA. REDSO environmental officer is out of Nairobi. HOUDEK##

PRJ: ADVANCE COPY 9-27

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BT
UNCLAS STATE 271134

ANNEX B

26 SEP 82
TOR: 0810
CN: 02957
ID

AIDAC

E.O. 12356: N/A
TAGS:
SUBJECT: IEE - KENYA PROGRAM, GRANT (615-0227)
-
REF: NAIROBI 21930

A CATEGORICAL EXCLUSION HAS BEEN RECOMMENDED ON THE SUBJECT IEE AND HAS BEEN APPROVED BY AA/AFR. SHULTZ
BT
#1134

NNNN

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3A(2) - NONPROJECT ASSISTANCE CHECKLIST

The criteria listed in Part A are applicable generally to FAA funds, and should be used irrespective of the program's funding source. In Part B a distinction is made between the criteria applicable to Security Supporting Assistance and the criteria applicable to Development Assistance. Selection of the appropriate criteria will depend on the funding source for the program.

CROSS-REFERENCES: IS COUNTRY CHECKLIST UP TO DATE? IDENTIFY. HAS STANDARD ITEM CHECKLIST BEEN REVIEWED? Yes, see Kitui Rural Health Project Paper (615-0206) approved on January 29, 1982. Yes.

A. GENERAL CRITERIA FOR NONPROJECT ASSISTANCE

1. FY 82 Approp. Act Sec. 523. FAA Sec 653(b)	
(a) Describe how Committees on Appropriations of Senate and House have been or will be notified concerning the nonproject assistance;	A Congressional notification was sent to Congress on Sept. 13, 1982 The 15-day expired on Sept. 27, 1982 without Congressional objection.
(b) is assistance within (Operational Year Budget) country or international organization allocation reported to the Congress (or not more than $1 million over that figure plus 10%)?	Yes
2. FAA Sec. 611(a)(2). If further legislative action is required within recipient country, what is basis for reasonable expectation that such action will be completed in time to permit orderly accomplishment of purpose of the assistance?	No further legislative action is required.
3. FAA Sec. 209, 619. Is assistance more efficiently and effectively given through regional or multilateral organizations? If so why is assistance not so given? Information and conclusion whether assistance will encourage regional development programs. If assistance is for newly independent country, is it furnished through multilateral organizations or in accordance with multilateral plans to the maximum extent appropriate?	No. It is country-specific balance of payments support.
4. FAA Sec. 601(a); (and Sec. 201(f) for development loans). Information and conclusions whether assistance will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and competition; (c) encourage development and use of cooperatives, credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture, and commerce; and (f) strengthen free labor unions.	Program will: increase the flow of international trade; foster private initiative and competition, discourage monopolistic practices, and improve technical efficiency of industry, agriculture, and commerce. Impact on development and use of cooperatives, credit unions and savings and loan associations and labor unions not clear, but no adverse impacts are anticipated.

A.

5. FAA Sec. 601(b). Information and conclusion on how assistance will encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise).

Program cash grant of FX will improve economy and permit increased importation of U.S. goods and investment in private sector oriented Kenya economy. U.S.-owned private enterprises established in Kenya will be allocated the FX. These enterprises will import key industrial inputs, in some cases from private U.S. companies.

6. FAA Sec. 612(b); Sec 636(h). Describe steps taken to assure that, to the maximum extent possible, the country is contributing local currencies to meet the cost of contractual and other services, and foreign currencies owned by the United States are utilized to meet the cost of contractual and other services.

Provisions in the grant agreement will require Kenya to utilize counterpart local currencies in mutually agreed upon activities, including short term loans to enterprises which were affected by the August 1 coup attempt.

7. FAA Sec. 612(d). Does the United States own excess foreign currency and, if so, what arrangements have been made for its release? No.

B. FUNDING CRITERIA FOR NONPROJECT ASSISTANCE

1. Nonproject Criteria for Security Supporting Assistance

a. FAA Sec. 531. How will this assistance support promote economic or political stability? Will assistance under this grant be used for military or paramilitary activities?

This assistance will help close a growing balance of payments gap by providing foreign exchange for the importation of goods required by local enterprises during a period of economic slowdown. Thus it will make a direct contribution to economic as well as political stability.

No.

2. FAA Sec. 534. Will ESF funds be used to finance the construction or the operation or maintenance of, or the supplying of fuel for, a nuclear facility? If so, has the President certified that such use of funds is indispensable to non-proliferation objectives?

No.

3. FAA Sec 609. If commodities use to be granted so that sale proceeds will accrue to the recipient country, have special Account (counterpart) arrangements been made?

N/A

4. Nonproject Criteria for Development Assistance

a. FAA Sec. 102(c); Sec.111; Sec. 281a.

Extent to which activity will (1) effectively involve the poor in development, by extending access to economy at local level, increasing labor-intensive production, spreading investment out from cities to small towns and rural areas; and (2) help develop cooperatives assist rural and urban poor to help themselves toward better life, and otherwise encourage democratic private and local government institutions?

The dollar grant will not directly involve the poor in development and help develop cooperatives. However, some local currency generated will be used for rural development.

b. FAA Sec. 103, 103A, 104, 105 106, 107.

Is assistance being made available: (include only applicable paragraph-- e.g., a, b, etc. -- which corresponds to sources of funds used. If more than one fund source is used for assistance, include relevant paragraph for each fund source.)

B4(b)

(1) [103] for agriculture, rural development or nutrition; if so, extent to which activity is specifically designed to increase productivity and income of rural poor; [103A] if for agricultural research, is full account taken of needs of small farmers; N/A

(2) [104] for population planning or health; if so, extent to which activity extends low-cost, integrated delivery systems to provide health and family planning services, especially to rural areas and poor; extent to which assistance gives attention to interrelationship between (A) population growth and (B) development and overall improvement in living standards in developing countries. Is activity designed to build motivation for small families in programs such as education in and out of school, maternal and child health services, agriculture production, rural development, and assistance to urban poor? N/A

(3) [105] for education, public administration, or human resources development; if so, extent to which activity strengthens nonformal education, makes formal education more relevant, especially for rural families and urban poor, or strengthens management capability of institutions enabling the poor to participate in development; N/A

(4) [106] for technical assistance, energy, research, reconstruction, and selected development problems; if so, extent activity is: N/A

(a) to help alleviate energy problem;

(b) reconstruction after natural or manmade disaster;

(c) for special development problem, and to enable proper utilization of earlier U.S. infrastructure, etc., assistance;

(d) for programs of urban development, especially small labor-intensive enterprises, marketing systems, and financial or other institutions to help urban poor participate in economic and social development.

(5) [107] by grants for coordinated private effort to develop and disseminate intermediate technologies appropriate for developing countries. N/A

B4(c)

c. Sec. 113. Extent to which assistance reflects appropriate emphasis on integrating women into the recipient country's national economy. N/A

d. FAA Sec. 281(b). Describe extent to which program recognizes the particular needs, desires, and capacities of the people of the country; utilizes the country's intellectual resources to encourage institutional development; and supports civic education and training in skills required for effective participation in governmental and political processes essential to self-g[illegible]ent. N/A

5. Nonproject Criteria for Development Assistance (Loans only)

a. FAA Sec. 201(b)(1). Information and conclusion on availability of financing from other free-world sources, including private sources within the United States. N/A

5. b. FAA Sec. 201(b)(2); 201(d). Information and conclusion on (1) capacity of the country to repay the loan, including reasonableness of repayment prospects, and (2) reasonableness and legality (under laws of country and United States) of lending and relending terms of the loan.

c. FAA Sec. 201(e). If loan is not made pursuant to a multilateral plan, and the amount of the loan exceeds $100,000, has country submitted to AID an application for such funds together with assurances to indicate that funds will be used in an economically and technically sound manner?

d. FAA Sec. 202(a). Total amount of money under loan which is going directly to private enterprise, is going to intermediate credit institutions or other borrowers for use by private enterprise, is being used to finance imports from private sources, or is otherwise being used to finance procurements from private sources?

6. Additional Criteria for Alliance for Progress

[Note: Alliance for Progress assistance should add the following two items to a nonproject checklist.]

N/A

a. FAA Sec. 251(b)(1)-(8). Does assistance take into account principles of the Act of Bogota and Charter of Punta del Este; and to what extent will the activity contribute to the economic or political integration of Latin America?

b. FAA Sec. 251(b)(8); 251(h). For loans has there been taken into account the effort made by recipient nation to repatriate capital invested in other countries by their own citizens? Is loan consistent with the findings and recommendations of the Inter-American Committee for the Alliance for Progress (now "CEPCIES," the Permanent Executive Committee of the OAS) in its annual review of national development activities?

5C(3) - STANDARD ITEM CHECKLIST

Listed below are the statutory items which normally will be covered routinely in those provisions of an assistance agreement dealing with its implementation, or covered in the agreement by imposing limits on certain uses of funds.

These items are arranged under the general headings of (A) Procurement, (B) Construction, and (C) Other Restrictions.

A. Procurement

1. FAA Sec. 602. Are there arrangements to permit U.S. small business to participate equitably in the furnishing of commodities and services financed?

   This Program Cash Grant does not provide financing specifically for procurement of goods and services. To the extent the host country decides to procure goods and services they will be encouraged to do so from U.S. sources. U.S. businessmen will not be precluded from furnishing commodities. It is likely that some commodities will be furnished by U.S. small business.

2. FAA Sec. 604(a). Will all procurement be from the U.S. except as otherwise determined by the President or under delegation from him?

   (See above.)

3. FAA Sec. 604(d). If the cooperating country discriminates against marine insurance companies authorized to do business in the U.S., will commodities be insured in the United States against marine risk with such a company?

4. FAA Sec. 604(e); ISDCA of 1980 Sec. 705(a). If offshore procurement of agricultural commodity or product is to be

   The purchase of agricultural commodities is not specifically financed under this Grant.

	financed, is there provision against such procurement when the domestic price of such commodity is less than parity? (Exception where commodity financed could not reasonably be procured in U.S.)	
5.	FAA Sec. 604(g). Will construction or engineering services be procured from firms of countries otherwise eligible under Code 941, but which have attained a competitive capability in international markets in one or these areas?	N/A
6.	FAA Sec. 603. Is the shipping excluded from compliance with requirement in section 901(b) of the Merchant Marine Act of 1936, as amended, that at least 50 per centum of the gross tonnage of commodities (computed separately for dry bulk carriers, dry cargo liners, and tankers) financed shall be transported on privately owned U.S. flag commercial vessels to the extent that such vessels are available at fair and reasonable rates?	N/A. See A.2. above
7.	FAA Sec. 621. If technical assistance is financed, will such assistance be furnished by private enterprise on a contract basis to the fullest extent practicable? If the facilities of other	N/A

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Federal agencies will be utilized, are they particularly suitable, not competitive with private enterprise, and made available without undue interference with domestic programs?

8. International Air Transport. Fair Competitive Practices Act, 1974. If air transportation of persons or property is financed on grant basis, will U.S. carriers be used to the extent such service is available?

N/A. This grant does not entail the financing of identifiable air transportation.

9. FY 1982 Appropriation Act Sec. 504. If the U.S. Government is a party to a contract for procurement, does the contract contain a provision authorizing termination of such contract for the convenience of the United States?

N/A

B. Construction

1. FAA Sec. 601(d). If capital (e.g., construction) project, will U.S. engineering and professional services to be used?

This section not applicable, since the Grant will not finance any identifiable construction activities

2. FAA Sec. 611(c). If contracts for construction are to be financed, will they be let on a competitive basis to maximum extent practicable?

3. FAA Sec. 620(k). If for construction of productive enterprise, will agggregate value of assistance to be furnished by the U.S. not exceed $100 million (except for productive enterprises in Egypt that were described in the CP)? N/A

C. Other Restrictions

1. FAA Sec. 122(b). If development loan, is interest rate at least 2% per annum during grace period and at least 3% per annum thereafter? N/A

2. FAA SEc. 301(d). If fund is established solely by U.S. contributions and administed by an internatioal organization, does Comptroller General have audit rights? N/A

3. FAA Sec. 620(h). Do arrangements exist to insure that United States foreign aid is not used in a manner which, contrary to the best interests of the United States, promotes or assists the foreign aid projects or activities of the Communist-bloc countries? Yes.

4. Will arrangements preclude use of financing:

a. FAA Sec. 104(f); FY 1982 Appropriation Act Sec. 525: (1) To pay for performance of abortions as a method of family Yes.

planning or to motivate or coerce persons to practice abortions; (2) to pay for performance of involuntary sterilization as method of family planning, or to coerce or provide financial incentive to any person to undergo sterilization; (3) to pay for any biomedical research which relates, in whole or part, to methods or the performance of abortions or involuntary sterilizations as a means of family planning; (4) to lobby for abortion?

b. FAA Sec. 620(g). To compensate owners for expropriated nationalized property? Yes.

c. FAA Sec. 660. To provide training or advice or provide any financial support for police, prisons, or oth law enforcement forces, except for narcotics programs? Yes.

d. FAA Sec. 662. For CIA activities? Yes.

e. FAA Sec. 636(i). For purchase, sale, long-term lease, exchange or guaranty of the sale of motor vehicles manufactured outside U.S., unless a waiver is obtained? Yes

f. FY 1982 Appropriation Act, Sec. 503. To pay pensions, annuities, retirement pay, or Yes.

adjusted service compensation for military personnel?	
g. FY 1982 Appropriation Act, Sec. 505. To pay U.N. assessments, arrearages or dues?	Yes
h. FY 1982 Appropriation Act, Sec. 506. To carry out provisions of FAA section 209(d) (Transfer of FAA funds to multilateral organizations for lending)?	Yes
i. FY 1982 Appropriation Act, Sec. 510. To finance the export of nuclear equipment, fuel, or technology or to train foreign nationals in nuclear fields?	Yes
j. FY 1982 Appropriation Act, Sec. 511.	
For the purpose of aiding the efforts of the government of such country to repress the legitimate rights of the population of such country contrary to the Universal Declaration of Human Rights?	Yes.
k. FY 1982 Appropriation Act, Sec. 515. To be used for publicity or propaganda purposes within U.S. not authorized by Congress?	Yes.

SUMMARY OF STRUCTURAL ADJUSTMENT PROGRAM

Structural Issues and Objectives	Action Already Taken	Steps to be Taken
I. Exchange Rate Policy		
1. Ensure that Kenyan economy remains internationally competitive and that the structure of domestic prices is appropriate	The Kenyan shilling was devalued by 20% vis-a-vis the SDR in 1981. Agricultural and energy prices were adjusted to reflect changes in the exchange rate.	Action. The IMF will continue to monitor the exchange rate, taking into account Kenya's balance of payments situation, as well as movements in key international currencies. The Bank will continue to review relative prices to ensure that exchange rate changes are appropriately reflected in domestic price interrelationships.
II. Industrialization and Trade Policy		
1. Rationalize the system of industrial protection	Letter of No Objection import bans were elimi 1980 budget presentation. New import schedules, providing clearer and simpler administrative mechanisms and increasing the proportion of items not subject to quota from 23% to 38%, were introduced in November, 1981.	Action. The number of import items subject to quota will be drastically reduced by shifting 20% of the items presently subject to quota to free import status each year for the next four, beginning in June, 1982. Guidelines provide that tariffs introduced to replace quotas will not exceed 100%. Program Development. A more uniform and moderate system is to be designed by June, 1983. A program for assisting industries which would be adversely affected by tariff reform will be formulated by June, 1983. Action. The new tariff schedule will be phased in during 1984-85.
2. Improve incentives for export	The shilling was devalued by 20% vis-a-vis the SDR during 1981. Export compensation was increased from 10% to 20% in June, 1980. The Government has undertaken to monitor the competitiveness of exports and to take whatever measures are necessary to ensure adequate financial incentives to export.	Program Development. The Government will undertake a general review of institutional support available to exporters, including the possible role of export finance, by end-1982. The results of this review will be discussed with the Bank and will be used to prepare an action program for export promotion by June 1983.
3. Rationalize the system of incentives to new industry	The Government has adopted new guidelines which provide for economic evaluation of investments to be supported and which restrict the use of exclusive technology licensing agreements, extraordinary tariff protection and use of quotas and import restrictions. These guidelines will be published by September, 1982.	Action: The Government will inform the Bank on incentives that have been granted on a semi-annual basis. The first report will be discussed with the Government in September, 1982.
4. Improve procedures used in deciding on financial participation of the Treasury in new ventures	The Government will ensure that new investments by the Treasury in parastatals or private enterprises are economically, financially and technically sound.	Action. A standard handbook for project evaluation will be adopted along with guidelines on estimation procedures by August, 1982. New regulations governing the review process will be introduced beginning in FY1982/83 which ensure that proper evaluation procedures have been followed. The Government will prepare a report outlining progress made by December, 1982. This will be reviewed with the Bank.

Structural Issues and Objectives	Action Already Taken	Steps to be Taken
III. Agricultural Policy		
1. Improve the functioning of domestic agricultural markets	Restrictions of maize movements introduced [illegible] ion relaxed.	Studies. The Government will undertake a review of maize marketing in order to develop recommendations on the appropriate future structure of the market. Preliminary terms of reference have been agreed upon and consultants will be agreed upon between the Bank and the Government. A high level steering group in Government will be named and will approve final terms of reference. A progress review will be held with the Bank midway through the study and final recommendations will be discussed with the Bank. The study will also make recommendations on an appropriate food security strategy and on a program of market development. Completion of the study is expected by end-January 1983. Action. The Government will decide on the optimal future structure of the grain market to achieve its goals, including the appropriate roles of the public and private sector and price regulation policy by March 1983. Program Development. The study and subsequent government decision will be followed by preparation of a plan to strenghten key institutions and implement decisions. A food security program and a market development program will then be prepared.
2. Clarify government pricing policy and improve the price determination mechanism	The Government has announced that the emphasis of pricing policy will be on establishing adequate incentives for producers and that food prices will not be subsidized (except in the case of emergency imports). The annual price review has been improved by making review procedures more comprehensive and systematic. Producer prices for major domestic crops were increased substantially in December, 1981 reflecting international price movements and exchange rate changes. Past Treasury loans to NCPB have been written off in recognition of subsidy elements implied in NCPBs past operation.	Action. The annual price review for 1983 will be monitored to ensure that it is based on import and export parities and provides adequate incentives to producers.

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Structural Issues and Objectives	Action Already Taken	Steps to be Taken
3. Improve the Management of Agricultural Projects and Programs	A review of procedures for planning, preparation and review of budget estimates, disbursement and expenditure control of Ministry of Agriculture has been undertaken. The Ministries of Agriculture and Livestock Development have established management systems units to identify management problems, prepare recommendations for improvement and assist in implementing reform. A task force has been established on budgeting and financial management of agricultural projects on an ongoing basis. The task force began meeting formally in January, 1982 and is making recommendations for rapid improvements in financial management. An expanded program of management training and development has been established to provide in-house training and longer term overseas training.	Action. The task force recommendations will serve as the basis for improvement of financial management and budgetary procedures for immediate implementation. Action. Technical assistance required, inter alia, to carry out improvements in management will be financed and its utilization agreed upon by the Bank under an agricultural technical assistance project.
4. Establish the basis for a more rational policy of land use and tenure		Action. Land issues will be given special attention in preparation of the next development plan. Task forces will be established with terms of reference to raview key land issues and will be given appropriate technical assistance. Analysis and recommendations will be reviewed by Government. Action. A review will be undertaken of the constraints on regularization of subdivision. A project will be prepared on the basis of this review to accelerate this process and will be discussed with Bank staff by the end of March, 1983.
IV. Energy		
Encourage efficient production and consumption patterns	The Government has followed a consistent policy of non-subsidization of energy prices and prices have been adjusted in line with recent exchange rate changes. A study of the traditional energy sector has been completed and a study of the modern energy sector is underway. A decision has been made to defer further public investments in fuel alcohol pending completion of the energy sector investment program and determination that specific investments in fuel alcohol have acceptable economic rates of return. An energy assessment report has been completed by Bank staff and discussed with the Government.	Program Development. A [illegible] investment program providing for both production and conservation in the modern and traditional sectors will be prepared on the basis of studies now underway and discussed with Bank staff by March 1983. Action. Pricing of energy sources will be discussed with Government in a project context.
V. Population		
Improve the effectiveness of Government efforts to promote family planning	A National Council on Population has been established in the Office of the Vice President to provide leadership for a new interagency, multi-media information and education campaign in population and family planning.	Action. A second Bank rural health and family planning project will begin in the second half of 1982 stressing improved information and expanded facilities and staff.

Structural Issues and Objectives	Action Already Taken	Steps to be Taken
VI. Resource Mobilization		
Increase the level and improve the intermediation of financial savings	Interest rate policy has been modified to recognize its effects on savings and investment, and the need for interest rates to reflect domestic inflation and the structure of international rates. Interest rates are subject to ongoing review and have been increased significantly in the last two years.	Studies. A study will be carried out of the sources and disposition of private saving, the role of incentives in mobilizing savings and the institutional and legal framework of the financial system. Completion is expected by end-1982. Action. Subject to the results of ongoing review and established criteria, Government will take action to maintain appropriate rates of interest.
VII. Planning Government Outlays		
Improve the process of evaluating, planning and budgeting Government outlays	Forward budgets have been prepared in FY1980/81 and FY1981/82 which trim expenditure plans to levels consistent with expected resources availability according to general criteria agreed on by Bank staff. Procedures for preparation of the forward budget and communication with operating ministries have been improved. The forward budget will in the future include a multi-year public sector investment program, in the context of which new projects will be approved, decisions made on priority of and timetables for implementation of ongoing projects, and funding programs revised to keep within resource availabilities. Technical capacity to carry out financial and economic evaluation of projects is being strengthened under a Bank-administered UNDP-financed technical assistance project. Revised procedures for project implementation and monitoring have been devised and pertinent directives to operating ministries have been issued.	Action. Standardized project evaluation criteria for new projects to be included in the forward budget will be introduced by September, 1982. They will include use of standard calculations of economic rates of return on projects. The intention is to ensure that all large projects have rates of return of at least 10%, or represent least-cost solutions. Action. The Government will begin the process of integrating expenditure plans of parastatal entities to the forward and annual budget during FY1982/83. Action. A public investment program will be formulated by the Government by September, 1982 and will be reviewed with assistance of Bank staff.
VIII. External [illegible]		
Improve the management of external debt and coordination of aid programs	A first external borrowing plan has been prepared and discussed with Bank staff. Debt reporting and accounting has been improved by strengthening the debt unit of the Treasury. A limit on external commercial borrowing of US$160 million for FY1981/82 has been established under an IMF agreement	Action. The size of Kenya's external debt and its implications for debt service will be monitored continuously. Annual external borrowing plans will be prepared for each fiscal year. The plan for 1983 will be agreed upon with the Government in December, 1982.
IX. Project Implementation		
Improve the pace of implementation of development projects	A joint Bank-Government of Kenya review of the causes of poor project implementation was undertaken in March 1982. A task force has been established to monitor administration of agencies seeking reimbursement from the Bank Group.	Action. A Project Implementation Committee will be established and a detailed reporting system installed. the Committee will be responsible to the Office of the President by June 1982. Action. A review of Bank Group projects under implementation with a view to rationalizing project commitments in order to live within present financial and administrative limitations is underway.

ANNEX E

December 3, 1981

Memorandum of the Government of Kenya on its Economic and Financial Policies

(1) In 1980 the Government of Kenya launched a medium-term program designed to correct emerging structural imbalances and to re-establish a higher growth rate with financial stability. The Government also proposed to use monetary and fiscal policies to control aggregate demand and to limit in the short run balance of payments deficits to manageable levels. The Fund supported the objectives of this program through a two-year stand-by arrangement approved on October 15, 1980 covering fiscal years 1980/81 and 1981/82.

(2) In 1980/81 Kenya faced difficulties in meeting its medium- and short-term objectives; many of the difficulties were beyond the country's control. Apart from weak demand abroad for Kenya's exports, Kenya's terms of trade deteriorated further and severe drought conditions weakened the productive sectors and required substantial imports of foodstuffs. With the return of more normal weather conditions, the outlook for agricultural production and growth now looks more favorable. In addition, fiscal developments in 1980/81 deviated significantly from the targets set forth in the program for that year. However, measures are now being implemented to correct the fiscal imbalance. These measures, together with actions on the exchange rate, on interest rates, and on import policy (all detailed below), provide the policy basis for the new stand-by arrangement.

(3) The Government's medium-term development program presented in 1980 included structural reforms to make the economy more outward looking and competitive. Toward this end, the Government undertook to strengthen export incentives and to open the domestic economy to greater foreign competition. Of major importance in achieving these objectives was the improvement of export incentives and a reform of the import system. The latter involved the gradual substitution of quantitative restrictions with tariffs, the reduction of the excessive protection enjoyed by certain sectors of the economy, and the adoption of a tariff policy which would reduce industries' intensive reliance on imported raw materials.

(4) To encourage exports and to limit the growth of imports, the exchange rate for the Kenya shilling was adjusted effective September 21, 1981, by 15 per cent in foreign currency terms from K Sh 1 = SDR 0.0985 to K Sh 1 = SDR 0.0837. This measure was in addition to the adjustment of about 5 per cent which occurred in February 1981. After the latest exchange rate measure, the Government will review the need for the continuation of the export compensation scheme. In addition, the Government will review the producer prices for the major food commodities in order to ensure that their relative prices do not decline vis-à-vis those for export commodities. The Government will keep the exchange rate under

continuous surveillance taking into account Kenya's balance of payments situation as well as movements in key international currencies.

(5) The last two budgets announced major adjustments in import tariffs involving 1,700 items (60 per cent of total); in the 1980/81 budget, the letters of no objection were removed and a 10 per cent import surcharge was introduced. However, further work in this area was delayed when it was realized that a complete review of the import system, which after many years of ad hoc changes had grown administratively complex, was needed. Work was immediately begun in preparing a new and comprehensive set of import schedules to permit a classification of imports according to priority. Such classification was needed in order to remove quantitative restrictions and bans, replacing them with appropriate tariffs. Because of its comprehensive nature, this task faced many difficulties and delays, but now the new import schedules have been published. An acute shortage of foreign exchange has made it difficult to implement an automatic processing of licenses. However, since November 10, 1981, imports into Kenya are being regulated on the basis of the new import schedules. The new schedules classify imports by priority, according to the following principles:

Schedule 1 includes items of high priority, namely raw materials, capital goods, spare parts, medicines, and agricultural equipment. The purpose is to give these goods automatic licensing by the Ministry of Commerce and to provide them with foreign exchange by the Central Bank without delay.

Schedule 2a includes two types of goods: high priority items which require prior approval of other government agencies, such as grains and petroleum products, and nonluxury consumer goods which are subject to quotas. The high priority items are freely importable as items in Schedule 1, once authorization by the regulatory agency has been received. The remaining items are subject to quotas, but once an importer obtains a quota for 2a items, he can import any item or combination of items within the schedule up to the limit of his quota.

Schedule 2b comprises those goods which are produced domestically or for which there are adequate domestic substitutes, and luxury items. All of these items have a low priority and are subject to quotas, equal to the average value of these imports in 1979-80.

It is the Government's objective to move an increasing number of goods to the less restrictive schedules after they have been subjected to appropriate tariff rate adjustments. The Government intends, by the end of June 1982, to switch into Schedule 1, 20 per cent of all items now subject to quantitative restrictions after further tariff adjustments have been introduced. In the following two years, items will be switched at a more rapid pace. In order to fully implement the Government's industrial policy in the medium term, the level of tariff protection will subsequently be lowered.

(6) In 1980/81 the budgetary outturn deviated markedly from the Government's objective to limit the overall deficit to 5-6 per cent of GDP, in part through factors beyond its control. The overall deficit amounted to about 11 per cent of GDP. In addition, unpaid vouchers amounting to K Sh 0.4 billion were accumulated during the year. Because of the larger overall deficit the Government exceeded the ceilings on net bank credit to the Government and net domestic credit at the end of June 1981, even though the previous ceilings had been observed. The Government intends to regain full control of its expenditure programs, to reduce the overall budgetary deficit in 1981/82 substantially to K Sh 3.9 billion, estimated as equivalent to 7.5 per cent of GDP, and to reduce significantly unpaid vouchers. The Government intends to finance the resulting overall deficit with a higher proportion of foreign borrowing on concessional terms and nonbank domestic resources than in the previous fiscal year. As a result, bank and Eurocurrency financing of the budget will be limited to K Sh 1.4 billion compared to K Sh 2.3 billion in 1980/81. The increased import duties and the other revenue measures adopted with the 1981/82 budget are expected to yield a net increase in revenue of K Sh 0.4 billion, while the recent devaluation of the Kenya shilling is estimated to yield additional revenues, mainly import duties, amounting to K Sh 0.7 billion. Taking into account these measures and the normal growth in revenues, the Government expects total revenues and grants to reach K Sh 16.8 billion in 1981/82, an increase of 13 per cent over the previous year. On the expenditure side, the Government has instituted severe economy measures which are expected to substantially reduce the ratio of total government expenditure to GDP. Recurrent expenditure (net of debt amortization), after allowing for the effects of the devaluation, is estimated at K Sh 14.2 billion, representing an increase of about 10 per cent, compared to an increase of 21 per cent in 1980/81. The Government does not intend to grant salary increases to civil servants in 1981/82 beyond the normal within grade increments. The reduced rate of increase in recurrent expenditure also reflects the Government's decision to contain total expenditures, specifically to curtail drastically foreign travel, purchases of new and replacement vehicles, and to limit increases in the number of civil servants. To achieve the latter, the Government intends to streamline functions within the civil service, with a large proportion of staff requirements being met from redeployment of existing staff and increases in productivity. A circular has been issued to spending ministries instructing them not to fill vacant posts without prior approval of the Directorate of Personnel Management and the Treasury. Such approval will only be granted on a restricted basis to fill necessary posts. Development expenditure is programmed at K Sh 6.2 billion, about the same level in nominal terms as in 1980/81. Projects amounting to K Sh 104 million included in the 1981/82 development budget have been cut, and a list of projects which could be rephased from the second half of FY 1981/82 into FY 1982/83 has been identified. These projects will be rephased if development expenditure during the first half of FY 1981/82 exceeds targeted levels. To ensure that the targeted level of development expenditure is not exceeded, all expenditure against "token provisions" requiring full domestic financing contained in the 1981/82 budget

has been frozen. To further ensure that the targeted overall deficit is not exceeded, the Government has strengthened expenditure controls and, with Fund technical assistance, is introducing a reporting system which will enable budgetary performance to be monitored on a monthly basis. Moreover, if the above policies are insufficient to limit the overall deficit to the targeted level, the Government is prepared to take additional measures before the end of February 1982. A list of contingency measures has been drawn up by the Government. Accordingly, we intend to limit the projected government deficit for the period July 1981 to December 1981 to K Sh 3,330 million. We will reach understandings with the Fund prior to April 1, 1982 on whether further measures would need to be undertaken to bring the projected government deficit for the fiscal year ending June 30, 1982 to K Sh 3,952 million. The projected government deficit referred to in the preceding sentence is consistent with projected total net government expenditure in accordance with the following projections: for the period to end-December 1981, K Sh 9,763 million; for the fiscal year ending June 30, 1982, K Sh 20,064 million. The budget deficit for the first quarter of fiscal year 1982/83 will be determined at the time of the program review to be held before August 1, 1982; during fiscal year 1982/83 the Government intends to further reduce the overall deficit in terms of GDP.

(7) Because of the objective with respect to the budget, the banking system will be better able to finance private sector activity. In 1981/82 private sector credit will be allowed to grow by 15.3 per cent compared to 9.5 per cent in 1980/81. Taking into account planned government borrowing, overall credit will grow by 13.6 per cent compared with 19.1 per cent in the previous year. Thus, total domestic bank credit which was K Sh 17.0 billion at the end of June 1981 will not be allowed to exceed K Sh 20.8 billion, including any further Eurocurrency borrowing after June 30, 1981, on January 31, 1982. Net bank credit to the Government, net of the deposits of the Cereals and Sugar Finance Corporation (CSFC) with the Treasury, and including any further use of Eurocurrency borrowing after June 30, 1981, which was K Sh 4.2 billion on June 30, 1981, will not be allowed to exceed K Sh 6.6 billion on January 31, 1982. In view of the rate of inflation which Kenya has suffered in the recent past, interest rates have been negative in real terms for some time. Consequently, there has been a disincentive for financial savings and a flow of funds toward financial institutions outside the commercial banks. In the 1981/82 budget, the Government announced a 2 per cent increase in both deposit and lending rates, and on September 21, 1981, commercial bank lending rates were raised by a further one percentage point to a maximum of 14 per cent, while deposit rates in the commercial banks were raised by two percentage points to a maximum of 11 per cent. The Government intends to keep interest rates under continuous review.

(8) In calendar year 1981, the current account deficit of the balance of payments is expected to narrow slightly to about 10 per cent of GDP compared to 13 per cent in 1980. Although exports are estimated to be

slightly reduced during the year due to lower export prices and a fall in petroleum exports, a substantial reduction in the growth of imports is projected, partly reflecting a smaller volume of crude oil imports. Moreover, an important increase in tourism earnings is projected. For 1981 the overall external deficit, excluding the drawing on a Eurocurrency loan, is estimated at SDR 273 million. As a result of the policy measures outlined in this note, it is expected that the current account deficit will be reduced to about 8 per cent in 1982, with a further adjustment expected in 1983.

(9) In 1981 Kenya's debt service ratio is estimated at 13.0 per cent and it is expected to rise slightly in the following two years, but will remain at a manageable level. Consequently, the Government of Kenya feels that there is sufficient room to maneuver with respect to additional foreign borrowing in order to allow the attainment of balance of payments equilibrium within the next two or three years, the needed period for the Government's medium-term structural policies to take hold. However, recognizing the need for prudent action in this area, the Government intends to limit the contracting of public and publicly guaranteed external borrowing on commercial terms in the maturity range of 1-12 years to US$160 million during the 15 months ending in September 1982.