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Kenya 1992-93
Office of the President

Mr. Karaosmanoglu

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: December 9, 1993

TO: Mr. Edward V.K. Jaycox, Vice President, Africa Region

FROM: Francis X. Colaço, Director, AF2 FXC

EXTENSION: 34036

SUBJECT: ***KENYA: IDA's Country Assistance Strategy***

1. As you know, several positive developments have taken place in recent months in our policy dialogue with the Kenyan Authorities. Serious slippages in macroeconomic management in the early summer were followed by several months of satisfactory implementation by the Government of the IMF-monitored program and major progress towards meeting the conditions for release of the second tranche of the Education Sector Adjustment Credit (EDSAC). During October/November 1993, we successfully negotiated the Policy Framework Paper (PFP) for 1994-96, including the implementation of some substantial upfront actions. This paved the way for agreement between the Government and the IMF on a one-year ESAF arrangement which is scheduled for IMF-Board discussion on December 22, 1993. The Consultative Group meeting of donors on Kenya also met in late November 1993 for the first time in two years. Donors indicated new commitments for 1994 totalling $850 million, of which $170 million is in the form of quick-disbursing balance of payments support. These amounts are sufficient to fund the residual external financing gap for 1994 as envisioned under the ESAF arrangement. However, donors emphasized that the translation of these commitments into disbursements depended on the timely and decisive implementation by the Government of its economic reform agenda as well as the resolution of outstanding issues of political reform and corruption (see attached Press Release). Separately, on December 3, 1993, we released the second tranche of EDSAC after the final condition--involving the compliance of a particular commercial bank with Kenya's Banking Act and prudential regulations--was met.

2. We plan to monitor very closely the implementation of the PFP. Our colleagues in the Resident Mission will update the PFP's policy matrix on a monthly basis, identify and report any slippages, and discuss them with the Government. We at headquarters also propose to supervise the implementation of the PFP about twice during the first half of 1994. Donors will be kept informed of progress through their regular monthly meetings in Nairobi, and through an informal donors meeting which is tentatively scheduled for Paris in July 1994.

3. In keeping with our current country assistance strategy for Kenya, we have been operating for over a year now in the core mode. Now that the stabilization and reform programs are back on track, we propose to move to the base lending case with the important exception that adjustment lending would only be considered if satisfactory performance under the PFP is sustained over the next six months. The initiation and preparation of such an operation would be subject to the customary internal review and discussion. At present, we are updating our country assistance strategy for presentation to the Executive Directors in March 1994 along with the Small Enterprise Training and Technology Project. If you agree, we will use this opportunity to signal this slight modification of our position on the timing of further adjustment lending. At that time, we would also indicate any anticipated changes in the coverage, size and tranching of

adjustment lending which may be necessary possibly to ensure that the detailed design of our lending program maximizes the incentives to the Government to sustain the reform effort over the medium-term.

Attachment

cc: Karaosmanoglu, Stern, Fox, Kalantzopoulos (EXC); Husain (AFRCE); Lethem, Miovic (AF2DR); Carter, Magnus, Bruce, Rajaram, Jordan (AF2CO); Ganguly (AF2AE); Hindle (AF2PE); Weissman (AF2EI); Maas (AF2PH)

CBruce/cab

World Bank

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PRESS RELEASE
For Immediate Publication

MEETING OF THE CONSULTATIVE GROUP FOR KENYA

Paris, November 23, 1993 -- The Consultative Group for Kenya met on November 22 and 23, 1993, under the Chairmanship of Mr. Francis X. Colaço, Director, Eastern Africa Department of the World Bank. The Kenya Delegation was led by the Honorable W. Musalia Mudavadi, Minister of Finance, and included Mr. Micah Cheserem, Governor of the Central Bank of Kenya.

Delegates to the meeting reviewed Kenya's economic and social reforms since the last Consultative Group meeting held in November 1991, and its reform agenda for the future. All delegates expressed concern over the deterioration in economic management that occurred after the last meeting, but warmly welcomed the recent significant efforts of the Government to reestablish an appropriate macroeconomic framework and initiate structural reforms. They noted, in particular, the progress in liberalizing the external sector, strengthening monetary control, enforcing financial sector discipline, and liberalizing maize imports and movement. There was general agreement that these policy actions have resulted in a stabilization of the economy: since mid-year, the rate of inflation has decelerated, the market-determined exchange rate has appreciated, the external payments position strengthened and exports appear buoyant. All participants, including the Kenya delegation, stressed however that this positive refocussing in recent months on improving macroeconomic management and implementing structural reform must be sustained if accelerated economic growth, the impetus to employment creation and poverty reduction, is to be achieved.

Emphasizing the importance and urgency it attaches to such reform, the Government noted that it had just formulated a medium-term reform agenda which will guide major structural changes to Kenya's economy over the next three years. The Government has also submitted a one-year programme to the IMF in support of a request for a one-year arrangement under the Enhanced Structural Adjustment Facility (ESAF). The Kenya delegation assured donors that its Government was committed to aggressively implementing this medium-term agenda and the ESAF supported programme, especially in the areas of public expenditure rationalization, civil service reform, private sector development and parastatal reform - areas which donors identified at the 1991 Consultative Group meeting as critical to achieving sustainable economic development and essential for obtaining external financial assistance. It also stressed the Government's commitment to completing liberalization of maize marketing and finalizing a National Environmental Action Plan and a Poverty Assessment during the first half of 1994. Delegates welcomed the Kenya Government's commitment to this reform agenda, while reiterating the importance of strong implementation performance, particularly over the coming months, if Kenya's substantial potential for economic development and broad-based improvement of human well-being is to be realized.

Bilateral donors acknowledged that Kenya's multi-party elections last December were a major and welcome first step to developing an environment conducive to a more democratic and open society. However, special concern was expressed over recent incidents of ethnic clashes. Bilateral donors underlined the importance of concerted Government action to defuse the underlying tension and deal with unrest through evenhanded application of the law, and some indicated a willingness to provide support to the Government's efforts in this regard. Bilateral donors also underlined the need for the Government to respect the basic freedoms of political expression and assembly. Delegates expressed concern over widespread corruption, which in some cases had undermined the impact of reforms. They emphasized the need for the Government to act to ensure that prompt legal action is taken against those involved in corruption.

Donors indicated that new commitments for 1994 could reach about US$ 850 million, including about US$ 170 million of general balance of payments support. Such a level of commitments would adequately cover Kenya's external financing requirements for 1994, provided that appropriate arrangements are made to deal with existing debt service arrears. However, donors emphasized that the translation of these indications of new commitments into disbursements in 1994 depended on progress in implementing the economic reform agenda, as well as strong positive steps on human rights, governance and corruption. Donors noted that the Kenya Government hoped to meet the balance of its external financing requirements for 1994 through a multilateral arrangement for rephasing existing debt service arrears, and expressed the hope that an appropriate arrangement could be concluded in the near future.

Delegates noted that Kenya would likely face substantial additional cereal import requirements in 1994, due to major shortfalls in local production as the result of adverse weather conditions. A number of delegates indicated their willingness to consider providing Kenya with additional financing to meet these requirements through commitments of food aid, as needs are further assessed in appropriate fora during the coming months.

The meeting was attended by delegations from Belgium, Denmark, Finland, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, the United States, the African Development Bank, the European Commission, the European Investment Bank, the International Fund for Agricultural Development, the International Monetary Fund, the OPEC Fund for International Development, the Saudi Fund for Development and the United Nations Development Programme. Canada, Ireland and the Organization for Economic Cooperation and Development attended as Observers.

The Consultative Group agreed to reconvene in about one year.

SecM93-1234

FROM: Vice President and Secretary

December 7, 1993

CONSULTATIVE GROUP MEETING FOR KENYA

Attached for information is a note entitled "Kenya: Consultative Group Meeting, November 22-23, 1993".

Distribution:

Executive Directors and Alternates
Office of the President
Executive Vice Presidents, IFC and MIGA
Vice Presidents, Bank, IFC and MIGA

KENYA

CONSULTATIVE GROUP MEETING, NOVEMBER 22-23, 1993

Report to the Executive Directors

The focus of the Kenya Consultative Group (CG) Meeting this year was on Kenya's economic and social reforms since the last CG Meeting held in November 1991, and its reform agenda for the future. The meeting was chaired by Mr. Francis X. Colaço, Director, Eastern Africa Department. The Kenya delegation was led by the Honorable W. Musalia Mudavadi, Minister of Finance, and included Mr. Micah Cheserem, Governor of the Central Bank of Kenya.

Kenya's past economic performance had generally been unsatisfactory, and until recently, mixed progress had been made on structural reforms which had been agreed as being necessary at the November 1991 CG. There therefore remained much skepticism among the international donor community, when the convening of the CG was announced in early October, as to the Government's commitment to further reform and to the chances of a successful meeting being held under such circumstances. For this reason, this year's CG was not of the "business-as-usual" format. Instead of devoting the afternoon of the first day to a special topic, almost the entirety of the meeting was spent on exchanging views on economic progress achieved and policy measures taken in the past several months, and on the Government's proposed economic policy framework; many delegates also brought special attention to such issues as ongoing ethnic clashes, corruption and freedom of expression and assembly.

Delegates to the meeting welcomed the recent efforts of the Government to reestablish an appropriate macroeconomic framework and to initiate structural reforms aimed at reversing the deterioration in economic performance that had occurred after the last meeting. In particular, they noted the progress in: (i) liberalizing the external sector; (ii) strengthening monetary control; (iii) enforcing financial sector discipline; and (iv) liberalizing maize imports and movement. As a result of these efforts, there was general agreement that the Kenyan economy had stabilized; since mid-year, interest rates have started to decline. the rate of inflation has decelerated, the now market-determined exchange rate has appreciated, the external payments position strengthened and exports appear buoyant.

Agreeing that accelerated economic growth is necessary for employment creation and poverty reduction, both the delegates and the Kenya delegation stressed that recent efforts on improving macroeconomic management and implementing structural reform must be sustained if such growth is to be achieved. Emphasizing the importance and urgency it attaches to such reform, the Government noted that it had just formulated a medium-term reform agenda, i.e., **Policy Framework Paper for 1994-1996** (PFP) which will guide major structural changes to Kenya's economy over the next three years. It also noted that it had just submitted a one-year programme to the IMF in support of request for a one-year arrangement under the Enhanced Structural Adjustment Facility (ESAF).

While complimenting the Government on these recent developments, the delegates expressed continuing skepticism about the Government's commitment to this reform agenda and reiterated the necessity of strong implementation performance, especially over the coming months, if Kenya's substantial potential for broad-based economic development was to be realized. Candidly acknowledging that errors had been made in the past and that Kenya's credibility both at home and abroad had suffered as a result of these errors, the Kenya delegation assured donors that it now was committed, as demonstrated by its actions during the past several months, to aggressively implementing this medium-term agenda and the ESAF-supported program. In particular, it reiterated the areas that donors had identified at the 1991 Consultative Group meeting (i.e., public expenditure rationalization, civil service reform, private sector development and parastatal reform) as critical to achieving sustainable economic growth, and recognized that progress on all these fronts would be essential for obtaining external financial assistance. The Kenya delegation further explained that for the first time, not only had the concerned ministries been included in the design of the policies in their respective areas as reflected in the PFP, but that the PFP itself had been presented and discussed in the Cabinet. The delegates were encouraged by the Kenya delegation's announcement that the Government's commitment to future reform would be further demonstrated once the PFP is reflected in a Sessional Paper which is expected to shortly be presented to and discussed in the Parliament, thus giving the reform agenda wider public exposure and participation. The Kenya delegation also restated the Government's commitment to completing full liberalization of maize marketing, as well as to finalizing a National Environmental Action Plan and a Poverty Assessment by end-June 1994.

On the political front, bilateral delegates acknowledged that Kenya's multi-party elections last December were an important first step to developing an environment conducive to a more democratic and open society. However, special concern was expressed over recent incidents of ethnic clashes, and the bilateral delegates underscored the importance they attached to the Government taking appropriate action to defuse these underlying ethnic tensions and to address this unrest through evenhanded application of the law. They also underlined the need for the Government to respect the basic freedoms of political expression and assembly. There was grave concern expressed that widespread corruption was in numerous instances undermining the effect of reform initiatives; at the same time, there was general agreement that many opportunities for corruption would be removed with the liberalization and deregulation of the economy accompanied with bold reforms in the parastatal, civil service and financial sectors. Nevertheless, there was a strong sense among delegates that legal action against those involved in currently known cases of corruption, including fraud and the embezzlement of public funds, has not been systematic and definitely has been too slow. Prompt and vigorous actions in this area was seen as essential for restoring donor confidence in Kenya.

Delegates indicated that financial assistance in 1994 could reach the order of US$850 million, including about US$170 million of general balance of payments support. This level of commitments would adequately cover Kenya's external financing requirements for 1994, provided that appropriate arrangements are made to deal with existing debt service arrears in the amount of about US$700 million. (On this latter point, the Kenya delegation reported that it hoped to initiate discussions on a multilateral basis for rescheduling accumulated arrears shortly, and expressed confidence that an appropriate arrangement would be successfully concluded in the near future.) However, delegates once again reemphasized that the translation of these indications of new commitments into disbursements during the coming year depended on progress by the Government in implementing its economic reform agenda; bilateral delegates further stressed the importance of strong positive steps on human rights, governance and corruption if these disbursements were to be realized. To meet the substantial additional cereal import requirements expected next year, due to major shortfalls in local production, primarily as the result of adverse weather conditions experienced this year, a number of delegates indicated their willingness to consider providing Kenya with additional financing; however, it was agreed that these needs would be assessed in appropriate fora during the coming months.

At the suggestion of a number of delegates, it was agreed that delegates would meet informally in mid-1994 to review Kenya's economic performance and progress in implementing its reform agenda.

International Bank for Reconstruction and Development

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SecM93-1176

FROM: Vice President and Secretary

November 12, 1993

KENYA: Policy Framework Paper for 1994-1996

1. Attached is a Policy Framework Paper for Kenya.* It was prepared by the Government of Kenya with the joint assistance of the staffs of the Fund and the Bank. The policy framework outlines the Government's objectives for the medium-term and reflects the understandings reached between the Government and the Fund and the Bank on the framework for an adjustment program. A policy matrix summarizing these understandings, as well as a macroeconomic indicators table prepared by Bank and Fund staff, are attached to the paper.

2. The paper also indicates the estimated external financing requirement for 1994 to 1996. A part of this requirement is expected to be met by future IDA lending, but the volume and timing of such lending, both project and adjustment related, will continue to be dealt with in the usual manner under the Bank's normal procedures.

3. This being the fifth Policy Framework Paper for Kenya, the document is being distributed to the Executive Directors for information.

*Questions on this document should be referred to Mr. Anand Rajaram (Ext. 33754)

Distribution:

Executive Directors and Alternates
Office of the President
Executive Vice Presidents, IFC and MIGA
Vice Presidents, Bank, IFC and MIGA
Directors and Department Heads, Bank, IFC and MIGA

KENYA

Policy Framework Paper for 1994-1996 1/

Prepared by the Government of Kenya in collaboration
with the staffs of the IMF and the World Bank

November 10, 1993

I. Introduction

1. In early 1989, the Government of Kenya requested support under a three-year arrangement under the enhanced structural adjustment facility (ESAF) for its 1989/90-1991/92 programme; sectoral adjustment credits from IDA also provided support for the programme.2/ The programme sought to: achieve positive growth in per capita real GDP, reduce inflation to the level of Kenya's trading partners, lower the external current account deficit, and build up international reserves. A firm stance on fiscal and monetary policies and flexible exchange rate management were intended to provide the macroeconomic stability necessary to ensure success of structural reforms in the areas of government revenue and expenditure, parastatals, agriculture, financial sector, and external trade.

2. Following some progress in the first years of the ESAF programme in the liberalization of trade, prices, and the financial sector, economic conditions turned significantly more adverse in 1991. Real GDP growth dropped from 5 percent in 1989 to 2.3 percent in 1991, and inflation accelerated from 13.5 percent to 19.6 percent (annual average). While the current account deficit (including official transfers) improved to 3.2 percent of GDP, owing to administrative attempts to restrain imports, gross reserves fell to just 1.1 months of imports, in part because of a decline in aid flows. External payments arrears emerged in 1991 for the first time in Kenya's history. Deteriorating performance in macroeconomic and structural policy implementation over the period contributed, among other factors, to a decision by donors in November 1991 to refrain from indicating new aid commitments to Kenya. In January 1992, IDA decided to delay release of new tranches of existing commitments of balance of payments support3/ until a satisfactory macro-economic framework was restored. A large external financing gap emerged during 1991, and Kenya failed to conclude the mid-term review of the third annual arrangement under the ESAF. After attempts to bring the programme back on track, the ESAF arrangement was eventually allowed to expire in March 1993 without the final disbursement. In December 1992, IDA cancelled the final tranche of the Agricultural Sector Adjustment Operation Credit, citing policy reversal on maize market liberalization. Disbursements on the second tranche of

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1/ This paper updates and extends the policy framework paper of July 2, 1991 and has been prepared in conjunction with the annual ESAF arrangement for October 1, 1993 to September 30, 1994.

2/ The Financial Sector Adjustment Credit (FSAC), Agricultural Sector Adjustment Operation (ASAO II), Education Sector Adjustment Credit (EDSAC) and Export Development Project (EDP) were four adjustment credits provided by IDA to Kenya over the period 1989-1991.

3/ EDSAC, EDP, and ASAO II.

the Export Development Project Credit were held up until May 1993 and the Education Sector Adjustment Credit second tranche has not yet been released.

II. Policy Performance: July 1991-October 1993

3. Rapid deterioration in macroeconomic performance characterized the period up to March 1993. Early in this period, macroeconomic management was affected by a severe drought as well as Presidential and Parliamentary elections that were held for the first time under a multi-party system in December 1992. Serious problems were encountered over the period in the implementation of macroeconomic policies, in particular concerning monetary control and, to a lesser extent, fiscal policy; and in sustaining reforms in maize marketing and trade and exchange liberalization. Moreover, weak export performance, together with the cessation of balance of payments support, brought about severe foreign exchange shortages and a major compression of imports. Under these circumstances, real GDP growth declined to 0.4 percent in 1992 and inflation accelerated further to 34 percent in December 1992, and to over 100 percent in June 1993 (annualized quarterly rate). Moreover, by April 1993, external payments arrears equivalent to $686 million had been built up and gross international reserves remained at just 1.5 months of imports.

4. Strong revenue measures were taken during the second half of the fiscal year to contain the 1991/92 budget deficit to 4.8 percent of GDP (commitment basis, excluding grants), close to the revised target for the year. However, there was also recurrence of expenditures in excess of Treasury authorized limits in 1991/92, and a stock of outstanding bills, as well as external debt service arrears, were carried over to the 1992/93 budget. The deficit increased to 10.4 percent of GDP (commitment basis, excluding grants) in 1992/93, reflecting primarily expenditure overruns relating to higher interest payments on both foreign and domestic debt, resulting from the exchange rate depreciation during the fiscal year and aggressive treasury bill sales at high interest rates during the last quarter of the fiscal year.

5. Significant changes have been made to Kenya's tax system since 1991/92, in the direction of broadening the tax base and increasing the elasticity of the tax system, including for value added taxes (VAT). Import duties were also rationalized over the period, including a reduction in the level and dispersion of rates. Owing to pressures for increased revenues, however, duty rates were raised by 25 percent across the board in September 1993, pending identification of alternative revenue sources.

6. Reforms in the education sector since 1991 helped control the growth of the primary teaching force and reduce budgetary pressures. In the health sector, user charges with appropriate exemptions for disadvantaged groups were introduced. The Government has also taken major steps to address the critical situation of Kenya's valuable wildlife resources, mainly by banning ivory trade and strengthening poaching control measures.

7. Despite important structural reforms in the financial sector in 1991, including full decontrol of interest rates and introduction of open market operations, monetary policy became increasingly expansionary through March 1993, largely because of easy access to central bank credit, through persistent overdrafts of weak commercial banks, as well as deficiencies in meeting cash reserve requirements and excessive use of Central Bank of Kenya's (CBK) rediscount facilities. Excessive liquidity expansion became a major destabilizing force in the economy.

8. Following the reversal of exchange and trade liberalization measures in late March 1993, the liberalization programme was resumed in mid-May, with (i) the introduction of 50 percent retention for all exports; (ii) resumption of trading of retained foreign exchange at market-determined exchange rates, with strict limits on transactions at the official exchange rate; (iii) abolition of the import and foreign exchange licensing system, with liberalization of current transaction payments; and (iv) most recently, the unification of the exchange rate at the market rate.

9. Following substantial progress in price decontrol in 1991, prices were liberalized on 20 product groups in 1992. A further four important product groups have been liberalized since March 1993.

10. Important progress in structural reform has been made since April 1993, with some significant measures undertaken, in contrast to the lags in implementation experienced earlier. While work on an institutional framework for the divestiture and privatization of public enterprises was initiated in late 1991, and broad restructuring plans for 5 of the larger strategic parastatals were developed, initial implementation was much slower than planned. However, more recently, implementation has accelerated, particularly as concerns privatization. Civil service restructuring fell far short of expectations in 1992; however, the civil service reform plan has recently been approved by Government, and retrenchment of civil service positions has now begun; further rationalization of the civil service was also achieved through a reduction in the number of government ministries from 28 to 23 in early 1993.

11. Finally, in the financial sector, the CBK has taken significant steps since March 1993 to control liquidity expansion. The statutory cash ratio was raised from 6 to 12 percent in 3 stages, while penalties for non-compliance were increased; access by commercial banks to CBK overdraft was eliminated, and access to CBK's rediscount and overnight advances were strictly limited; the volume of treasury bill issues was substantially increased, pushing the discount rate to real positive levels; CBK's rediscount rate was linked to the highest accepted discount rate at recent treasury bill auctions; the cheque clearing process was tightened to allow for same-day debits and credits; and clearing house arrangements were revised to remove participation by the CBK. However, up to May monetary discipline remained weak due to substantial loss-making activities on the part of the CBK, arising from irregularities in inter-bank and foreign exchange transactions with a few commercial banks. Subsequently, strong steps were taken to restore monetary discipline, and substantial changes were made to the management of the CBK including the appointment of a new Governor. Since March, three major banks have been closed as well as nine non-bank financial institutions.

12. Owing to strong policy actions taken in the recent past, particularly the substantial tightening of the financial system, there are indications that the economy has started stabilizing. Since June of this year, the rate of inflation has decelerated, the market exchange rate has appreciated, and exports are buoyant.

III. Objectives and Policies for 1994-1996

13. The Government has become increasingly aware of the disquieting trends which have emerged over the past several years. The rate of growth of GDP has declined and is now below population growth; unemployment has become an ever-growing concern; and environmental problems have become increasingly acute. While the external economic environment has not been helpful, the main sources of these trends can be traced to the burden of declining efficiency in the public sector and to an

inadequately supportive environment for efficient private-sector activity. In pursuit of its overall goal of reducing poverty in Kenya, the Government therefore intends to substantially accelerate the pace of implementation of reforms aimed at: accelerating export-led economic growth and employment creation, which is essential for any sustained reduction in poverty; improving access by ordinary Kenyans to basic education and health services; and, where necessary, providing support to those unable to fend for themselves. The 1994-96 period covered by this PFP will be a first step in this longer term effort; and the balance of this paper describes the specific steps that will be taken.

14. An overriding goal of Government economic policy is to return to renewed growth as soon as possible. On the basis of policies outlined in this paper, it is expected that GDP growth will recover to 5-6 percent per annum in 1995 and 1996. The increased economic activity is expected to derive from higher private-sector investment in response to more stable macroeconomic conditions, as well as more efficient access to imported inputs and capital goods. In addition, the increased efficiency of investment associated with the restructuring of key public enterprises is also expected to boost economic growth in the medium term. A higher level of national saving is expected to come from sustained fiscal adjustment over the period, as well as the response of private saving to positive real interest rates. In turn, the higher level of saving will contribute to lowering the external current account deficit (excluding grants) from 4.2 percent of GDP in 1992 to about 1 percent of GDP in 1996. Exports are expected to respond positively to the incentives introduced through the liberalized exchange and trade regime.

Macroeconomic Stabilization

15. The immediate objective of macroeconomic policy is a rapid deceleration in inflation and strengthening of the external payments position. While inflation is expected to increase from 27 percent in 1992 to 46 percent in 1993 (annual average), the Government aims to keep the rate of inflation below 10 per cent per year over the medium term. This objective will be achieved through the following policy measures:

(i) continued strict monetary control by the CBK, relying on market-based policy instruments to encourage the establishment and maintenance of positive real interest rates for both lending and borrowing by commercial banks;

(ii) strengthening of the financial system by fully enforcing prudential regulations, and taking decisive actions to deal with the problems of distressed financial institutions;

(iii) a substantial and sustained reduction in the budget deficit, with strictly limited net credit from the CBK over the 1994-96 period;

(iv) more effective public expenditure management and strict enforcement of expenditure controls to avoid unauthorized expenditures; and

(v) accelerated progress in parastatal reform, to improve public enterprise financial performance.

Monetary and financial sector policies

16. Restrained monetary policy and a sound financial system will be critical factors to achieve price stability and a sustainable external position, as well as promote growth through efficient mobilization

and allocation of saving. Importantly in this regard, the CBK will continue the recent efforts to restore its credibility in the financial system, which was severely damaged by lax licensing of financial institutions, ineffective enforcement of prudential regulations and failure to control lending to distressed commercial banks. To this end, in the immediate future, the CBK will focus on reasserting disciplined monetary management while strengthening its supervisory role in the financial system. The CBK will then begin to play an important role in promoting further financial market development, notably secondary markets in Government securities.

17. Monetary policy will aim at containing liquidity expansion at a pace consistent with targeted growth rates of GDP and inflation and maintaining positive real interest rates. Specifically, the CBK will continue to manage domestic liquidity through market interventions in Treasury bills, in order to achieve target levels of net domestic assets (NDA) of the CBK, consistent with the broader monetary objectives. The CBK's monetary stance will be supported by strict enforcement and appropriate changes in the statutory cash ratio, and strict limits on access to CBK credit through its rediscount and overnight lending facilities.

18. The CBK will focus on improving the soundness of the financial system through a number of measures which should all be substantially completed by end-1994. The CBK Act will be reviewed to determine any needed amendments to define more clearly the responsibilities and accountability of the CBK, including in the area of monetary policy. Proposals for amendments to the Banking Act are under review by relevant authorities as well as the private financial community. Any needed revisions to the Banking Act and the CBK Act would be incorporated in the Finance Bill for June 1994. No new bank licenses will be issued before July 1994. The Government will divest its equity holdings in commercial banks, starting with the National Bank of Kenya, whose shares will be offered for sale by June 1994 after appropriate restructuring; by June 1996, the Government will have progressively reduced its share holding in Kenya Commercial Bank and Post Bank to a minority. Furthermore, the CBK will continue the efforts already underway to tighten enforcement of prudential regulations in the financial system, which has resulted in placing under statutory management or revoking licenses of banks and non-bank financial institutions (NBFIs) for failure to meet prudential criteria. By June 1994, commercial banks with affiliate NBFIs will be required to meet statutory cash and liquidity ratios on a consolidated basis. To improve the financial position of the National Social Security Fund (NSSF), an action plan will be prepared by June 1994, drawing on the results of an actuarial study on its financial stability and the soundness of its investments, to be completed in early 1994.

19. The CBK will also work toward improving the effectiveness of open market operations in government securities and ensuring an efficient transmission of changes in government security rates to savings and lending rates of commercial banks. To this end, the CBK will promote development of secondary markets in Treasury bills, which will include, among other things, efforts to promote market makers in such bills, as well as encourage the establishment of a central depository for Treasury bills by the private sector to ensure an efficient delivery and payment system for secondary market transactions. In an effort to foster increased market demand for both Treasury bills and bonds, the CBK will sponsor publicity campaigns targeted at individual investors, lower minimum denominations of the securities on offer, and appoint commercial banks as agents for the sale of Treasury securities. The proposed central depository will also facilitate further capital market development, by serving as a depository for trading in shares and other financial instruments. Further steps will also be taken to encourage expansion of the activities of the Nairobi Stock Exchange (NSE), including expanding its membership, broadening its coverage to include trading in treasury bonds and other financial

instruments, and promoting increased floating of equity issues. An expanded role for the NSE would also assist in the privatization programme for public enterprises.

External policies

20. Recovery and sustained economic growth in Kenya depends on strong export growth, which will be supported by the recent liberalization of the exchange and trade system. Sound monetary and fiscal policies assisted by interventions in the foreign exchange market should result in a stable exchange rate. The Government expects to be able to achieve this during the next three years while accelerating economic growth and winding down recourse to general balance of payments financing. The Government intends to increase international reserves of the CBK to at least two months of imports by end-1996 and to settle existing arrears on external public debt as soon as practical. In order to safeguard the external position, the Government will tightly limit contracting and guaranteeing of new non-concessional external borrowing by the public sector. A stable nominal exchange rate will be maintained, through strict fiscal and monetary policy, in support of the inflation objective.

21. Reforms in this PFP period will seek to further liberalize trade and investment regulations. Increased economic integration with the Preferential Trade Area (PTA) countries and enhanced export incentives will be achieved by actions that will aim to move Kenya's tariff structure towards the lowest prevailing structure in the region. The goal will be to at least reverse the recent temporary 25 percent increase in import duty rates by July 1994. Subsequently, the Government intends to pursue further tariff reductions at a steady pace, with the objective of achieving a maximum tariff of 30 percent and with the number of rates reduced to 4 (including the zero rate) by July 1997. As a result of these measures the weighted average tariff will decline from its present level. Any necessary offsetting revenue measures will be designed in good time (see para 24). By July 1994, remaining export taxes will be removed and export licensing will be abolished except for a short negative list established for security, health, and environmental reasons.

22. The streamlining of Customs procedures is important for enhanced revenue collection and improved trade flows. Appropriate measures to be taken in 1994 to achieve this goal will include a full review and reform of customs procedures, computerization of home use entries and cash accounting, and provision of training. In this context, transit regulations and security arrangements will be modified by July 1994 to prevent leakages which diminish revenue collections and the protective effect of the tariff. The PTA harmonized transit charge will be implemented on a reciprocal basis by July 1994. Export incentives will be maintained by the already announced expansion of the duty/VAT remission scheme which is administered by the Export Promotion Programme Office (EPPO). The EPPO's ability to administer the duty/VAT remission scheme which is essential for exporters has lately been hampered by the practice of requiring that agency also to process duty-free inputs to selected importers. Appropriate corrective action will be taken by December 1993. The Government also intends to build on the success of the Kenya Exporter Assistance Scheme to help manufacturers develop new markets.

Budgetary policies

23. A substantial tightening of fiscal policy in 1993/94 is aimed at reducing the overall budget deficit (commitment basis, excluding grants) by 4.3 percentage points to 6.1 percent of GDP. Over the medium term, fiscal policy will remain tight, with emphasis on restraint of recurrent expenditures and further revenue enhancement. The overall budget deficit (commitment basis, excluding grants) is targeted to decline to about 3 percent of GDP in 1994/95 and to 2 percent of GDP by 1995/96; including grants, the budget will be in deficit by 1.8 percent of GDP in 1994/95 and will be balanced

by 1995/96. A major objective of fiscal policy over the PFP period is to sharply reduce the level of domestic borrowing for deficit financing, and to the extent possible make net repayments on domestic debt, thereby freeing resources for private sector activity.

24. Central Government revenue is targeted to increase from 22 percent of GDP in 1992/93 to 23 percent of GDP in 1993/94 and 1994/95 and increase further to 24 percent in 1995/96. The overall goal is to enhance revenue collection through broadening of the tax base while reducing the maximum rates on import duties, income taxes and VAT. The broadening of the tax base will be accomplished, inter alia, by removing tax exemptions to public enterprises and by expanding VAT coverage in the service sector. Measures to enhance the collection of duties will include an improved Pre-Shipment Inspection (PSI) of imports to be implemented by January 1994. The recent re-introduction of a personal identification number (PIN) system for tax assessments and further commitment to computerized tax administration will also result in improved revenue collection in the medium term. The pace of the reduction in maximum tax rates, especially for income tax and VAT, will be determined in the light of the achievements in enhancing revenue in order to safeguard the targets on total revenue.

25. The Government is committed to reduce overall spending in the course of this PFP period, while concurrently shifting its focus towards expenditure which fosters economic growth. Total expenditure and net lending is expected to be reduced to about 29 percent of GDP in 1993/94 and further to 26 percent in 1994/95 and 1995/96. The fall in expenditure as a percentage of GDP is expected to occur due to: (i) reduced interest charges; (ii) the elimination of the subsidy to the National Cereals and Produce Board (NCPB); (iii) the retrenchment in the civil service; (iv) a rationalization of expenditures of the Government, including security expenditures.

26. Achievement of the budget deficit targets for 1993/94 and the medium term will be supported by improved enforcement of budget monitoring and control. The issuance of circulars on the accountability of accounting officers with respect to procurement procedures and unauthorized or extrabudgetary expenditures (issued in September 1993) will be complemented by enforcement of sanctions in cases of non-adherence. It has been reaffirmed to accounting officers that certifying undelivered goods as actually delivered will result in appropriate legal action and dismissal. Similar measures will be taken with respect to government officials involved in cases of financial irregularities. Lastly, in 1993/94, the Government will initiate measures to clear the backlog of pending bills and to improve the expenditure disbursement, control, monitoring, and reporting systems.

27. Local governments, which are responsible for maintenance of local public infrastructure and provision of local services, have faced increasing resource constraints that have led to substantial decline in the quality of their operations. The Government will address these concerns by initiating actions to reform local government financing by increasing local revenue buoyancy, improving revenue collections, and rationalizing the expenditure process.

Public Expenditure Policies

28. A detailed review of public expenditure is now underway with the assistance of IDA and other donors, and the first results will be available in January 1994. The Government will discuss the results with IDA in early 1994 and agree on those that could helpfully be used as input to future budgets. There will be significant progress over the PFP period, beginning with the 1994/95 budget, in shifting allocation of budget resources towards the core functions of Government: the maintenance of law and order and the administration of justice; the provision of broad-based basic education and health services;

the provision of economic infrastructure; and the protection of the environment. The government's objective is to substantially raise civil service wages to move towards parity vis-a-vis the private sector. This should be achieved while reducing the wage bill in relation to GDP as the size of the civil service will be reduced through retrenchment. In order to spur growth, development expenditure and recurrent non-wage operating and maintenance expenditure will increase as a share of GDP over the PFP period.

29. At least 75 percent of the development budget will be allocated to projects that satisfy the core government functions enumerated above, with priority given to those that reach a large number of Kenyans, particularly the poor. Furthermore, the Government will continue with its recent efforts to establish and enforce clear objective economic and technical criteria for project selection, which will apply to all projects, including those in the core functional areas of government (as enumerated above) and also serving a large number of poor Kenyans. Following an initial effort in 1992/93, the number of projects to be included in future budgets (beginning in 1994/95) will be limited, so that the Government's contribution will be fully funded, and implementation speeded-up. To this end, the Government will soon complete its efforts to rationalize the projects portfolio by identifying and terminating non-priority projects. If development expenditure has to be curtailed below the amount budgeted, the Government will give priority to fully protecting funding for the projects serving the core government functional areas.

30. For public enterprises, the Ministry of Finance will intensify its review and approval of all investment proposals by public enterprises to ensure that they accord with Government priorities and meet technical and economic criteria. The Ministry of Finance will also review and approve any commitments or expenditures that have contingent implications for the government budget (eg. borrowings involving government guarantees).

Civil Service Reform and Capacity Building

31. As Kenya enters a period of significantly accelerated structural change there will be a need for flexible and responsive management, and strengthened analytical and policy making capability. To restructure the public service, a Civil Service Reform Programme and Action Plan has been approved by the Government. The Government is committed to the comprehensive reform and capacity building proposed in this document, covering civil service organization, financial and performance management, staffing levels, personnel management, and pay and benefits. A secretariat has been set up to manage the process. By December 1993, the Government will carry out the following actions in this regard: (i) a draft policy statement redefining the scope of responsibilities of the civil service and identifying functions which will be divested will be prepared; (ii) the key ministries to be restructured in the first year of the programme will be identified; and (iii) the early retirement programme including an adequate safety net will be made fully operational. Donor support for the safety net will be actively sought.

32. As a result of incentives for early retirement and a hiring freeze on levels A-G, staff levels had been reduced to 265,161 by June 1993. The Government plans that about 26,000 net positions will be eliminated in 1993/94 (including about 14,000 vacancies) and a further 16,000 positions will be eliminated each year for the following three years (1994/95-1996/97). The Government also intends to initiate actions towards monetization of benefits (to be implemented in the 1995/96 budget) in line with recommendations of the Action Plan. A code of ethics for civil servants, including increased financial accountability and clear rules governing conflict of interest, will be considered for introduction by July 1995. Reforms of the judicial and police services along the lines of the civil service reform will also be developed.

33. In the longer term, improved policy formulation and implementation capacity depends primarily on the creation of an environment supportive of objective analysis and professionalism, a key goal of civil service reform. In the short term, the Government will give consideration to intensified training for key policy analysts. The Ministries of Finance and Planning and National Development will prepare action plans to strengthen their capacity by March 1994. At the CBK, capacity needs to be built in key operational departments, including banking supervision, foreign exchange operations, and domestic and foreign debt management. The CBK will also develop an action plan for staff development by March 1994.

Domestic Market Liberalization

34. The Government has almost completely eliminated price controls. The three remaining controls are on most petroleum fuels and on pharmaceutical drugs for treatment and management of cancer, AIDS, hypertension and diabetes, under the General Price Control Order; and on maize and maize flour, under the Specific Price Control Order. These remaining price controls will be removed by July 1994.

35. The Government is committed to undertaking significant reforms to facilitate private investment and initiative while putting appropriate safeguards against anti-competitive behaviour. In order to facilitate job and output creation, the Government will substantially reduce the number of national and local fees and licenses required for new startups and minimize restrictions on retail and wholesale trade under the Trade and Licensing Act by July 1994. The Government intends to take additional steps to reduce regulations that constrain private sector development on the basis of a study being undertaken by IDA. In order to allow more rapid reorganization of companies and foster a more disciplined environment for the private sector, the law relating to bankruptcy, liquidation and recovery of debts will be reviewed and appropriate modifying legislation presented to Parliament by July 1994. The statutory monopoly rights of the Kenya National Trading Company (KNTC) and the Kenya Planters Cooperative Union (KPCU), will be eliminated by March 1994. By July 1994, the Government will take actions to reduce obstacles to the competitive functioning of the labour market.

Public Enterprises

36. The intention of the Government is to achieve significant and irreversible public enterprise reform in the course of this PFP period, with commercially viable operation of strategic public enterprises and substantial divestiture of GOK equity interest in non-strategic enterprises as the immediate goals. For strategic public enterprises, legislation adopting a new Corporate Governance system will be considered by the Government by November 1993 and submitted to Parliament by February 1994. Implementation of this reform will, inter alia, formalize an arms-length, transparent, owner-manager relationship between the Government and the management of strategic parastatals. It will provide the framework within which the Government will appoint the Boards of public enterprises (with adequately qualified appointees meeting specified criteria), and negotiate performance contracts with them to define objectives and operational performance criteria and enhance incentives for improved performance.

37. A number of steps will be taken to improve actual performance of strategic parastatals: (i) a recent subsidy study estimated direct and indirect financial flows from the GOK to the parastatals to be in the order of 5.5 percent of GDP on average over the period 1989/90 - 1991/92. A draft subsidy reduction plan has been prepared and will be considered by the Government by February 1994. Under the plan, indirect subsidies will be progressively eliminated by the end of 1996/97. For this purpose,

indirect subsidies are defined as exemptions from direct and indirect taxes, below-market interest rates and waiver of guarantee fees on any new loans/guarantees to public enterprises by the Government, below-market rents on public enterprises' use of GOK land, and any other treatment more favorable than that available to private operators; (ii) tariff adjustments will be instituted as needed to reduce the need for subsidies for public monopolies. Appropriate regulatory bodies for public and private monopolies will be established by June 1995. Tariff autonomy will be given to all parastatals operating in competitive markets; (iii) individual performance contracts between the Government and all strategic parastatals will be in place by June 1995; and (iv) an action plan for the elimination of parastatal cross debts will be prepared and implemented by June 1994.

38. The Government will significantly accelerate the pace of privatization of the non-strategic public enterprises during 1994-96. Out of 207 non-strategic parastatals (including those in which Government has a minority shareholding), 190 remain to be brought to the point of sale or otherwise disposed of. Of these, twenty five will be brought to the point of sale before December 1994, including Kenya Airways, Gilgil Telecommunications Manufacturing Facility, at least two sugar factories, all Cotton Board (CB) ginneries, and the freight handling services at Nairobi and Mombasa airports. Transactions to be completed during 1994 include the disposal of three ginneries (by July). Over half the remaining non-strategic parastatals will be disposed of in two roughly equal tranches in 1995 and 1996. The Government is currently considering the possibility of establishing one or more unit trusts as vehicles for disposing of smaller non-strategic parastatals, for example those held by Industrial and Commercial Development Corporation (ICDC) and Industrial Development Bank (IDB). It is also carefully considering ways of ensuring as wide access as possible of Kenyans to the opportunity to participate in ownership of divested enterprises.

Agricultural Policies

39. Over the medium term, the major aim of agricultural policies will be the speedy recovery of agricultural production covering food crops, major commodities, industrial raw materials, and export crops. In the long term, the private sector will be expected to aggressively expand output while the role of the Government will be largely confined to policy formulation and provision of infrastructure and research and extension services. In order for Kenya's agricultural sector to grow at its potential of 3-4 percent per annum, actions are needed in policy formulation and delivery of basic services, and to end the domination of the sector by public sector marketing and distribution organizations.

40. A number of steps will be taken to strengthen policy formulation and the delivery of basic services. Over the next two years, the Ministry of Agriculture, Livestock Development and Marketing will be reorganized and institutionally strengthened to rationalize its role, structure and functions. This process would have five facets to it. First, the role and strategic functions of the ministry in an agricultural sector increasingly reliant on private sector initiative will be reviewed and appropriate reorganization implemented. Second, the management of the operations of technical units in the ministry which provide strategic services to farmers, mostly research and extension services, will be strengthened. Third, serious efforts will be made to privatize a number of services, including tractor hire services and some veterinary services. Fourth, for services that cannot be privatized, cost recovery will be implemented at as high a level as possible. And finally, the effectiveness of the ministry should be improved as a result of the government-wide effort at civil service reform and increased funding for non-wage operations and maintenance expenditures.

41. The most important parastatal reform to be undertaken in agriculture relates to maize. The Government has now removed all restrictions on the import of maize and the domestic movement of imported maize. It has also removed all restrictions on the movement of domestically produced maize in loads of up to eighty-eight 90 kilogramme bags. By July 1994, maize prices and movement will be fully liberalized.

42. In this new policy environment, the role of the National Cereals and Produce Board (NCPB) will be confined to managing a strategic maize reserve. Initially the maximum size of the strategic reserve would be set at 3 million 90 kilogramme bags. To ensure food security, the strategic grain reserve will be supplemented by a foreign exchange reserve, initially of US$ 60 million, earmarked for emergency maize imports. Consistent with its new role, NCPB will substantially reduce its storage capacity through sale or lease. Staff reduction will also be necessary. NCPB will purchase maize at no more than the export parity price, and will sell for no less than the import parity price.

43. The Government recognizes the need to clarify the roles of the various bodies engaged in the dairy sector. In the first part of 1994, the Dairy Board will be strengthened to enable it to perform its role in encouraging a competitive market for dairy products. Legislation to give effect to a liberalized environment for dairy marketing will be introduced to Parliament by March 1994. The Government will notify Kenya Cooperative Creameries that it must prepare and agree with its creditors by March 1994 on a restructuring plan aimed at reestablishing its commercial viability on the same basis as any private operator, and successfully complete this plan by June 1995, failing which the Government will seek recovery of any unpaid loans through normal legal process.

44. Additional parastatal and other reforms in the agricultural sector will be implemented as follows:

a. privatization of all five sugar factories is expected to be completed during 1994-96. Two factories will be brought to the point of sale by December 1994, and the remaining three in the first half of 1995.

b. Cotton Board ginneries will also be privatized (see para 38), and by September 1994 legislation will be presented to Parliament to restructure the Cotton Board.

c. a policy announcement regarding a market oriented oilseed industry will be made by December 1994.

d. by March 1994, GOK will publish its policy statement on the tea sector, indicating its intention to divest KTDA's shareholding in tea factories by December 1994.

e. a review of the institutional structure of the coffee industry will be completed by June 1994.

45. The cooperative movement has played an important role in the development of the national economy. With liberalization, cooperatives need to improve services rendered to members, since they are free to get goods and services from other sources. In this new environment it is necessary to review the legal and policy framework for cooperatives and the implications of this situation for the role of the Ministry of Cooperative Development. This review will be completed by June 1994, and any resulting legal, policy or institutional changes will be implemented during 1994/95.

Environment

46. Rising population pressures, migration and rapid urbanization have increased the need for urgent actions to preserve and rehabilitate Kenya's unique and fragile environment. Forest lands and wildlife habitats are being reduced through human encroachment and indiscriminate harvesting, inappropriate farming practices are contributing to land degradation, while inadequate physical planning has created a crisis in urban environmental management. In response to these challenges, the Government is preparing a comprehensive NEAP which will be completed and formally adopted by May, 1994. The NEAP aims to translate broad environmental concerns into specific action plans and identify policy measures and investment priorities. While recognizing the need to develop a comprehensive approach to deal with Kenya's environmental problems, the Government's immediate priorities and actions focus on forestry, wetlands, ASALs, and the wildlife sector and the incorporation of environmental concerns into the public investment programme.

47. In the forestry subsector, the GOK intends to reshape its policy and related legislation to emphasize: indigenous forest conservation, protection and management; increased participation of smallholder farmers and the private sector in forestry activities; the carrying out of a comprehensive inventory of natural and plantation forests; and improved research and extension. The forestry policy statement and a master plan will be completed by May 1994. With respect to water resources management, the Government will introduce a tariff on wastewater discharge by March 1994 with the revenues to be utilized for the operations of water treatment facilities. Actions to protect water catchment areas will also be undertaken in 1994 (see para 52). Maintenance of adequate wildlife habitat represents a pressing challenge in the face of growing pressure for subdivision and allocation of land for private development. To ensure that environmental and economic factors are properly considered in land use decisions, the Government will undertake a land use policy study to be completed by June 1995 which will provide recommendations regarding the best sustainable use of different land types and areas, including those areas which should be designated for conservation to maintain biological diversity and environmental services. In the interim, the Government will mandate by January 1994 that biological diversity and environmental assessments will be carried out prior to allocation or development of any existing undeveloped public land. Finally, the Government will incorporate, gradually and where appropriate, environmental criteria for major projects in its public investment programme. In particular, environmental impact assessments will be conducted for all energy projects.

Infrastructure and Transport

48. Improved infrastructure is critical to attract and enlarge private domestic and foreign investment in Kenya. The Government recognizes that inadequate maintenance over many years has had the effect of significantly reducing the quality of infrastructure in a number of subsectors. It is most visible in, but not confined to, the transport sector where poor maintenance and vehicle overloading have caused at least one third of the road and highway network to deteriorate to the point where immediate rehabilitation is required. In order to provide an independent source of funding for road network development and maintenance, a special levy on motor fuels will be introduced by legislation by January 1994, in place of existing road tolls. The levy will initially be set at a level that will provide the bulk of funds required for road maintenance and will, over time, be raised to finance development expenditure as well. A strategy to address the maintenance, rehabilitation and upgrading of roads will be developed during 1993/94.

49. A Corporate Plan for restructuring Kenya Railways (KR) was approved by the KR Board of Directors in September 1992. The Plan includes actions to (i) divest peripheral activities and contract out others; (ii) limit freight services to 23 main freight stations on the network where 90 percent of

traffic exists; and (iii) reduce staff levels. A Performance Contract will be agreed between the Government and the Board of KR by March 1994, specifying full compensation to KR for any non-commercial services provided at government request. Following a tariff increase of 30 percent in March 1993 and a further increase of 20 percent in July 1993, a third tariff increase will be implemented in early 1994.

50. Regarding Kenya Ports Authority (KPA), a Performance Contract between GOK and KPA will be completed before September 1994. With a view to beginning the elimination of indirect subsidies, KPA's exemption from income taxes will be withdrawn with effect from 1994/95. The Government accepts the recommendations of the strategic overview study conducted under the Parastatal reform programme for privatizing the maintenance of cargo handling equipment and port infrastructure as well as empowering KPA to contract out stevedoring to the private sector. These actions will be taken by September 1994.

51. In recent years, KPTC has made a significant contribution to Kenya's development, through the substantial expansion of the telecommunications network, throughout the country. However, the Government recognizes that KPTC's performance has created a major drain on the budget and hence on the performance of the economy. Strong action must therefore be taken to remedy the situation. The Board of KPTC has decided that the posts and telecommunications activities should be separated into two companies. The Government has endorsed this decision, with the substantial privatization of telecommunications services as the longer-term goal. A number of immediate first steps will be taken to facilitate this process and to improve KPTC's performance. A new Board will be appointed for KPTC by December 1993, consisting of members with appropriate experience and relevant background. As soon as possible, a contract will be signed with a reputable, qualified and experienced management, entrusted with full operational responsibility for KPTC. The new management will be in place by March 1994. Its contract will (i) clearly specify financial targets to be achieved; (ii) give KPTC's new management full authority to undertake any actions, including staff reductions, necessary to achieve them, subject to the normal Board approvals; (iii) require the new management to take appropriate steps to separate the postal and telecommunications activities; and (iv) require KPTC's new management to draw up detailed plans for privatization. By June 1994, Government will introduce legislation to Parliament for the separation of the post and telecommunications functions and to facilitate privatization of those functions which are to be divested. The new Board of KPTC will agree on a performance contract with the Government by June 1994 consistent with the actions above, including provisions for the immediate removal of KPTC's exemption from income tax and for payment of market interest rates on KPTC borrowing. In the meantime, the agreed plan for staff reduction and strengthening financial performance will proceed.

52. The Government intends to address the marked deterioration in water supply infrastructure across the country which can principally be traced to inadequate user tariffs. Despite the declared official policy of charging urban consumers a water tariff to cover capital amortization and O & M costs while setting rural tariffs to cover only O & M, actual revenue from water charges constitutes less than 10% of the total recurrent expenditure. To correct this gross imbalance, urban and rural consumer tariffs will be adjusted half-yearly to raise collections to at least 70% of recurrent expenditure by 1996. The preparation of a comprehensive investment plan for the rehabilitation/extension of existing water supply schemes, many of which are in poor condition as a result of inadequate maintenance by financially weak operating agencies, will be an important area for Government action in 1994. Finally, the Government intends to undertake a review of the status of national water resources management and planning, keeping in view the anticipated requirements of the agricultural sector as well as the water

supply subsector. During 1994, the Government will be proposing appropriate amendments to the Water Act and related legislation to protect water catchment areas.

Energy

53. The implementation of a sound policy framework and an appropriate investment programme is critical to addressing the increasingly serious shortfalls in power supply capacity. Urgent investments are also needed in the Mombasa-Nairobi oil pipeline, to avoid the risk of disruption of oil supplies; as well as in renewable energy resources (wood-fuels, photo-voltaics, and windmills) in particular, to enhance energy supplies in rural and remote areas. Starting in 1993/94, the Government will prepare annually a rolling five year least-cost investment programme for power and petroleum in agreement with IDA; projects will be evaluated taking account of their environmental impact. Overall investment requirements in the energy sector are estimated at more than US$ 1 billion over the next five years. The following policy reforms need to accompany the energy sector investment programme: (i) re-organization of the power sector to (a) separate regulatory and commercial functions and set up an effective regulatory arrangement; (b) rationalize the institutions and assets in the sector through a separation of the generation function and the transmission and distribution functions into separate organizations; (c) development of an action plan to enhance efficiency through reduced overstaffing and achievement of a customer-staff ratio of 45 by the end of 1995; and (d) encourage private sector involvement through contracting out services and inviting bids for private investment in power development. Appropriate legislation for (a) and (b) would be presented to Parliament by September 1994; (ii) both the level and structure of electricity tariffs will be adjusted so as to achieve an operational profit by Kenya Power and Lighting Corporation (KPLC) and allow it to raise the local capital to sustain a power sector investment programme - tariffs will be raised to at least 75 percent of long run marginal cost (LRMC) in three annual steps starting March 1, 1994, with at least half of the overall real increase taking place in the first step; and (iii) the procurement, marketing and pricing of crude oil and petroleum products will be fully liberalized by July 1994. Performance contracts between the GOK and the various energy sector parastatals (KPLC, Tana River Development Company (TRDC), Kenya Power Company (KPC), and National Oil Corporation of Kenya (NOCK)) will be completed by September 1994.

Human Resource Development

54. Population The 1989 Kenya Demographic and Health Survey (KDHS) indicated that population growth rates may have peaked and entered a period of decline in Kenya. The preliminary results from the 1993 KDHS confirm the continuing decline in the population growth rate with a dramatic decline in fertility and major increase in the use of modern contraceptives. The lowered fertility itself reflects a decline in desired family size. Despite these successes there is also evidence that there continues to be unmet demand for family planning services. The population of Kenya will continue to increase relatively rapidly because of the large number of women entering their childbearing age. To achieve an earlier population stabilization date, the Government will continue to implement appropriate and sensitive population policies. The Government has recently indicated its intention to undertake mass media activities in population and health. Greater reliance on non-governmental organizations (NGOs) and the private sector will allow better coverage of the population. Increased emphasis on family planning service delivery through programmes such as social marketing are expected to push contraceptive prevalence rates even higher. In addition, measures to eliminate structural constraints to further fertility decline will be undertaken (see para 64). Following GOK review of the recommendations from a recent seminar, restructuring of the National Council for Population and Development will be undertaken by March 1994, with the objective of redefining its role as a policy

making entity, by eliminating many of its bureaucratic functions, streamlining staff positions, and improving staff career prospects to improve implementation of population programmes.

55. AIDS Control and Health Policy The HIV/AIDS epidemic is quickly assuming crisis proportions with the number of HIV infections rising from 0.7 million in 1992 to a projected 1.2 million in 1995 and 1.7 million by 2000. In addition, sexually transmitted diseases (STDs) are on the increase. The adverse implications of AIDS for Kenya's development underlines the need for strengthening preventive health care since prevention and treatment of STDs is proven to be one of the cost-effective ways to reduce HIV incidence. The development of an STD prevention programme, including AIDS, is needed as a matter of urgency. While the Government has mounted a concerted effort to increase public awareness of the disease the need is for interventions that bring about behavioral change. Following the lead taken by the Ministry of Health (MOH) and the Ministry of Planning and National Development (MPND), an AIDS prevention and treatment/management programme will be developed by January 1994. The strategy, which will be developed together with donors and NGOs, will distinguish between treatment for those who are HIV positive while designing appropriate community-based home care for those with AIDS. Critical to the success of an STD/HIV prevention/treatment programme is the need for adequate drug supplies. In this context, the MOH is developing a National Drug Policy and a supporting Quality Control Laboratory which, upon GOK approval and implementation by June 1994, are expected to have a major positive impact on the quality and availability of drugs and dressings in the market.

56. The principle of cost recovery has been accepted as essential for the sustainable provision of Government services. MOH has introduced a progressive set of hospital in-patient user charges with exemptions for those unable to pay and for services that need to be promoted for social reasons (child health, treatment of STDs, etc.). Such user charges will be extended to health centers in December 1993. The hospital user charges will be reviewed in December 1993 to see if adjustments in fee levels and exemptions are required, taking account of the revenue impact, inflation, household budget data from the HWMS, the use of funds so raised, etc. A similar review for the health center user charges will be conducted in June 1994. It is expected that monetization of in-kind benefits under the civil service reform will allow the exemption from hospital user charges granted to civil servants to be discontinued by June 1995. The GOK intends to raise user charge collections as a percent of MOH recurrent expenditures from the present level of 1.7% to 9% over the period 1994/95-1996/97. Currently, revenue from user charges go into the Facility Improvement Fund (FIF) which is managed by the respective District Health Management Boards (DHMB). To ensure that DHMB have control over health care operations in the districts, GOK will consider expanding the terms of reference of DHMB to include management of budgetary allocations to the districts, but only after appropriate procedures to identify accountable officials and ensure timely audits of DHMB accounts are in place.

57. During 1993/94, the Government will review the scope for expanding enrollments and coverage in the National Hospital Insurance Fund (NHIF). Given the problems in the financial sector where the bulk of NHIF deposits are placed, a detailed audit of the fund will be completed by January 1994 to establish the financial status of the NHIF.

58. In the medium term, the Government is firmly committed to major reform in the health sector and will have developed a comprehensive reform programme by June 1994. The framework of this reform programme will build on the health sector strategy note recently prepared by the Ministry of Health and endorsed by the President, and will focus on improved resource mobilization and efficient allocation to cost effective public health interventions. This reform programme will cover restructuring

of the Ministry of Health, health financing, expenditure, staffing needs and training, reform of the NHIF, decentralization of management authority to district levels, the relative roles of private and public sectors, and pharmaceuticals.

59. Nutrition Interventions The nutritional status of children is widely regarded as a reliable indicator of societal welfare. High infant mortality, and underweight and stunted children in many parts of Kenya reported by Child Nutrition Surveys reflect the high incidence of diseases such as diarrhoea and malaria as well as nutritional deficiencies, poverty and lack of knowledge. The Ministry of Health undertakes feeding and treatment of severely malnourished children at hospitals and health centers, and the Ministry of Culture and Social Services provides similar support for very malnourished children under five years, but such interventions do little to stem the problem. The school milk programme, organized by the Ministry of Education, aims to provide every child with 0.2 litres of milk twice a week. Both because it is untargeted and because each calorie supplied through milk could be provided at one sixth the cost via the school feeding programme this has proven to be an excessively costly form of intervention. To maximize the use of scarce budgetary resources, the effort to improve the nutritional status of school-age children will be limited to children in disadvantaged districts. Instead of milk, the intervention will rely on the feeding of cooked meals based on maize and beans. Milk programmes will be targeted to reach pre-primary and pre-school children in arid and semi-arid areas. Other interventions to be encouraged will include deworming school children and vitamin A prophylaxis, both of which have significant health benefits.

60. Education Policies and Reforms The Government's objective during this PFP period is to increase the access and quality of education while continuing the process of controlling and rationalizing its own expenditures in the sector. The issues to be addressed include the need to reallocate expenditures towards primary and secondary education by reducing the share spent on university education; within the allocations to schools, there remains a need to increase the proportion of spending on supplies of educational equipment and, in the case of poor districts and other disadvantaged areas, the provision of textbooks, relative to what is spent on teacher salaries. Other problems that will continue to be addressed include low student-teacher ratios, a worrying decline in primary school enrollment due to dropout, large numbers of untrained primary and secondary school teachers, and weak science teaching at all levels. Low female enrollment in ASAL areas, and more generally at secondary school and university level, will also require corrective Government intervention.

61. At the primary level, the Government has stabilized the size of the teaching force at about 175,000 and is committed to not recruiting any more untrained teachers. The Government will prepare a 10 year forward forecast of teacher training requirements (including the needs of untrained in-service teachers) and a plan to address that requirement, taking account of the designed capacity of the Primary Teachers Colleges. While the goal of achieving minimum norms for student/teacher ratios will continue to be pursued, this will require reversing the current decline in student enrollment. Scholarships and means-tested bursary programmes to secondary school students will be expanded and the Government will consider appropriate financial interventions at the primary level in order to preserve educational equity, and access by vulnerable groups necessary to increase enrollment. The Government is committed, as part of its overall rationalization of public expenditures, to increase allocations to non-salary items such as textbooks and other educational material. At the secondary level, the Government will allocate the necessary resources to improve the quality of science education.

62. To arrest and reverse the excessive share of expenditures going to university education, the Government has initiated the process of cost recovery. Increased cost sharing at the public universities

will be facilitated by separating university charges for tuition from those for board and lodging, with effect from July 1994, and moving toward full cost recovery for board and lodging by July 1995. Students at public and private universities unable to meet the costs of their education from their own or parental resources will be eligible for loans. Students at public universities will continue to be eligible for means-tested public bursaries as well. In addition, a study of private universities will look into the question of whether students there can also be eligible for means-tested public bursaries. Means-testing will be introduced for loans by March 1994 and the interest rate on such loans will be gradually adjusted to achieve positive real rates of interest. Loans will be made and recovered by commercial banks contracted for the purpose on the basis of competitive bidding. To address the longer term issues of public university funding, the Government will prepare a Public University Development Plan by March 1994, featuring 10 year projections, a 6 year plan and a 3 year budget proposal. The Government also intends to introduce a system of lump-sum grants to a restructured Commission of Higher Education (CHE) by July 1994 to replace the existing practice of direct funding of individual universities. A restructured CHE would then be responsible for planning, management and allocation of the grants to individual universities on a competitive basis, taking account of defined need.

63. In general, the thrust of reforms to the funding arrangements and management of educational institutions in 1994-96 will seek to decentralize decision making by gradually enhancing the capacity, responsibility and accountability of local authorities and management councils/boards/committees of educational institutions. In line with this objective, the functions of the Teachers Service Commission (TSC), which is currently responsible for teacher registration, recruitment, remuneration, deployment and discipline, will be reviewed. The responsibilities of the TSC will then be rationalized to decentralize functions which are more appropriately managed at the local level while strengthening the TSC to handle those that can only be centrally enforced. Other policies to achieve sectoral objectives will include a commitment to a gradually liberalized price policy at all levels of education and expanded scope for private sector participation in establishing and operating educational institutions as well as publication of books and production of educational materials.

64. Women in Development The Government will continue its efforts to ensure that women participate and benefit equally from the development process. The approach, as before, will emphasize the integration of women into mainstream activities rather than create separate programmes. Efforts to improve opportunities for women have focussed on improving their human capital through increasing their access to education, health care, and, given the increasingly important role played by women in the rural sector, by improving agricultural extension support to women farmers. Since the last PFP the Government has focussed on redesigning the agricultural extension service to provide information directly relevant and accessible to rural women. The budget neutral recruitment of women as extension staff, use of women's groups to disseminate technical information, and integration of home economics messages and information on labour saving appropriate technologies into the extension advice, have all sought to improve productivity. These efforts will be continued and extended. The Government will increase its efforts to increase the proportion of girls who attend primary school in ASAL areas and generally, who continue their secondary and university education, and encourage their enrollment in science and technical courses, through measures discussed in para 61. Increased education and income opportunity will contribute to improved child health and reductions in family size. The Government will also initiate ways to improve women's access to productive resources such as agricultural inputs, water, fuelwood and credit. In particular, the Government will attempt to emulate successful projects and support rural water supply systems that are empowered by community participation and NGO involvement and can significantly improve the quality of life of women and the community as a whole.

IV. Poverty Reduction and the Social Impact of Adjustment

65. The overall policy framework set out above has poverty reduction as its driving objective. The stabilization policies and structural reforms proposed are designed to release the potential for growth in incomes and employment essential to sustained poverty reduction. A second and equally central element of the Government's approach to poverty reduction is to significantly increase the proportion of public expenditures that go to basic social service programmes that more effectively reach a large number of the poor in Kenya. Given overall constraints on resource availability, this will require a commitment to reorienting, rather than enlarging, total budgetary expenditures to poverty-reducing interventions.

66. While the restoration of growth and provision of productive employment, which are necessary conditions for sustained poverty reduction, will depend on broad policy measures to be undertaken over 1994-96, direct interventions will be needed in the short term to alleviate poverty. A more comprehensive approach to designing programmes targeted at the poor is expected to emerge from a review of public expenditure and a poverty assessment that are to be completed early in 1994. Nevertheless, it is generally agreed that the majority of the poor are geographically concentrated in a few provinces with the landless and pastoralists representing a large proportion of the poor. Pregnant and lactating women and children under the age of five face particularly large risks from the malnutrition and vulnerability to disease that accompanies poverty. In the short term, the Government will consider these population groups as the core target group for its poverty reducing interventions. Timely analysis of the information collected by the National Household Welfare Monitoring and Evaluation surveys which were launched towards the end of 1992 will be used to identify other population segments needing assistance and to improve the effectiveness of targeting. Specifically, the Government will, by June 1994, undertake to target the milk programme only to pre-school children in disadvantaged areas and to offer cooked meals to school-age children of the poor. Immunization against childhood diseases and malaria prevention programmes will be generally expanded, in keeping with the increased emphasis on primary and preventive health services. Self-targeting public works programmes that provide income to the poor and create productive assets (example: access to safe water) will also be developed. The Government also intends to focus on measures that reduce the number but increase the quality of cattle in ASAL areas, thereby increasing the sustainability of livelihoods in that environmentally fragile region. For these areas the Government will also focus on research and extension for drought resistant crops and the development of micro-catchment projects.

67. Unprecedented inflation and stagnation of income have accentuated public concerns about the impact of future policies and reforms. However, the Government expects that the main impact of these policies and reforms on the poor will be favourable and that many of these fears will be quelled by the re-emergence of economic growth. Nevertheless, the Government is concerned about the likely dislocations that will follow civil service reform, accelerated parastatal reform, and liberalization of the maize market. In order to address the adverse impact on retrenched civil service and parastatal employees, the Government will put in place a safety net that will provide transitional support. Design of the safety net will be completed by December 1993. The need for and mechanisms for providing offsetting support to the poorest who may be affected by food price increases will be reviewed in the context of the forthcoming poverty assessment.

V. External Financing Requirements

68. Over the period 1994-96, Kenya's current account deficit (excluding official transfers) is projected to decline slightly, moving from the historically low level of 1.6 percent of GDP in 1993 to 0.8 percent of GDP in 1996. Volume growth of exports of goods is expected to continue, in line with recent trends, at about 7 percent a year, while net service exports are projected to resume more rapid growth with the recovery of tourism. Import volumes are expected to recover sharply in 1994 from their very depressed level of 1993, growing by about 13 percent, and then resume more normal growth of about 7 percent a year.

69. Despite the only modest increase in the current account deficit, Kenya will require substantial new commitments of external financing over the next few years. Following a necessary substantial increase in external reserves in 1993 - both to bring general reserves up from recent very low levels and to create a special reserve for emergency maize imports (see para 42) - reserves will need to increase gradually, by about $60 million a year during 1994-96. Amortization of existing debt is assumed to increase towards the end of the PFP period reflecting phased settlement/refinancing of arrears.

70. Overall financing required during 1994-96 through disbursements from public sources is estimated at $2.4 billion. In mobilizing these resources, the Government intends to limit contraction as well as guarantee of new non-concessional external borrowing (other than any refinancing of arrears) by the public sector. Nevertheless, because of the impact of phased settlement/refinancing of arrears, the debt service ratio by the end of the PFP period is likely to be only marginally lower than its estimated level of 29.6 percent in 1993.

71. Disbursements from existing grants and loan commitments in 1994-96 are projected to be $0.8 billion. This leaves a financing gap of $1.6 billion which would need to be filled by new commitments by donors. While difficult to estimate, expected new commitments from official sources could generate disbursements of about $0.3 billion over the PFP period, in which case there would be a residual gap to be filled by exceptional financing (including phased settlement/refinancing of arrears) of $1.3 billion.

KENYA
SUMMARY AND TIMETABLE OF POLICY ACTIONS, 1994-1996

	OBJECTIVES AND POLICIES	STRATEGIES AND MEASURES	TIMING
I. Monetary and Financial Sector Policies	Re-establish CBK credibility and effectiveness in monetary control and regulation of financial system. Contain liquidity expansion to rate consistent with targeted rates of GDP growth, inflation and maintenance of positive real interest rates.	Achieve target levels of NDA through market intervention in Treasury bills. Enforce cash ratio and limits on CBK's rediscount and overdraft facilities to support monetary stance.	1993/94 continuous
		Review CBK Act and Banking Act to determine necessary amendments and incorporate needed revisions in Finance Bill of June 1994.	June 1994
		Require commercial banks with NBFI affiliates to meet cash and liquidity ratios on consolidated accounts.	by June 1994
	Ensure transmission of interest rates on government securities to savings and lending rates of commercial banks by development of secondary market for GOK securities	Lower minimum denominations on offer, target individual investor by advertising, appoint commercial banks as agents for sale of GOK securities, encourage private sector to establish central depository to facilitate secondary market payments and delivery.	
	Divest Government holdings in commercial banks	Restructure National Bank and offer GOK shares for sale to public	by June 1994
		Progressively reduce GOK shares in Kenya Commercial Bank and Post Bank to a minority position.	by June 1996
	Improve financial position of the National Social Security Fund (NSSF)	Prepare action plan for NSSF drawing on actuarial study.	by June 1994
II. External Policies			
a. Exchange rate management	Stable exchange rate	Complement sound monetary and fiscal policies with interventions in the foreign exchange market to maintain a stable exchange rate.	Continuous
b. Trade reform	Increase economic integration with the PTA countries and enhance export incentives through tariff reform and elimination of export taxes. Reduce export licensing.	Pursue steady tariff reform with the objective of achieving a maximum duty rate of 30% with number of rates (including zero rate) reduced to 4.	by July 1997

KENYA
SUMMARY AND TIMETABLE OF POLICY ACTIONS, 1994-1996

	OBJECTIVES AND POLICIES	STRATEGIES AND MEASURES	TIMING
		Eliminate export taxes and reduce export license to short negative list of items restricted for health, security and environmental reasons.	by July 1994
	Improve import transit system	Introduce PTA harmonized transit charge on a reciprocal basis	by July 1994
		Modify transit regulations and security arrangements to prevent delays and leakages.	by July 1994
	Streamline Customs procedures and improve revenue collection	Introduce new PSI arrangement	January 1994
		Complete full review and reform of customs procedures.	by December 1994
c. External debt	Reduce external arrears.	Settle external public debt arrears as soon as practical.	1994-96
		Tightly limit public sector non-concessional external borrowing and guarantees.	1994-96
III. Budgetary Policies	Reduce government budget deficits (commitment basis, excluding grants) to level consistent with noninflationary domestic financing. Target of 2% of GDP by 1995/96. Correspondingly limit domestic borrowing for deficit finance to nonbank sources.	Raise Revenue/GDP ratio to 23% in 93/94 and further to 24% in 95/96 through broadening of the tax base and improving collection.	1993/94 - 1995/96
		Reduce expenditure/GDP ratio to 29 percent in 93/94 and further to 26% in subsequent years, through reduced interest charges, elimination of maize subsidy, civil service reform and rationalization of expenditure.	1993/94-1995/96
		Improve budget monitoring and control and initiate measures to clear pending bills.	1993/94 continuous
		GOK will initiate reforms to local government financing to improve their capacity to provide local services.	during 1994
IV. Public Expenditure Policies	Reallocate resources towards "core" functions of Government - law and order, administration of justice, provision of basic social services, infrastructure, and protection of the environment.	Begin to reallocate resources to these core areas from 1994/95 budget.	1994/95 continuous
		Allocate 75% of development budget to projects in "core" functions of GOK, especially those serving the poor.	1994/95 continuous

KENYA
SUMMARY AND TIMETABLE OF POLICY ACTIONS, 1994-1996

	OBJECTIVES AND POLICIES	STRATEGIES AND MEASURES	TIMING
		These projects will be fully protected if budgeted expenditures are to be reduced.	
		Increase share of non-wage O&M and development expenditures while reducing share of wage bill in total.	1994/95 continuous
	Select development projects using objective technical and economic criteria	Continue rationalization of on-going projects and ensure that new projects meet criteria and are fully funded.	1994/95 continuous
		Intensify review and approval of PE investment proposals as well as all commitments/expenditures with contingent implications for budget	1994/95 continuous
V. Civil Service Reform and Capacity Building	Restructure civil service to improve public sector management capacity	By December 1993, GOK will i) prepare a draft policy statement redefining the scope of responsibilities of the civil service and identifying functions to be divested ii) identify key ministries to be restructured in the first year of the program iii) consider and operationalize an early retirement program, including a safety net.	by December 1993
		Eliminate 26,000 net positions in 1993/94 (including 14,000 vacancies) and a further 16,000 net positions from 1994/95-1996/97.	1993/94 1994/95-1996/97
		Monetize benefits in line with recommendations of Action Plan.	in 1995/96 budget
		Introduce code of ethics for civil servants, including rules governing conflict of interest	by July 1995
	Improve policy making capacity at key ministries and agencies.	Action plans to be prepared by MOF and MPND to strengthen policy making capacity	by March 1994
		CBK to develop action plan for staff development in key operational departme	by March 1994
VI. Domestic Market Liberalization	Complete liberalization of prices.	Remaining price controls to be lifted by July 1994	by July 1994

KENYA
SUMMARY AND TIMETABLE OF POLICY ACTIONS, 1994-1996

	OBJECTIVES AND POLICIES	STRATEGIES AND MEASURES	TIMING
	Regulatory Reform	Reduce number of local fees and licences for new startups and minimize restrictions on trade under Trade and Licensing Act.	by July 1994
		Eliminate statutory monopolies of parastatals. Specifically eliminate: - KNTC sugar monopoly - KPCU milling monopoly	by March 1994
		Review law relating to bankruptcy, liquidation and recovery of debts to allow rapid reorganization/settlement. Present modifying legislation to Parliament.	by July 1994
		Take actions to reduce obstacles to competitive functioning of labour market.	1993/94
VII. Public Enterprise Reform	Achieve commercially viable operation of strategic public enterprises.	Present Corporate Governance legislation for Government consideration	by November 1993
		Present Corporate Governance legislation for Parliamentary consideration	by February 1994
		Government to consider draft subsidy reduction plan.	by February 1994
		Indirect subsidies to public enterpr. to be eliminated by end 1996/97.	1994/95 - 1996/97
		Prepare and enforce performance contracts (PC) with all strategic public enterprises.	by June 1995
		Prepare an action plan for elimination of all public enterprise cross debts	by June 1994
		Establish appropriate regulatory bodies for public and private monopolies.	by June 1995
	Substantially divest GOK equity interest in non-strategic public enterprises while ensuring that a broad cross-section of Kenyans can participate in ownership of divested enterprises.	Bring 25 of remaining 190 non-strategic public enterprises to point of sale by end 1994. These 25 will include Kenya Airways, Gilgil manufacturing facility, at least 2 sugar factories, all Cotton Board ginneries, and freight handling services at Nairobi and Mombasa airports.	by December 1994

KENYA
SUMMARY AND TIMETABLE OF POLICY ACTIONS, 1994-1996

	OBJECTIVES AND POLICIES	STRATEGIES AND MEASURES	TIMING
		Dispose off half of remaining GOK equity in public enterprises in two roughly equal tranches in 1995 and 1996.	1995-1996
VIII. Agricultural Policies	Create policy environment to spur recovery of food crop, commodity, export and industrial raw material production. Limit role of govt. to policy formulation, and efficient provision of infrastructure and research and extension services.	Reorganize Ministry of Agriculture, Livestock Development and Marketing to: i) focus its role in supporting private sector initiative, ii) improve management of units responsible for providing strategic services, iii) privatize some services, iv) improve cost recovery in public services, v) increase allocations to non-wage operations and maintenance activities.	1994-95
	Liberalization of the maize market.	Maize price and movement decontrol	by July 1994
		Limit role of NCPB to managing a maximum strategic maize stock of 3 million 90 kilogram bags. Reduce NCPB storage capacity and staff accordingly. NCPB to purchase maize at no more than the export parity price and sell at no less than import parity price.	continuous
		Kenya Cooperative Creameries to agree with its creditors on a restructuring plan by March 1994. Such plan to be successfully implemented by June 1995 failing which creditors may seek recovery of unpaid loans.	by March 1994 by June 1995
		Introduce to Parliament legislation to give effect to a liberalized environment for the dairy industry.	by March 1994
		Complete privatization of five sugar factories.	1994-96
		Bring all five sugar factories to the point of sale - two by end 1994 and the other three by June 1995.	1994-95
		Present legislation to Parliament to restructure the Cotton Board.	by September 1994
		Complete privatization transactions for three ginneries by July 1994.	July 1994
		Bring other three ginneries to point	December

KENYA
SUMMARY AND TIMETABLE OF POLICY ACTIONS, 1994-1996

	OBJECTIVES AND POLICIES	STRATEGIES AND MEASURES	TIMING
		of sale by end 1994.	1994
		GOK policy statement supporting a market oriented oilseed industry to be announced.	by December 1994
		GOK to publish policy statement on tea sector.	by March 1994
		KTDA's shares in tea factories to be divested by December 1994.	by December 1994
		Complete review of institutional structure of coffee industry.	by June 1994
		Government to review legal and policy framework of cooperatives and implications for role of Ministry of Coop.Development.	by June 1994
		Implementation of legal, policy and institutional changes resulting from the review.	1994/95
IX. Environment	Protect scarce environmental resources from effects of population growth, rapid urbanization, and inappropriate farming practices.	Complete and formally adopt the National Environment Action Plan by May 1994.	by May 1994
		Finalize forestry master plan by May 1994.	by May 1994
		Introduce tariff on wastewater discharge to be used for operations of water treatment facilities	by March 1994
		Mandate environmental and biological diversity assessments prior to allocation or development of undeveloped public land	by January 1994
		Complete land use study to guide best sustainable use of land	by June 1995
		Incorporate environmental criteria in all major public projects.	Continuous
X. Infrastructure and Transport	Undertake policies and actions essential to restoring and improving the quality of infrastructure - roads, water supply and transport services.	Introduce legislation for special levy on fuels to fund road maintenance and development in place of existing road tolls.	by January 1994
	Roads	GOK to develop a strategy to address the maintenance, rehabilitation and upgrading of roads.	during 1993/94

KENYA
SUMMARY AND TIMETABLE OF POLICY ACTIONS, 1994-1996

OBJECTIVES AND POLICIES	STRATEGIES AND MEASURES	TIMING
Railways	Implement Corporate Action Plan approved by Kenya Railways Board.	
	Conclude Performance contract with Kenya Railways specifying full compensation.	by March 1994
Ports	Conclude Performance contract with Kenya Port Authority.	by September 1994
	Eliminate KPA's exemption from income taxation.	from 1994/95
	KPA to privatize maintenance of cargo handling equipment and port infrastructure and stevedoring.	by September 1994
Post and Telecommunications	Appointment of a new Board of Directors of Kenya Post and Telecommunications consisting of qualified members.	by November 1993
	Appoint new management of KPTC with full operational responsibility for achieving financial targets, staff reduction, separation of post and telecomm., and facilitate privatization of activities to be divested.	by March 1994
	Conclude Performance Contract with new management of KPTC.	by June 1994
	GOK to introduce legislation in Parliament for separation of post and telecommunications.	by June 1994
Water Supply	Adjust urban and rural water tariffs half-yearly to raise collections to at least 70% of recurrent expenditure by 1996.	half-yearly 1994-96
	GOK to prepare comprehensive investment plan for rehabilitation of existing water supply schemes.	during 1994
	Government to complete review of national water resource management and planning, taking account of requirements of agricultural sector and water supply subsector.	by end 1994

KENYA
SUMMARY AND TIMETABLE OF POLICY ACTIONS, 1994-1996

	OBJECTIVES AND POLICIES	STRATEGIES AND MEASURES	TIMING
		GOK to propose amendments to Water Act and related legislation to protect water catchment areas	during 1994
XI. Energy	Policy reforms to address growing capacity constraints, in electricity generation and oil pipeline supply and to develop renewable energy sources.	GOK to prepare annually a rolling five year investment program for power and petroleum in agreement with IDA.	from 1994 continuous
		Present legislation to Parliament to assist in reorganization of the power sector by: a) separating commercial and regulatory functions and setting up a regulatory commission; b) separating generation from transmission and distribution.	by September 1994
		Raise electricity tariffs to 75% of LRMC in three annual steps to allow KPLC an operational profit and allow it to sustain an investment program. First step to cover half of overall real increase needed.	from March 1994
		Complete performance contracts with energy sector public enterprises - KPLC, TRDC, KPC, NOCK.	by September 1994
XII. Human Resource Development			
a. Population	Continue efforts to bring down population growth rates.	Increase collaboration with NGOs and private sector to improve quality of family planning service delivery and increase contraceptive prevalence rates further.	1993/94 continuous
		Restructure NCPD to focus its role on policy making.	by March 1994
b. AIDS control and Health Policy	Arrest the increase in AIDS cases through prevention and treatment of STDs and interventions which bring about behavioral change. Develop cost effective means of managing care for HIV positive and AIDS patients.	GOK to develop an AIDS prevention and treatment/management programme	by January 1994
		Government approval of National Drug Policy and setting up of Quality Control Laboratory.	by June 1994

KENYA
SUMMARY AND TIMETABLE OF POLICY ACTIONS, 1994-1996

	OBJECTIVES AND POLICIES	STRATEGIES AND MEASURES	TIMING
	Improve cost recovery, increase allocations to preventive/primary health care, ensure that poor are protected from increased user charges.	Review hospital user charges by December 93 and health center user charges by June 1994.	December '93 June 1994
		Periodically adjust user charges to raise collections from 1.7% to 9% of recurrent expenditures.	1994/95 - 1996/97
		Conduct detailed audit of NHIF.	by January 1994
		Develop comprehensive health reform program to guide reforms in later years.	by June 1994
	Improve effectiveness of nutritional interventions.	Replace school milk programme with meals programme targetted to students in poor areas.	by June 1994
c. Education	Increase access and quality of education while reallocating expenditures from university to basic education.	Government will prepare a 10 year forward forecast and plan to address teacher training requirements.	
	Increase enrollment and retention, particularly female enrollment - at primary level in ASAL areas, and secon at secondary school level more generally.	Expand the use of scholarships and means tested bursaries at secondary school level to preserve access and increase enrollment.	from 1994/95
		GOK to allocate necessary resources to improving quality of science education at all levels.	from 1994/95
		Separate university tuition charges from costs of board and lodging. Move toward full cost recovery for room and board at universities by July 1995	1994/95
		Introduce means testing for student loans with gradual adjustment to positive real rates of interest.	March 1994
		Move to system of flat grants to the Commission for Higher Education in lieu of direct budgetary allocations to individual universities.	July 1994
		Government to prepare a Public University Development Plan.	by March 1994

KENYA
SUMMARY AND TIMETABLE OF POLICY ACTIONS, 1994-1996

	OBJECTIVES AND POLICIES	STRATEGIES AND MEASURES	TIMING
XIII. Poverty Reduction and Social Impact of Adjustment	Make targeted interventions to reduce the effect of poverty.	Target school meals programme and pre-school milk programme to reach poor districts and areas.	June 1994
		Use self-targeting public works programmes to provide employment and income for poor.	1994 - 1996
		For ASAL areas, implement actions to improve cattle quality, provide extension support for drought hardy crops, and develop micro-catchment projects.	1994 - 1996
		Government will complete the design of the safety net for retrenched civil servants and employees of public enterprises.	by December 1993

Table 1: External Financing Requirements, 1992 – 1996
(In millions of US$)

	Actual	Est.	Projections		
	1992	1993	1994	1995	1996
External Financing Requirements	502	603	1215	522	703
Current Account, excluding Net Official Transfers & Interest Payments	115	–137	–137	–170	–170
Interest Payments	241	235	237	257	232
Amortization (PPG)	409	381	407	379	575
IMF Repurchases	83	62	14	36	58
Private and Short Term Capital (net) 1/	–45	–75	–51	–49	–50
Reduction in Arrears	–387	–68	695	0	0
Reserve Build–up 2/	86	205	50	69	58
Disbursements: Existing Commitments	502	571	354	299	188
Grants	225	137	97	83	57
Loans – Official Creditors	278	434	257	216	131
Financing Gap	0	32	861	223	515
Disbursements: Expected New Project Commitments	0	0	50	76	188
Grants	0	0	13	28	57
Loans – Official Creditors	0	0	37	48	131
Remaining Gap	0	32	811	147	330

1/ Includes rounding errors and omissions.
2/ Estimate for 1993 includes a special reserve for emergency maize imports.

Source: Data provided by the Kenyan authorities; World Bank and Fund staff estimates.

Table 2: Key Indicators, 1990–1996

Key Indicators	Actual 1990	1991	1992	Est. 1993	Projections 1994	1995	1996
Real GDP growth (factor cost)	4.3	2.3	0.4	0.2	3.0	5.0	6.0
Real GDP growth per capita	0.5	–1.5	–3.1	–3.4	–0.6	1.4	2.3
Inflation (CPI, annual average) 1/	15.7	19.6	27.3	46.1	24.0	7.5	7.5
Change in net domestic assets of CBK 2/	24.4	19.9	48.9	...	...	...	...
Reserve money growth	21.8	15.7	26.5	...	...	...	...
Broad money growth	15.5	20.9	33.6	...	...	...	...
External debt/GDP	57.8	66.9	69.0	90.8	97.1	90.1	83.1
External debt/exports GNFS 3/	207.0	235.0	259.1	250.8	250.2	227.7	210.0
External debt service/exports GNFS 3/	32.5	30.5	32.9	29.6	25.8	24.1	28.9
Gross national saving/GDP	18.7	17.6	14.5	17.6	19.1	22.3	24.6
Gross investment/GDP	23.9	20.8	16.1	17.0	19.0	22.0	23.9
Fixed capital formation	20.4	18.9	15.8	16.8	17.0	19.0	20.9
Central Government	4.5	3.3	2.9	3.0	3.2	3.5	3.5
Other	15.9	15.6	12.9	13.8	13.8	15.5	17.4
Change in stocks	3.5	1.9	0.3	0.2	2.0	3.0	3.0
Central Government revenue/GDP 4/	22.7	23.7	22.2	23.2	23.3	24.0	24.0
Central Government expenditure/GDP 4/	31.2	28.4	32.5	29.4	26.2	26.0	26.0
Central Government deficit (exc grants)/GDP 4/	–8.6	–4.8	–10.4	–6.1	–2.9	–2.0	–2.0
Central Government deficit (incl grants)/GDP 4/	–6.6	–2.9	–9.2	–4.7	–1.8	0.0	0.0
Export growth (volume)	8.1	–3.5	–2.2	6.4	8.4	7.2	6.4
Exports/GDP	12.1	11.4	11.1	11.8	12.4	12.7	12.8
Import growth (volume)	–14.1	–8.9	–3.6	–10.1	13.2	7.8	7.4
Imports/GDP	13.6	11.6	10.6	9.8	11.0	11.3	11.5
Current account def (excl grants; SDR million)	486.0	337.0	251.0	70.0	72.0	63.0	46.0
Current account def/GDP (excl. official transfers)	7.5	5.7	4.2	1.6	1.5	1.2	0.8
Current account def/GDP (incl. official transfers)	5.2	3.2	1.6	–0.6	–0.2	–0.4	–0.7
Gross official reserves (months of imports)	1.4	1.1	1.2	1.8	1.9	2.1	2.3
Real effective exchange rate (–depr)	–9.6	–7.1	11.4	...	...	...	...

Source: Data provided by the Kenyan authorities; World Bank and Fund staff estimates and projections.

1/ Composite index for Nairobi.
2/ In percent of initial reserve money stock; CBK, Central Bank of Kenya.
3/ GNFS, goods and non–factor services.
4/ Fiscal year beginning July 1 of the calendar year indicated.

The World Bank
Washington, D.C. 20433
U.S.A.

ERNEST STERN
Managing Director

Faxed

November 8, 1993

Mr. Jaycox

Kenya PFP

Kim -

The PFP is quite surreal in scope given Kenya's track record. As we move beyond the PFP to our lending program, specificity needs to increase sharply --- even if this means focusing on fewer areas.

As to the PFP, we should not accept a dilution of para 41. This particular liberalization has been supported in the past by our adjustment operations. Similarly, a dilution of para 53 should not be acceptable unless a delay is required for technical reasons on the industry side, which is hard to envisage.

Finally, I would prefer a more explicit statement on the limits of non-concessional borrowing. An outright prohibition, except for refinancing, would seem to be in order, given the debt situation. But, even if not zero, a specific cap should be agreed on. If that cannot be achieved in the PFP, it should be introduced in the next available credit negotiations. It is hard to justify the use of IDA funds and Fifth Dimension financing for a country which continues to add to its non-concessional external debt outstanding.

cc: Messrs. Colaco, Karaosmanoglu

File

THE WORLD BANK/IFC/M.I.G.A.

ROUTING SLIP	DATE: September 30, 1993

NAME	ROOM NO.
Mr. Attila Karaosmanoglu	E-1227

	URGENT		PER YOUR REQUEST
	FOR COMMENT		PER OUR CONVERSATION
	FOR ACTION		SEE MY EMAIL
	FOR APPROVAL/CLEARANCE	X	FOR INFORMATION
	FOR SIGNATURE		LET'S DISCUSS
	NOTE AND CIRCULATE		NOTE AND RETURN

RE: KENYA - EDSAC

REMARKS: \

Attached is a complete set of documents relevant to Kenya EDSAC.

FROM:	ROOM:	EXTENSION:
Francis X. Colaço FXC	J10-157	34036

The World Bank
Washington, D.C. 20433
U.S.A.

EDWARD V. K. JAYCOX
Vice President,
Africa Region

September 30, 1993

Honorable Musalia Mudavadi
Minister for Finance
Ministry of Finance
Nairobi, Kenya

Dear Mr. Minister:

Thank you for your letter of 29th September, 1993, and for the Governor, CBK's letter of 30th September, 1993. I appreciate the information contained in your letter, and the efforts under way to resolve the problems of Trans-National. I would like to confirm to you that, on the assumption that the present macro-economic and education sector policy environment remains in place, all conditions for the release of the second tranche of the EDSAC have been met, with the exception of that relating to Trans-National. This latter condition would be met when either: (i) we receive a report by Price Waterhouse, confirmed by the Governor, CBK, indicating that, not later than 30th November, 1993: Trans-National is in compliance with Sections 10, 11, 17, 18 and 19 of the Banking Act; no other significant breaches of banking regulations require reporting in accordance with Section 24 (4) of the Banking Act; and the requirements of subparagraphs (a) and (d) of the letter of 29th September, 1993, from the Managing Director, Trans-National Bank Ltd., to the Governor, CBK, have been met; or (ii) you notify us of the revocation of Trans-National Bank Ltd.'s license.

In view of the above, we are unable at this point in time to conclude that satisfactory progress has been made and all necessary actions taken for purposes of second tranche release. As required under para. 5 of Schedule 1 to the Development Credit Agreement for the EDSAC, we accordingly have to give notice that, unless appropriate progress is made and necessary action taken in respect of the one outstanding issue referred to above, we reserve the right to cancel the unwithdrawn amount of the Credit or any part thereof. We trust, however, that this 90-day period will allow you ample time to bring this matter to a satisfactory conclusion, either by production of an audit report as indicated above, or, if need be, by revocation of the license of Trans-National Bank Ltd.

I am pleased to confirm that we look forward to working with you and the IMF on the completion of a new Policy Framework Paper (PFP) in October/November. We propose that the mission to discuss the PFP should start between 11th and 18th October, 1993. We also look forward to the Consultative Group Meeting, which we have agreed should take place on 22nd and 23rd November, 1993.

Yours sincerely,

EJaycox

cc & cw: R. Soopramanien (LEGAF)

cc: Mmes./Messrs. A. Karaosmanoglu (EXC); F. Lethem, P. Miovic (AF2DR); R. Hindle (AF2PE); S. Ganguly (AF2AE); J. Maas (AF2PH); S. Weissman (AF2EI); S. O'Brien (AF2KE); C. Bruce, A. Rajaram (AF2CO); Africa Information Files

Colaço/Carter/Magnus:lc

REPUBLIC OF KENYA

MINISTRY OF FINANCE

Telegraphic Address: 22921
FINANCE-NAIROBI
FAX No. 330426
Telephone: Nairobi 338111
When replying please quote

Ref. No. ....

and date

THE TREASURY
P.O. Box 30007
NAIROBI
KENYA

September 29, 1993

Mr. Edward V.K. Jaycox
Vice President
Africa Region
World Bank
Washington, D.C. 20433

Dear Mr. Jaycox:

Please find attached a self-explanatory letter sent to the Governor of Central Bank of Kenya by the Managing Director of Trans-National Bank Ltd. I wish to confirm that:

(a) Any officer of Trans-National who has not repaid in full any unsecured loan or advance to him/her from Trans-National by 29th October, 1993 will immediately be removed from his/her position as an officer of the Bank and will therefore be barred from holding office in any other bank in Kenya; and

(b) Any failure by Trans-National to meet the requirements set out in subparagraphs (a) to (h) of the Managing Director's letter, or the emergence of any evidence that any statement in his letter is untrue or incorrect will result in prompt action being taken in accordance with Section 6(b) of the Banking Act.

Yours sincerely,

W. MUSALIA MUDAVADI
MINISTER FOR FINANCE

Attachment (1)

Trans-National Bank Limited
Silopark House, 2nd Floor, Mama Ngina street. P.O. Box 75840 Nairobi
Telephones 224234/224235/224236/224237/339201/2/3/4
339223/339225. Telex 25722 T. Bank

PRIVATE & CONFIDENTIAL

September 29, 1993

Mr. M. Cheserem
Governor
Sheraton Washington Hotel
Washington
Room No. 6306

Fax No. (202) 2340015

Dear Mr. Governor,

Over the past several days, we have had an opportunity to review together issues relating to the financial situation of Trans-National Bank. Aware of the seriousness of the financial difficulties that the Bank presently faces, I am now writing to you to set out actions recently taken and proposals for further actions over the next several weeks that are aimed at restoring the soundness of the institution. The term "Trans-National", when used in this letter, refers to Trans-National Bank Ltd., together with all of its subsidiaries.

I can confirm that, as a result of new equity contributions by existing shareholders, Trans-National Bank Ltd's paid-in capital has been increased substantially, from Kshs. 124 million to Kshs. 369 million.

As you know, the special investigation of Trans-National's portfolio of loans and advances recently undertaken by Deloitte and Touche indicated that, as at 31st August, 1993, loans and advances in excess of Kshs. 5 million each that were classified as non-performing or doubtful amounted to an aggregate of Kshs. 924 million. I am pleased to be able to report that Kshs. 227 million of that amount has now been recovered.

At close of business on 31st August, 1993, deposits by parastatal bodies at Trans-National amounted to Kshs 968 million. The balance remains unchanged. Trans-National Bank Ltd.'s cash ratio now stands at 10.7%.

Turning to the future, I would like to outline a number of actions Trans-National will be taking over the next several weeks to restore its financial soundness and to ensure full compliance with all banking regulations:

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(a) With the exception of overnight inter-bank advances, Trans-National will make no new loans or advances, nor will it permit the level of existing loans and advances to increase, until such time as I receive formal confirmation from you that CBK considers that Trans-National is in compliance with all banking regulations.

(b) I confirm that Trans-National agree that CBK should immediately delegate one or more members of staff from its Supervision Department to be present full-time at Trans-National. They will be given full access to any information relating to the operations of Trans-National that they require, and will of course be free to report any findings to CBK.

(c) I have notified the individuals concerned that all unsecured loans and advances made to officers and employees of Trans-National, or to their Associates, must be repaid to Trans-National in full by 29th October, 1993, bringing to their attention the prospect that action could be taken against them in accordance with Sections 34(2) (b) and 48(1)(c) of the Banking Act.

(d) the remaining balances held in existing accounts at Trans-National by parastatals with which any officer of Trans-National has any financial or professional relationship will be fully drawn down and the relevant accounts permanently closed by 29th October, 1993. The balance on these accounts is currently kshs. 352 million. Until you confirm to me that Trans-National is full compliance with all banking regulations, there will be no increase in the current level of other parastatáls' deposits at Trans-National, whose aggregate level is presently kshs. 616 million and no new parastatal accounts will be opened.

(e) by 29th October, 1993, Trans-National will have obtained additional repayments or additional full securitisation of the principal of non-performing and doubtful loans and advances identified in the auditor's special investigation mentioned above and/or additional infusion of paid-in capital, amounting to a total of kshs. 500 million.

(f) by 29th October, 1993, Trans-National will comply with the limits on lending to a single borrower set out in Section 10 of the Banking Act.

(g) as soon as possible after 29th October, 1993, but not later than 30th November, 1993, Trans-National will comply with all banking regulations, including the prescribed capital adequancy requirements.

(h) Trans-National will meet the prescribed cash ratio requirements; however, in addition, on no day until you confirm to me that CBK considers that Trans-National is in compliance with all banking regulations, will be cash ratio be allowed to fall below 80% of the prescribed ratio.

[initials]

......./3

On 30th April, 1993, CBK wrote to Trans-National Bank Ltd. to inform the Bank that, unless it met statutory ratios by 31st July, 1993, the Bank's licence would be revoked. I confirm my understanding that this communication constituted notice of revocation of banking licence in accordance with Section: 6(i) of the Banking Act. More specifically, I confirm that, since the notice period in CBK's letter has expired, without Trans-National Bank Ltd. complying with the requirements set out in that letter, Trans-National Bank Ltd.'s banking licence is now subject to revocation at any time, for any reason, including, but not limited to: (i) failure on the part of Trans-National to meet any of the requirements or execute any of the actions set out in subparagraphs (a) to (h) above; and (ii) evidence that any statement contained in this letter is untrue or incorrect.

If need arises, for example due to public discussion of the present situation of Trans-National, I will be ready to make a public statement at your request, explaining Trans-National's present financial situation, and outlining the corrective measures agreed with CBK.

Yours sincerely,

F.G.E TATE
MANAGING DIRECTOR

Copy to: Michael F. Carter
Chief of Operation,
E. Africa Division
World Bank
Washington D.C.

Fax No. (202) 4738262

Governor

BANKI KUU YA KENYA

CENTRAL BANK OF KENYA

Haile Selassie Avenue
P.O. Box 60000 Nairobi Kenya
Telephone 226431 Telex 22324 Fax 728662

September 30, 1993

Mr. Edward V.K. Jaycox
Vice President
Africa Region
World Bank
Washington, D.C. 20433

Dear Mr. Jaycox:

I attach a copy of a letter that I have sent to Price Waterhouse, appointing them to carry out a special audit of Trans-National Bank Ltd. and setting out the terms of reference for this audit.

I can confirm that Trans-National Bank Ltd's cash ratio on 29th September, 1993 was 10.7%. I can also confirm that I will make every effort to ensure that new capital injections to Trans-National are not financed by recourse to unsecured loans from any institution in which the Kenya Government has an interest.

Yours sincerely,

MICAH CHESEREM
GOVERNOR
CENTRAL BANK OF KENYA

Attachment (1)

FAX: - 254-2- 335937

Governor

BANKI KUU YA KENYA

CENTRAL BANK OF KENYA

Haile Selassie Avenue
P.O. Box 60000 Nairobi Kenya
Telephone 226431 Telex 22324 Fax 728662

September 30, 1993

Mr. G.R. May
The Chairman
Price Waterhouse
Certified Public Accountants
P.O. Box 41968
NAIROBI - Kenya

Dear Mr. May:

This is to confirm your appointment to undertake special audit of the Trans-National Bank Ltd. in accordance with the attached terms of reference.

Yours sincerely,

MICAH CHESEREM
GOVERNOR
CENTRAL BANK OF KENYA

Attachment (1)

DRAFT TERMS OF REFERENCE FOR AUDITOR RE: TRANSNATIONAL BANK LTD.

1. In Accordance with the provisions of Section 24(3) (b) of the Banking Act, the Central Bank of Kenya (CBK) appoints Price Waterhouse to undertake a special audit of Transnational Bank Ltd. and its subsidiaries and affiliates (referred to together as Transnational below).

2. You will begin this assignment on 11th October, 1993.

3. In undertaking this special audit, you should specifically:

(a) assess the quality of these institutions' respective "loans and advances" portfolio, as of 30th September, 1993, based on an account-by-account examination of those accounts in an amount of KSh 1.0 million and above, for the purpose of categorizing and determining the amount of specific provisions required for each account (as provided under the CBK's guidelines for establishing said provisions);

(b) verify the representations of fact made in the letter from the Managing Director, Transnational Bank Ltd., to the Governor of the CBK, dated —th September, 1993 (Attachment 1);

(c) confirm compliance or otherwise of Transnational with the requirements set out in subparagraphs (a), (c), (d), (e), (f) and (h) of Attachment 1; and

(d) confirm as of 30th November, 1993 (or any earlier date in November as agreed with Transnational Bank Ltd.) the extent of compliance of Transnational with the requirements set our in sub-paragraphs (a) and (d) of Attachment 1 and Sections 10, 11, 17, 18 and 19 of the Banking Act. You should also include any report as required under Section 24 (b) of the Banking Act.

4. Price Waterhouse will submit to the Governor of the CBK, reports on the activities outlined above, as follows:

* paragraph 3(a) - no later than 29th October, 1993;
* paragraph 3(b) - no later than 29th October, 1993;
* paragraph 3(c) - no later than 12th November, 1993;
* paragraph 3(d) - no later than two weeks after the date agreed with Transnational Bank Ltd.

Attachment 1

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: September 29, 1993

TO: Mr. Michel Camdessus

FROM: Attila Karaosmanoglu AK

EXTENSION: Kenya

As promised, I am sending you the attached note regarding the latest status of our negotiations with the Kenyans. I hope it will be useful for your meeting with the Kenyan Delegation.

cc: Mr. Preston

The World Bank/IFC/MIGA
O F F I C E   M E M O R A N D U M

DATE: September 29, 1993 05:25pm

TO: Attila Karaosmanoglu (ATTILA KARAOSMANOGLU)

FROM: Francis X. Colaco, AF2DR (FRANCIS X. COLACO)

EXT.: 34036

SUBJECT: **Kenya**

IDA is now close to agreement with the Kenya delegation on actions to resolve the remaining obstacle to release of We expect to complete the necessary documentation tomorrow (unless there are last minute changes on the Kenyan side).

Our agreement covers an action programme for the restructuring of Transnational bank by the end of November, failing which remedies under Section 6(b) of the Banking Act (dealing with revocation of licences) would be invoked. Once the restructuring of the bank is completed to IDA's satisfaction, or Section 6(b) is invoked, IDA would release the second tranche of EDSAC. If however action on these lines is not completed before the end of December, the outstanding balance of EDSAC would be cancelled.

Given the substantial progress with the rest of Kenya's adjustment programme, we have however agreed that, notwithstanding the need to wait for actions on Transnational bank before EDSAC tranche release, we could proceed with the PFP mission (subject to IMF agreement) in October, and with the Consultative Group meeting in late November. IDA will make public that it is encouraged by recent policy developments in Kenya, and that invitations will now be issued for a Consultative Group meeting.

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: September 27, 1993

TO: Memorandum for the Record

FROM: Francis X. Colaço (AF2DR)

EXTENSION: 34036

SUBJECT: 1993 Annual Meetings - Kenya Delegation - Meeting with Mr. Preston

1. The Kenya delegation met with Mr. Preston on September 24. Those attending were:

Delegation	**Bank**
Musalia Mudavadi	Lewis Preston
Micah Kiprono Cheserem	Attila Karaosmanoglu
Wilfred Koinange	Edward V.K. Jaycox
Denis Afande	Matthew McHugh
	Francis Colaço

2. Mr. Preston opened the meeting by inviting the Minister to react to the issues that had been raised during discussions with regional staff earlier in the day. Minister Mudavadi responded that he was looking to take concrete actions in the shortest possible time and that he hoped to be able to resolve the outstanding issue of TransNational Bank before he left town. He apologized to the Bank for past Kenyan behavior; assurances had been given to the Bank on which they had not delivered. Kenya's economy was sick, but there had been progress in the trade, foreign exchange, monetary and financial areas. Difficulties remained with parastatals, but he indicated substantial progress could be made. He was of the view that World Bank and IMF programs did not operate effectively because political participants had not been brought in early enough and there had not been greater honesty in making them aware of the consequences of measures to be taken. Responding to questions on civil service reform and maize pricing, Minister Mudavadi indicated that the government had already launched on a program of civil service reform and that maize prices had been increased substantially (so as to reduce, but not quite eliminate the subsidy) as part of an effort to meet IMF budget deficit ceilings. Responding to a question on the refugee situation, Minister Mudavadi said that there were still a number of Somalis and Southern Sudanese in Kenya.

3. Governor Cheserem said that he had been in the private sector until he had recently joined the Central Bank. The trade regime had shackled the private sector, and recent measures were much welcomed. The Central Bank had not functioned and he had taken the step of dismissing a number of officers. Mr. Karaosmanoglu said that the process which had started should include irreversible steps.

4. Minister Mudavadi said that he was caught up in a legacy which he wished he had not inherited. Mr. Preston added that there were skeptics in the donor community about Kenya

and that they had to be won back in an adverse aid climate, but that he believed in Kenya and that he thought that donors did too. Minister Mudavadi added that donors were trying to pass the buck to the World Bank and the IMF, rather than admitting that they have difficulties with Kenya or in their domestic economies. Mr. Preston said that Bank staff were accustomed to this; Mr. Jaycox added that the Bank had defended Kenya many times over the years, and the institution's credibility was at stake.

5. It was agreed that Mr. Preston would be kept informed on progress in discussions between the Kenya delegation and Bank staff.

cc: Messrs./Mmes.: Preston, Karaosmanoglu, McHugh, Kalantzopoulos (EXC)
Jaycox (AFR)
O'Brien (AF2EA)
AF2DMT
Institutional Files
Africa Files

FXColaço:mcp

BRIEFING FOR MR. PRESTON

KENYA

You will be meeting with a Delegation from Kenya to be led by the Honorable Musalia Mudavadi, Governor for the Bank and Minister of Finance. Mr. Jaycox, Regional Vice President, and Mr. Francis Colaço, Director of AF2, will attend from the Bank. The principal issues likely to be raised and suggested responses are outlined below.

1. Release of the Second Tranche of the Education Sector Adjustment Credit. The delegation will likely stress that major measures to bring Kenya's macroeconomic program back on track have in fact been taken by the Government. The delegation will also probably emphasize the importance of the donors resuming quick-disbursing assistance to Kenya, noting that the lack of such support is a major contributor to the country's economic woes.

> You may wish to note that the economic situation in Kenya is now substantially worse than at the time of last year's Annual Meetings, because of domestic policy failures. The Bank recognizes that major actions have been initiated over the past year; however, these have been often reversed. Following intensive discussions with the Kenyans, all but one of the actions for tranche release have been met. The remaining condition relates to Transnational Bank, which we are asking should be closed. The Kenyans may come with an alternative position, and if earlier discussion with the delegation indicates that an alternative may be worth considering, Mr. Karaosmanoglu will brief you verbally.

2. Implications for the World Bank if Kenya Does Not Implement Outstanding Financial Sector and Fiscal Actions.

> You may wish to indicate that unless the outstanding required actions are taken within the next few days, the Government will be notified that unwithdrawn amounts under the EDSAC will be canceled within 90 days as provided under the Credit Agreement. This notification would mean that we would be unable to proceed with the tentatively scheduled PFP in early October. Then the November CG Meeting would surely be postponed. The Bank would retreat to a core program (of no more than $100 million per year).

1993 ANNUAL MEETINGS BRIEF

Name of Country: KENYA **Date: September 17, 1993**

Meeting with:
Hon. Musalia Mudavadi, Minister of Finance
Mr. Micah Cheserem, Governor, Central Bank of Kenya
Dr. Wilfred K. Koinange, Permanent Secretary, Ministry of Finance

Population: 25.7 million (1992) **Estimated Growth Rate:** 3.6% (1992)
GNP Per Capita: $330 (1992)

	US$ Million			US$ Million
Total Commitments to date:	2,966.4	FY93	Commitments:	115.0
Of which:			Disbursements:	168.0
Bank (41 operations):	933.4		Amortization:	100.0
IDA (81 operations):	2,033.0			
Total Undisbursed:	613.5			
Lending Program, FY94-95:	537.0			
IDA (7 operations)				

Summary Data (%)	Average 1988-92	Projected 1993		
GDP Growth	3.5	-0.6	Aid Group Meeting:	CG
Export 1/ Growth	6.0	10.1	Last Meeting:	Nov 1991 (Informal meeting held May 1993)
Import 1/ Growth	4.7	2.6		
Current Act. Deficit (% GDP) 2/	-6.8	-3.2		
Gross Debt Service Ratio	31.8	31.9 3/		
Annual Inflation Rate	17.7	43.0	IMF Status:	Negotiations of new ESAF tentatively scheduled for mid-Oct 1993

1/ Including non-factor services.
2/ Excluding grants.
3/ Assuming partial repayment of external arrears.

Background: Last year's brief underlined the urgent need for stabilization and a "big push" on reforms in order to address a burgeoning unemployment problem. That need has yet to be addressed, as inconsistent and delayed stabilization measures have contributed to an acceleration of inflation (increasing from 27 percent in 1992 to a projected 43 percent in 1993), and reduced GDP growth (1.7 percent in 1991 and 0.5 percent in 1992). With population growing at 3.6 percent, GDP per capita has been falling since 1990. Structural reforms to improve the performance of a dominant public sector and to encourage private sector investment have been inadequate. Progress was made in 1993 in liberalizing the external sector: import licensing has been dismantled and replaced by a small negative list; the number of tariff rates has been reduced and the levels have been lowered; the scope and amount of foreign exchange retained by exporters has been widened; and the difference between the official exchange rate and the interbank exchange rate has been brought within the margin of 10 percent. However, specific financial sector and budgetary actions needed to bring the macroeconomic program back on track remain outstanding. This has jeopardized release of remaining tranches under IDA's ongoing education sector adjustment operation.

Issues likely to be raised by the Delegation:

(a) Second Tranche Release under EDSAC
(b) Resumption of quick-disbursing BOP support for Kenya
(c) Convening of a CG meeting
(d) Maize shortage and financial assistance to meet food shortfall

Issues to be raised by Bank Management:

(a) Accelerated parastatal, public expenditure and civil service reform
(b) Promotion of private sector development
(c) Importance of full Government commitment to FY94 Poverty Assessment and National Environmental Action Plan (NEAP)

Attachments:
I. Five Year Lending Program FY93-97 (FY93 actual)
II. Biographical Information
III. IBRD Capital Subscription Status
IV. IBRD Outstanding MOV Obligations

KENYA

1993 Annual Meetings Brief

Background

1. At the last Consultative Group Meeting (in November 1991), donors agreed to defer indications of new commitments pending progress on governance and macroeconomic performance. Opposition parties were subsequently legalized, the electoral process was reformed, and multi-party elections were held in December 1992. The general consensus of the international community was that the elections, resulting in the return of KANU to power, by-and-large reflected the will of the Kenyan people. Macroeconomic performance, however, continued to be unsatisfactory. An interim IMF/IDA review mission in September 1992 concluded that the Government fell short of the shadow program requirements agreed earlier in the year with the Fund. Following intensive discussions during last year's Annual Meetings, IDA set out a number of specific actions for immediate implementation to improve exchange and trade policy and to reassert control over excessive monetary expansion, so that a sound macroeconomic framework for IDA's ongoing adjustment operations [i.e., the Second Agriculture Sector Adjustment Operation (ASAO II), Export Development Project (EDP) and Education Sector Adjustment Credit (EDSAC)] could be established. Initially, there was no response from the Government. IDA proceeded to cancel the outstanding tranche of the ASAO II because of the Government's outright reversal of earlier enacted maize movement reform. In mid-February 1993, the Government informed IDA that the trade and exchange rate measures had been introduced; however, no action was taken on the monetary/financial front. Moreover, an IMF/IDA review mission in March found that monetary expansion continued to accelerate, fueled largely by major increases in access to Central Bank credit by a number of politically well-connected insolvent banks. The mission was unable to reach agreement with the Government on the immediate corrective measures necessary to address the current macroeconomic imbalances. There followed a short period in late March and early April when the Government, attempting to go-it-alone, reversed some of the recently announced policies and initiated actions to control money supply. The recognition of the inadequacy of such ad hoc measures and the ultimate necessity of a stabilization program led to an agreement with IDA in mid-April on specific measures to be taken in the monetary, financial and external areas, and with the IMF in May of a new IMF monitored program covering the period April-December 1993, again designed to restore the macroeconomic framework.

2. On May 7, IDA approved the release of the second tranche of the EDP. In his April letter to IDA, the Minister of Finance recognized that "serious imbalances have arisen in the management of aggregate demand in Kenya" and gave assurances that the Government was "ready to take additional action...as the evolving economic situation may require." This commitment was reiterated to Mr. Jaycox during his discussions with President Moi in Nairobi on April 21; during this discussion, Mr. Jaycox not only underlined the importance IDA attached to Kenya's building on these initial actions, but also stressed that the donor community would be looking for evidence that the recent initial improvement in macroeconomic management was being sustained. In two Informal Donors Meetings held since last year's Annual Meetings (i.e., on March 15 in London and on May 25 in Paris), all donors concurred that the establishment of a track record of continued sound economic management, as well as the need for further steps by the Government in substantial structural reform (in the areas identified at the November 1991 CG Meeting) were prerequisites for a successful CG being convened - possibly in the latter part of November 1993.

<u>Recent Developments</u>

3. By early June, the remaining subsector-specific conditions under the EDSAC had been met. On the macroeconomic front, a number of actions agreed at the time of April second tranche release of the EDP had been undertaken. The documentation approving release of the second tranche was thus prepared and, in fact, had been signed-off by Management (but not transmitted) when monetary data brought to IDA's attention indicated that the Central Bank of Kenya (CBK) had vastly overstated its success in absorbing excess liquidity. Subsequent information revealed further unsettling events, in particular, that the CBK persisted in irresponsible monetary expansion and that various irregular (and apparently coordinated) transactions between several banks had seriously undermined the macroeconomic policy measures that the Government had put in place in April and May. In early August, IDA again communicated to the Government a list of specific monetary/financial

sector and budgetary actions that would be needed to once again bring the macroeconomic program back on track. Three issues remain outstanding, despite the efforts of a recently returned IDA mission to resolve these matters in the field. This development raises serious concerns with respect to the Government's commitment to implement monetary policy and to enforce strict discipline in the financial system on a sustainable basis. Mr. Carter (Chief, AF2CO) has just concluded discussions in Nairobi with the Minister of Finance and the Governor of the CBK in a final effort to bring this impasse to satisfactory and timely resolution. In a letter to Minister Mudavadi (whose contents were endorsed by a subsequent letter from Mr. Colaço), the following three actions were indicated as required for EDSAC release: (a) closure of Transitional Bank, either through appointment of a liquidator, or through appointment of a statutory manager and revocation of this institution's banking license; (b) closure of Exchange Bank and Pan African Bank, either through revocation of their licenses when the current notice period expires on September 22, or though prior appointment of liquidators; and (c) confirmation of implementation of complementary measures to eliminate the shortfall in the FY94 budget due to the cost of financing maize subsidies. If the remaining required actions have not been taken within the week, we propose to notify the Borrower that if the required actions are not taken within 90 days (as provided under the EDSAC Agreement), unwithdrawn amounts under the EDSAC will be canceled. Were this to be the case, preparations for a scheduled PFP would be postponed and it is then highly unlikely that a CG meeting would be held in November.

Issues likely to be raised by the Delegation

1. **Issue: Second tranche release under EDSAC.** The delegation will stress that major measures to bring Kenya's macroeconomic program back on track have in fact been taken since last year's Annual Meetings and will probably suggest that IDA has been "moving the goalpost". **Management** may wish to respond that while IDA recognizes that major actions have been initiated over the past year, the lack of consistency in performance combined with the essential nature of measures required for financial sector discipline and fiscal discipline could lead to the cancellation of the second tranche of EDSAC, with consequences for PFP preparation and a November CG.

2. **Issue: Resumption of quick-disbursing BOP support for Kenya.** The delegation will emphasize the importance of the donors resuming quick-disbursing assistance to Kenya, noting that the lack of such support is a major contributor to the country's economic woes. **Management** may wish to stress that domestic policy failure, not the withholding of quick-disbursing BOP support, is at the heart of Kenya's economic problems and that the actions in the areas noted above are essential before there can be any discussion of new balance of payments support (BOP).

3. **Issue: Convening of a CG Meeting.** The delegation will stress the need to convene a CG Meeting, tentatively scheduled for November 18-19, 1993. In response, **Management** might recall that all participants agreed at the May 1993 Informal Donors Meeting that establishment of a track record of continued sound economic management and implementation of reform was essential for a successful CG to be held.

4. **Issue: Maize shortage and financial assistance to meet food shortfall.** The delegation is likely to bring up the topic of the anticipated 1993 long-rain maize shortage and the resultant FY94 fiscal impact arising out of the need to finance the shortage. This and the continuing refugee situation are likely to be cited as conditions for justifying the urgent need for quick-disbursing funds. **Management** may want to stress that any emergency drought assistance would be considered separately from the issues of quick-disbursing BOP assistance (as was done this past fiscal year, i.e., the $20 million Emergency Drought Recovery Project). In addition, **Management** may want to use this opportunity to reiterate the importance it attaches to full liberalization of the maize market. There is strong evidence that the persistent reluctance of the Government to liberalize the market is entirely political. In response to a request for financial assistance, **Management** might want to note that contingent upon agreement with the Government on the issue of maize liberalization, we understand that the EEC has discussed with Government the use of Cereal Sector Reform Program funds to support a range of remedial actions, including the financing of maize imports by the Government or the private sector, and other options to increase future maize deliveries. USAID may also be willing to participate in such a program, if the sector is liberalized.

Issues to be raised by Bank Management

1. **Issue: Accelerated parastatal, public expenditure and civil service reform.** The sustainability of stabilization measures will depend on significant improvements in the efficiency of public expenditures. Likewise, civil service and parastatal reform are crucial to both stabilization and growth objectives. The upcoming PFP negotiations provide an excellent opportunity to formulate a "big push" on reform. **Management** may wish to welcome the Government's August 23 launching of its **Civil Service Reform Program** and Secretariat, at the same time stressing the importance of Government now demonstrating its commitment by proceeding aggressively on the implementation front. **The Public Expenditure Review**, expected to commence within the month, is expected to support Government efforts in achieving economic recovery inter alia through fiscal discipline, by clearly defining expenditure priorities, investigating carefully the impact of government spending (including its effect on the poor) and helping to define broad parameters for subsequent budgets. Regarding the need for structural adjustment of Kenya's public sector, the gradual pace of reform that was envisaged even a year ago is likely to be inadequate to spur the revival of the private sector, which is essential to sustained growth in incomes and employment. **Management** might wish to again express its concern with Government's commitment to reform, noting that **a Parastatal Reform and Privatization Technical Assistance Credit** (approved by the Bank's Board last December) **has yet to be declared effective** due to the Government's delay to-date in approving the new system of corporate governance (as agreed during negotiations).

2. **Issue: Private Sector Development. Management** might emphasize that the main disincentives to private sector development and investment in Kenya are the high level of uncertainty associated with conducting business in Kenya and the deteriorating quality of infrastructure. In addition, both the design and enforcement of business laws and regulations need to be improved.

3. **Issue: Importance of full Government commitment to FY94 Poverty Assessment and National Environmental Action Plan (NEAP).** IDA is currently undertaking with the Government a poverty assessment to better identify the extent and composition of poverty, and to identify the measures likely to help reduce poverty as well as the scope for more targeted interventions to redress the more serious manifestations of poverty. **Management** may wish to stress that any successful effort to raise the living standards of not only the average Kenyan, but also of Kenya's poorest, must rely on broad-based economic growth that generates efficient employment and income generating activities in the private sector. IDA is also providing financial assistance to the Government for preparation of the **NEAP**. Success, however, will depend entirely on strong Government commitment and the integral involvement of all affected ministries, agencies, governmental and non-governmental organizations, and local resource user groups. **Management** may want to reiterate the great importance that IDA attaches to both of these activities, including timely completion (i.e., by the end of FY94 at the latest). **Management** may wish to remind the delegation that during the recent IDA replenishment process, it was decided that completion of the NEAP would be a requirement for all IDA-recipient countries to retain their eligibility for IDA funding starting July 1994.

BIOGRAPHICAL INFORMATION

Delegation of Kenya

The Honorable W. Musalia Mudavadi
Minister of Finance; Governor, Bank

Mr. Mudavadi was born in 1960. He received a B.A. in Land Economics from the University of Nairobi. From 1984 to 1989 he served as the Director (Land Economist/Valuer) with Tysons Ltd. He served as Minister for Supplies and Marketing 1989-1992, and was appointed Minister of Finance in January 1993. Minister Mudavadi led the Kenya delegation at the May 1993 Informal Donors Meeting in Paris.

Mr. Micah Cheserem, Governor
Central Bánk of Kenya; Governor, Fund

Mr. Cheserem was born in 1948. He attended Strathmore College of Accounting 1969-70. Mr. Cheserem has worked as an accountant in several Kenyan companies since 1971, having served as Chief Accountant in East African Industries from 1981-1991. Until his appointment as Governor of the Central Bank of Kenya in July 1993, Mr. Cheserem was the Commercial Director of Lever Brothers (Malawi) Ltd.

Dr. Wilfred K. Koinange
Permanent Secretary
Office of President and Ministry of Finance

Born in Kiambu District in 1939, Dr. Koinange has a medical background, having earned a Bachelor of Medicine and Surgery degree from Makerere University (Uganda) in 1965. He pursued graduate study at London University's Institute of Chest Diseases and at Edinburgh University, at which time he became a member of the Royal College of Physicians. Dr. Koinange also received a diploma in epidemiology and control of tuberculosis from Charles University (Prague). He worked in the Ministry of Health for 22 years in various capacities and also served as a Director of Medical Services (DMS). His most recent position was Permanent Secretary, Ministry of Agriculture. He was appointed Permanent Secretary, Ministry of Finance in December 1991.

Attachment V

KENYA: Debt Service to the Bank

1. During the past year, Kenya has remained "current", despite a persistent pattern of being late. Should the impasse on EDSAC tranche release not be resolved satisfactorily, Kenya will register in FY94 a negative net transfer of IBRD and IDA funds estimated at $30 million. [For FY93, including quick-disbursing funds of almost $89 million, the final net transfer was a negative $8.7 million.]

2. The effect of putting Kenya "on cancellation notice" could provide the impetus for breaking the logjam within the Government, thus facilitating quick resolution of the present impasse on EDSAC; on the other hand, cancellation of this balance-of-payments support could lead Kenya (which has external arrears to all creditors at end-June 1993 of SDR 520 million) to stop making scheduled payments to the Bank (for 1994: IBRD principal and interest of $148 million; IDA of $23 million).

ANNUAL MEETINGS 1993

SUMMARY OF IFC ACTIVITIES

KENYA

- Kenya has significant potential to attract foreign investment. The private sector will have to be the primary engine of growth.

- Until the mid-1980's Kenya was one of the most active countries for IFC in Africa. Since then our investments have declined as private investment declined following an overall deterioration in economic performance and the investment environment. The main problem is poor government policies towards private sector activity, aggravated by recent political problems.

- IFC currently has a portfolio of 12 projects in Kenya, for a total exposure of US$36 million (US$26.4 million in loans and US$9.6 million equity). Most of the portfolio is in industrial projects (paper accounts for over 50% of the total) and hotels. IFC has four Capital Markets investments. Generally, the portfolio has performed well, with collection problems associated with unavailability of foreign exchange at official rates.

- Small business activites continue to be channelled through the Africa Enterprise Fund, run from the Nairobi office.

- The Africa Project Development Facility continues to be active, helping Kenyan entrepreneurs prepare their projects.

- In the capital markets area, besides investments in financial institutions, we are providing ongoing technical assistance to the Capital Market Authority in developing a regulatory framework, modernizing the Nairobi Stock Exchange, and opening up Kenya's securities market to foreign portfolio investors

- A Private Sector Assessment was recently completed, jointly with IBRD

- In 1993, our areas of concentration, both for mainstream projects and small businesss are:
    - on export oriented sectors, mainly tourism and agribusiness;
    - selected import substitution industries which are efficient; e.g. cement, paper production.
    - in capital markets, explore opportunities to establish merchant banks, reinsurance companies and the provision of lines of credit to local financial institutions.

Keep.

September 20, 1993

Mr. Jaycox:

KENYA

Steve O'Brien called me from Nairobi last evening to say that you will receive, through the Kenyan Embassy, a letter from Minister Mudavadi. As Steve understood it, the essential request will be that we not start the clock ticking on cancellation of EDSAC second tranche, until the Minister's meeting with you and Mr. Preston on Friday.

As we already know: (a) they have gazetted, on Friday, an increase in maize price (in agreement with IMF), although this was not public knowledge on Saturday; (b) the licenses of Exchange and Pan African Banks are to be revoked effective September 22; and (c) on the basis of the external audit, the Minister and the Governor are convinced of the desirability of liquidating TransNational Bank, but still have not been able to convince involved parties of this.

Francis

Francis

Attila:
Camdessus meets
with the Kenyans
on September 29
at 7PM
Francis

REPUBLIC OF KENYA
MINISTRY OF FINANCE

Telegraphic Address: 22921
FINANCE-NAIROBI
FAX No. 330426
Telephone: Nairobi 338111
When replying please quote

Ref No. ZZ 71/011
and date

THE TREASURY
P.O. Box 30007
NAIROBI
KENYA

CONFIDENTIAL

18th September, 1993

Mr. E.K.V. Jaycox,
Vice-President,
The World Bank,
WASHINGTON, D.C., 20433,
U.S.A.

Dear Mr Jaycox,

RE: EDSAC RELEASE

With reference to Mr. Carter's letter to me dated 14th September, 1993, as confirmed by Mr. Colaco's telefax of 16th September, 1993, I wish to inform you that I have issued a notice to the Exchange Bank and the Pan African Bank that their licences will be revoked on 23rd September, 1993.

We raised the retail price of maize by 33% to Shs.32.65 per 2 Kg. With this price adjustment, the subsidy requirement for maize in 1993/94 is estimated at Shs.3.8 billion, which exceeds the present budgetted provision of Shs.2.0 billion. We are adopting revenue and expenditure measures that will cover the deficit shortfall.

I believe therefore the only remaining issue for the release of EDSAC, Second Tranche, relates to the Trans-National Bank. I am aware that numerous promises to impose financial discipline on this bank have been made and not fulfilled and I fully agree with your assessment regarding the seriousness of the misconduct of this bank.

His Excellency the President was made aware for the first time the full extent of the malpractices in the Bank on 14th September, 1993. He is determined to ensure recovery of loans is made so that public funds deposited with the bank will be paid. In the meantime, significant amounts of loans and advances have been repaid.

I understand that a decision likely to have serious repercussions on EDSAC may be taken soon. This is to request that you defer such decision till I discuss this with you next week when I am in Washington.

Yours Sincerely,

W. MUSALIA MUDAVADI
MINISTER FOR FINANCE

CONFIDENTIAL

REPUBLIC OF KENYA
MINISTRY OF FINANCE

Telegraphic Address: 22921
FINANCE-NAIROBI
FAX No. 330426
Telephone: Nairobi 338111
When replying please quote

THE TREASURY
P.O. Box 30007
NAIROBI
KENYA

Ref. No. ZZ/TS/IMF/32
and date

18th September, 19 93

The Directors,
Exchange Bank Ltd.,
P.O. Box 28442,
NAIROBI.

Dear Sirs,

REVOCATION OF BANKING LICENCE

I refer to my earlier letter in which I notified you of my intention to revoke the banking licence granted to you under the Banking Act (Cap 488). I have carefully considered the representations made by your institution and in this regard I regret to advise that I have decided to revoke your licence on 23rd day of September, 1993.

The licence and the certificate of specification should now be surrendered to the Treasury and the Central Bank respectively for cancellation.

After the date of revocation you shall confine your activities to recovery of debts owed to the institution and the settlement of liabilities owed to depositors and other creditors.

W. MUSALIA-MUDAVADI
MINISTER FOR FINANCE

REPUBLIC OF KENYA

MINISTRY OF FINANCE

Telegraphic Address: [illegible]
FINANCE-NAIROBI
FAX No. 338420
Telephone: Nairobi 338111
When replying please quote

Ref. No. ZZ/TS/IMF/32
and date

THE TREASURY
P.O. Box 30007
NAIROBI
KENYA

18th September, 1993

The Directors,
Pan African Bank Ltd.,
P.O. Box 45334,
NAIROBI.

Dear Sirs,

REVOCATION OF BANKING LICENCE

I refer to my earlier letter in which I notified you of my intention to revoke the banking licence granted to you under the Banking Act (Cap 488). I have carefully considered the representations made by your institution and in this regard I regret to advise that I have decided to revoke your licence on 23rd day of September, 1993.

The licence and the certificate of specification should now be surrendered to the Treasury and the Central Bank respectively for cancellation.

After the date of revocation you shall confine your activities to recovery of debts owed to the institution and the settlement of liabilities owed to depositors and other creditors.

W. MUSALIA MUDAVADI
MINISTER FOR FINANCE

THE WORLD BANK/IFC/M.I.G.A.

Headquarters: Washington, D.C. 20433 U.S.A.
Tel. No. (202) 477-1234 // Fax Tel. No. (202) 477-6391 // Telex No. RCA 248423

FACSIMILE COVER SHEET AND MESSAGE

File

DATE: April 27, 1993

NO. OF PAGES: 7 (including this sheet)

MESSAGE NUMBER:

TO
Name: Mr. A. Karaosmanoglu
Organization:

Fax Tel. No. 477-6869
City:
Country:

FROM
Name: Francis X. Colaço
Dept./Div. AF2DR
Room No. J10-157

Fax Tel. No. 473-5453
Dept/Div No.
Tel. No.

SUBJECT: KENYA

MESSAGE:

This is the statement made by Mr. Erb of the Fund Board on Kenya.

Transmission authorized by: ______________________

If you experience any problem in receiving this transmission, inform the sender at the telephone or fax number listed above.

1884 (2-90)

Record Removal Notice

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Document Date April 22, 1993	**Document Type** Board Record	

Correspondents / Participants
[Mr. Erb, Fund Board]

Subject / Title
Kenya - Speaking Notes for an Informal Meeting with Selected Executive Directors

Exception(s)
Information Provided by Member Countries or Third Parties in Confidence

Additional Comments

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.

Withdrawn by	Date
Kim Brenner-Delp	November 28, 2022

A L L - I N - 1   N O T E

DATE: 15-Apr-1993 05:21pm

TO: Attila Karaosmanoglu (ATTILA KARAOSMANOGLU)

FROM: Michael Carter, AF2CO (MICHAEL CARTER)

EXT.: 34034

SUBJECT: **Kenya**

Attila,

The attached is the list of documentary evidence the Government would need to attach to their letter. The actions at (c), (d), (e), (f), (g), (h) of the draft letter have been taken. They are likely to meet the net domestic asset target for mid-April. The main areas they have to move on in the next few days would be those relating to prudential control over the financial institutions. The official exchange rate change would probably take place on Monday.

A L L - I N - 1 N O T E

DATE: 15-Apr-1993 04:55pm EST

TO: STEPHEN OBRIEN (STEPHEN OBRIEN @A1@KENYA)

FROM: Michael Carter, AF2CO (MICHAEL CARTER)

EXT.: 34034

SUBJECT: **Kenya Letter**

Steve,

You might want to pass on to the Minister and the Governor t , following list, which summarises the documentation they would need to attach to the letter:

- copy of Circular to banks informing them that henceforth, penalty system for not meeting cash ratio will be: 0.1% per day of shortfall for first fifteen working days; 0.2% per day for continuous period in excess of fifteen working days; and imposition of statutory management after failure to meet cash ratio for continuous period of thirty working days or for discontinuous period of thirty working days in any sixty working day period.

- documentary evidence (presumably from NBK) that GOK has cleared its arrears to NBK.

- a copy of the latest CBK data on commercial banks reserves \ ı the CBK and their estimated cash ratio.

- copy of notification by CBK to NBK in accordance with Section 6 of the Banking Act that NBK's licence will be revoked if NBK does not comply with statutory capital adequacy and liquidity requirements by 31st July, 1993.

- copy of specific notification by CBK to Transnational Bank that it will placed under statutory management if it does not meet the cash ratio within thirty working days of the date of the Circular referred to in the first paragraph above; and, in accordance with Section 6 of the Banking Act, that Transnational's license will be revoked if it does not comply with statutory capital adequacy and liquidity requirements by 31st July, 1993.

- copy of notifications from CBK to Trade Bank and to Pan-African bank that they have been placed under statutory management, indicating the name of the statutory manager, and notifying these banks in accordance with Section 6 of the Banking Act that their licences will be revoked unless they meet statutory capital adequacy and liquidity requirements within three months.

- copies of interim winding-up orders for: Nairobi Finance, International Finance, Inter-Africa Credit Finance, United Trustee Finance and Allied Credit.

- copies of applications to the High Court for interim winding-up orders for ....

- copies of notifications to ....that they have been placed under statutory management, indicating the name of the statutory manager, and notifying these NBFIs in accordance with Section 6 of the Banking Act that their licences will be revoked unless they meet statutory capital adequacy and liquidity requirements within four months.

statement of progress with restructuring of Industrial Development Bank.

- copy of notification in accordance with Section 6 of the Banking Act to Kenya National Capital Corporation that its license will be revoked unless it meets statutory capital adequacy and liquidity requirements by 31st July, 1993.

- copies of letters from CBK to the auditors of the institutions listed in Annex 2 of Mr. Colaco's letter of 30th March (except Trade Bank), instructing them, in accordance with Section 24 of the Banking Act, to carry out special audits of these institutions, to determine their financial condition and soundness, with particular emphasis on portfolio quality.

- copy of correspondence from Minister of Finance to concerned : ancial institutions revoking continuing exemptions to the Banking Act. (These letters could indicate a period within which the concerned institutions would be expected to get back into conformity with the Act - say thirty days).

- copy of notifications to NBFIs that, effective immediately, they are required to provide to CBK data on their liquidity ratio for the end of each ten day working period, and this within two days of the end of such period; and that any persistent failure to do so will result in action by CBK in accordance with Sections 32 and 49 of the Banking Act.

- copy of Circular to financial institutions limiting access to the rediscount window, effective 2nd May,1993, to the rediscount of Treasury Bills with less than 45 days to maturity.

- copy of Circular to financial institutions confirming that private paper is no longer rediscountable at the CBK.

- copy of Circular to financial institutions phasing out the export pre-shipment rediscount facility.

- copy of Circular to banks notifying them that the margin now applied to CBK discounts and advances is 2.5% over the maximum Treasury Bill rate from the latest tender.

- copy of instruction to NSSF that, with immediate effect, it must invest all net receipts in Treasury securities, and that it must limit deposits with any commercial bank or NBFI to below the level prevailing on 22nd March, 1993.

- copy of NSSF statement of its position with financial institutions as of 22nd March, 1993, and as of [17th April, 1993].

- copy of letter from the IMF confirming that the information it has received indicates that the target agreed with the IMF for r domestic assets of CBK on 15th April has been achieved.

A L L - I N - 1 N O T E

DATE: 15-Apr-1993 05:10pm

TO: Attila Karaosmanoglu (ATTILA KARAOSMANOGLU)

FROM: Michael Carter, AF2CO (MICHAEL CARTER)

EXT.: 34034

SUBJECT: **Kenya**

As requested.

A L L - I N - 1 N O T E

DATE:

TO: STEPHEN OBRIEN (STEPHEN OBRIEN @A1@KENYA)

FROM: Michael Carter, AF2CO (MICHAEL CARTER)

EXT.: 34034

SUBJECT: **Letter**

Dear Mr. Jaycox,

Following receipt of your letter of 22nd March, the Kenya Government has been giving serious consideration to the actions it should take to re-establish a sound macro-economic framework for Kenya's development. I am now writing to you to share with you the conclusions of our reflection on the specific issues raised in your letter, as well as those set out in Mr. Colaco's follow-up correspondence of 30th March. I very much hope that, on the basis of the information and assurances set out below, it will be possible for the Bank to proceed with the release of the second tranche of the Credit for the Export Development Project (EDP).

At the outset, I would like to make clear that the Kenya Government recognises that very serious imbalances have arisen in the management of aggregate demand in Kenya, especially in recent months. We are determined to now act forcefully to address this fundamental problem - indeed, a number of major actions have already been taken. In addition to the actions enumerated below, we are ready to take additional actions, in close consultation with the International Monetary Fund, as the evolving economic situation may require.

Turning to the points raised in your and Mr. Colaco's letters, I hope the following responses will be helpful.

(a) We have now instituted the following arrangements for dealing with banks that fail to meet the cash ratio of 8 percent (see attached circular). Any bank that persistently fails to meet the ratio - i.e. for a continuous period in excess of fifteen working days - will face doubled penalties for the period in excess of fifteen days.In the case that a bank continuously fails to meet the cash ratio for a period of thirty working days, or, in the case of a pattern of discontinuous failure to meet the ratio (defined as failing to meet the cash ratio on more than thirty working days in any period of sixty working days), the concerned bank will be placed under statutory management. As you know, the new cash requirement of 8 percent came into effect on 8th April. So far, no bank has continuously failed to meet the new 8 percent cash ratio - except [DETAILS].

(b) (i) In his letter, Mr. Colaco proposed that the institutions listed as "Category A" institutions should be placed in the hands of qualified receivers; and that their managements, shareholders and directors should be precluded from further involvement in banking activities. We are dealing with the problems of these institutions as follows.

- a significant part of the problems faced by the National Bank of Kenya arises from Government debt service arrears. These arrears, which stood at Kshs...... on 31st March, have now been fully cleared. This has allowed NBK to clear its overdraft with the Central Bank of Kenya (CBK) and meet the statutory cash ratio requirement. NBK's management has been notified that NBK must comply with statutory capital adequacy and liquidity requirements by July 31st. If this goal is achieved, divestiture will be initiated immediately; if not, NBK's license will immediately be revoked.
- as is now the case for all banks, Transnational Bank will be placed under statutory management if it does not comply with the cash ratio within thirty working days - i.e. by .... This requirement has been specifically brought to their attention. They have also been informed that they must also meet the statutory capital adequacy and liquidity requirements by 31st July, failing which the bank's license will immediately be revoked.
- Trade Bank (a category B institution) and Pan-African Bank have been placed under statutory management, which we have confided to .... [REPUTABLE AND EXPERIENCED BANKERS]. The shareholders will be asked by the statutory managers to prepare acceptable restructuring/recapitalisation plans, to meet statutory capital adequacy and liquidity requirements within three months, failing which these banks' licences will immediately be revoked.
- the following NBFIs are in the process of liquidation: Nairobi Finance, International Finance, Inter-Africa Credit Finance, Middle Africa Finance, United Trustee Finance, and Allied Credit. For these institutions, interim winding-up orders have been obtained from the High Court.
- at a meeting of the Special Investments Commitee on 16th April, the folliwng

NBFIs were found to be insolvent:......
Winding-up orders for these institutions have been sought from the High Court.

- at the same meeting of the SIC, the following institutions were found to be financially weak, butnotinsolvent:....... Statutory management has been put in place with a view to completing restructuring of these institutions within four months, failing which their licenses will be revoked.
- the Industrial Development Bank is being restructrued with technical assistance provided under IDA's Financial Institutions Technical Assistance Credit.
- finally, the Kenya National Capital Corporation is being dealt with in the same way as NBK, its parent company.

Documentation to confirm all of these actions is attached. I also want to make it clear that, as the liqidation/statutory management processses for the above institutions proceed, CBK will investigate carefully any apparent instances of wrongdoing, and will bring any relevant evidence to the attention of the legal authorities. Section 48 of the Banking Act, which governs the disqualification of officers of financial institutions in Kenya, will be strictly enforced.

(ii) we agree that special external audits of the institutions listed in annex 2 of Mr. Colaco's letter should be carried out, to determine their present financial condition and soundness, with particular emphasis on portfolio quality. In accoerdance with Section 24 of the Banking Act, instructions have been issued by CBK to the auditors of each of these institutions to immediately undertake this work, with completion to be achieved not later than the end of June, 1993 (see attached correspondence). We would wish to share their reports with IDA, and to exchange views with your staff on appropriate follow-up action. CBK will give guidance to auditors as they undertake this work, to ensure consistency of approaches, calling on the services of independent auditing consultants as necessary.

(iii) I wish to confirm to you that the Kenya Government has decided to introduce legislation at the earliest possible opportunity to amend Section 53 of the Banking Act to limit the powers conferred by that Section on the Minister of Finance to Sections 13 and 14 of the Act only. Pending such amendment, I will not consider exercising the authority conferred upon me by this Section except in respect of Sections 13 and 14.In addition, I can confirm that the concerned financial institutions have been notified that all continuing exemptions (i.e. those exemptions which provide continuing relief from provisions of the Banking Act - such as those relating to cash ratios - as opposed to exemptions relating to specific and completed transactions) granted to date in respect of Sections other than Sections 13 and 14 will be revoked in one month (see attached confirmatory correspondence).

(iv) NBFIs have been notified that, effective immediately, they are required to provide data on their liquidity ratio for the end of each ten working day period within two working days of the end of such period; and that any persistent failure to comply with this requirement will result in action by CBK in accordance with Sections 32 and 49 of the Banking Act (copy of notification attached).

(c) I can confirm that bank overdrafts with CBK have been reduced from Kshs 7,451 million as at end March 1993 to Kshs [3,000] million as at 15th April, 1993. The remaining balances will be cleared by 30th April, 1993, and no further overdraft facilities will be given banks after that.

(d) A circular has been issued (copy attached) to limit access to the rediscount window, effective 2nd May,1993, to the discount of Treasury Bills with less than 45 days to maturity. CBK overnight advances continue to be collateralized only by Treasury bonds or Bills. Private paper is no longer discountable at the CBK (see attached circular).The export pre-shipment rediscount facility is being phased out. No new commitments have been or will be entered into (see attached circular). The current balance on the facility is Kshs[780 million] (compared to Kshs 7,322 million at end December,1992), and this remaining balance will be cleared by end April, 1993, as remaining obligations mature. The agriculture financing rediscount facility is not operative, and will not be activated at any time in the future. As a consequence of all these actions, access to CBK advances and discounts is now limited to GOK advances, the rediscount window, and overnight advances to commercial banks.

(e) The weighted average Treasury Bill rate in the weekly auction has now reached [45] percent. Sufficient Treasury Bills will be offered in forthcoming auctions as necessary to meet the net domestic asset targets of the CBK and to achieve and maintain positive real interest rates.

(f) Through conversion to Treasury Bills, GOK's overdraft at CBK has been reduced to [Kshs 500] million, and will be held at or below Kshs 500 million from now on. The overdraft rate charged to CBK, and the rate for Treasury Bills acquired by CBK is the weighted average Treasury Bill rate from the latest tender.

(g) The margin now applied to CBK discounts and advances is now 2.5 percent over the maximum Treasury Bill rate from the latest tender. A copy of the Circular so notifying banks is attached.

(h) The NSSF has been instructed that, with immediate effect, it must invest all net receipts in Treasury securities, and that it must limit deposits in any commercial bank or NBFI to below the level prevailing on 22nd March, 1993. A copy of this instruction is attached, as is a statement of NSSF's position with financial institutions on 22nd March and at ......

(i) I can confirm that no new licenses will be issued for new banks or NBFIs until June 1994 at the earliest, and before time-bound actions to be adopted after consultation with IDA for enforcing prudential and regulatory requirements have been implemented.

(j) We have reached agreement with the Fund on a target for net domestic assets of CBK for 15th April,1993. I attach a letter from the Fund confirming that the information they have received indicates that this target has been achieved.

I believe that the points above provide an adequate response to the points made in your and Mr. Colaco's letters, with two exceptions - relating to import licensing and to the exchange rate. As you know, since your letter was written, the Government had to move to cancel the exchange and trade liberalisation initiated in mid-February. Following intensive discussion of this question with the Fund, we intend to proceed in the following manner, which the Fund has confirmed is acceptable to them. As you know, on ... April, we moved the official exchange rate from Kshs45 to Kshs... to the US dollar. The next steps will be to reintroduce foreign exchange retention for all exporters, at a uniform rate of 50 percent; and, simultaneously, to abolish any form of import licensing and foreign exchange allocation licensing, except for a short negative list of items restricted for security, health or environmnetal reasons (i.e. goods currently on Schedule 3c). The import procedures that we are developing in consultation with the Fund will ensure that there will be no prior clearance of imports (except those on the negative list) with any Government agency or the CBK.

In order to give comfort to the market, we would very much like to have access to the second tranche funds under the Credit for the Export Development Project (EDP) a few days before these next steps are taken.If it is agreeable to you that we proceed in this way, we would undertake to reintroduce foreign exchange retention and simultaneously abolish import licensing within five working days of notification to us of release of the second tranche of EDP. We will not seek release of the second tranche of the Education Sector Adjustment Credit, before agreement is reached on the one outstanding specific condition of tranche release, or before foreign exchange retention is reintroduced and import licensing is simultaneously abolished. We appreciate that failure on our part to reintroduce retention and abolish import licensing as described above would constitute a serious departure from a satisfactory macro-economic framework, which would have serious adverse consequences for any future quick-disbursing funding from IDA.

I very much look forward to your response to the contents of this letter. I want to make clear the firm determination of the Kenya Government to re-establish sound relationships with the Bank, and with the donor community at large.

Yours Sincerely,

Minister of Finance

A L L - I N - 1   N O T E

DATE: 15-Apr-1993 04:34pm

TO: Attila Karaosmanoglu (ATTILA KARAOSMANOGLU)

FROM: Michael Carter, AF2CO (MICHAEL CARTER)

EXT.: 34034

SUBJECT: **Kenya**

As requested.

CC: Francisco Aguirre-Sacasa (FRANCISCO AGUIRRE-SACASA)

A L L - I N - 1 N O T E

DATE: 15-Apr-1993 04:29pm EST

TO: Francisco Aguirre-Sacasa (FRANCISCO AGUIRRE-SACASA)

FROM: Michael Carter, AF2CO (MICHAEL CARTER)

EXT.: 34034

SUBJECT: **Kenya - Latest Developments**

This is to brief you on important developments in the last several days concerning Kenya.

As you know, Kenya's performance in implementing structural reforms over the past year or so has left much to be desired. As a result of delays and back-tracking on policy reforms, and because of increasingly unsatisfactory macro-economic performance, the release of second tranches of the three ongoing sectoral adjustment credits has been held up for many months. Because of back-tracking on maize marketing liberalisation, we cancelled the second tranche of one of these credits - the Second Agricultural Sector Adjustment Credit - last December. Sector specific conditions for the release of the second tranche of the Export Development Adjustment Credit (EDP) were met last summer, but the tranche release has been held up pending corrective action on the macro-economic side. The one outstanding condition for release of the second tranche of the Education Sector Adjustment Credit (EDSAC) is likely to be met shortly.

In December, 1991, the Fund suspended its ESAF, mainly because of growing fiscal imbalances. Although the Government took some corrective action, the rate of monetary expansion increased in 1992, accelerating dramatically to an annualised rate of over 30 percent in the second half. In October last year, Mr. Jaycox wrote to the Government setting out specific actions the Government would need to take to restore macro-economic stability sufficiently to allow us to proceed with tranche releases, given that the Fund-monitored programme was off-track. We received no satisfactory response to this letter, and, as is now apparent, with approaching elections, rather than addressing the issues we raised, the Government allowed money supply to grow very rapidly, leading to a sharp increase in inflation (now running at over 40 percent) and a major deterioration in the financial soundness of a significant number of financial institutions.

In February, the Government initiated exchange and trade system reforms along the lines we had requested back in October. However, in the absence of any monetary tightening, these led to a spiralling depreciation of the market exchange rate. Following a Fund mission which ended with failure to reach agreement on monetary measures, and an informal donors meeting in London which concluded that no additional financing should be provided to Kenya until the conditions for the release of IDA's tranches had been met, Mr. Jaycox wrote again to the Government to set out the specific actions it would have to take to restore macro-economic stability sufficient to allow tranche release, in the light of the gravely deteriorated situation since our earlier letter in October.Before this letter reached the Government, it announced it was abandoning the partial reforms undertaken in February, and publically denounced the measures proposed by the Bank and the Fund.

It is however now evident that since then there has been a major change in the Government's thinking. A small Fund mission visited Kenya last week, and I joined their discussions for the last two days. Realising that its actions have created a major crisis of confidence in the Kenya private sector and led to a drying up of foreign exchange inflows, the Government indicated to the Fund at the beginning of its mission its wish to take all the monetary and exchange measures proposed by the Fund in February. It had indeed already initiated major actions to remove liquidity from the economy, through greatly increased sales of Treasury Bills. By last Thursday, the average Treasury Bill auction rate had reached 43.5 percent, close to the level of 45 percent demanded by the February Fund mission, which the President had earlier denounced as "suicidal".

When I joined the discussions with the Minister of Finance, we briefly reviewed the actions requested in Mr. Jaycox' letter of 22nd March (and a supplementary letter from Mr. Colaco of 30th March). As a result of this discussion, we agreed to work together to prepare a draft of a reply by the Kenya Government to these letters which could permit us to consider that macro-economic stability had been restored. We spent seven hours with the Minister of Finance, the Governor of the Central Bank and the Fund staff last Friday preparing this draft, with the intention that it could be sent to the Bank in final form after: (a) the Bank's management had indicated that receipt of this letter would in principle be an acceptable basis for release of the second tranche of EDP; (b) the Kenya Government had decided it would be prepared to proceed with the actions proposed in the letter; and (c) after all actions referred to in the letter had been taken. The key actions cover (a) monetary tightening (most of these have already been taken over the past two weeks);(b) exchange and trade liberalisation (see below); and (c)initial actions to restore discipline to the management of the financial sector, and, specifically, to deal with the most severely distressed banks. With only minor variations, they fully meet the conditions set out in Mr. Jaycox' and Mr. Colaco's letters of last month.

Mr. Colaco reviewed the draft of the letter over the weekend. On my return to Washington, I met Mr. Jaycox on Tuesday, who confirmed we could informally indicate to the Government that completion of the actions indicated in the letter would in principle be a satisfactory basis for us to consider tranche release. Mr. Jaycox will be in Nairobi on Wednesday of next week at the invitation of President Moi, and I understand that the Minister of Finance hopes to take all actions to allow him to sign the letter before Mr. Jaycox arrives.

A key area where the Government is yet to take a final decision is the exchange rate. Two options are being considered. The first would be for the Government to move quickly (i.e. in the next few days, and before we would formally approve tranche release) with a major adjustment of the official rate, and at the same time reopen access to the inter-bank market for exporters (with an initial 50 percent retention rate). Given the extreme nervousness in the market following the events of the past weeks, is likely however that the Government will prefer, at the Fund's suggestion, to first move the official rate, and then to re-open access to the inter-bank market immediately after the second tranche of EDP is released. The draft letter to us is based on the second option, and acknowledges that failure by the Government to re-introduce access to the inter-bank market would make it unlikely that we would be able to consider the macro-economic framework to be on track if subsequently it seeks release of the second tranche of EDSAC.

The Fund believes that the measures the Government has taken over the last two weeks, together with those it will take in the next few days, restore the essentials of macro-economic stability, and will allow them to put a new shadow programme in place in the next three or four weeks. I gather that Mr. Erb intends to call Mr. Karaosmanoglu tomorrow to encourage IDA to r ease the second tranche of EDP as soon as possible. We have s..rted work on the necessary documentation.

CC: Francis X. Colaco (FRANCIS X. COLACO)

THE WORLD BANK/IFC/M.I.G.A. CONFIDENTIAL

ROUTING SLIP	DATE: March 12, 1993
NAME	**ROOM NO.**
Mr. Karaosmangolu	E-1227

	URGENT		PER YOUR REQUEST
	FOR COMMENT		PER OUR CONVERSATION
	FOR ACTION		SEE MY EMAIL
	FOR APPROVAL/CLEARANCE	X	FOR INFORMATION
	FOR SIGNATURE		LET'S DISCUSS
	NOTE AND CIRCULATE		NOTE AND RETURN

RE: KENYA

REMARKS:

This is the briefing we prepared for Mr. Jaycox's meeting with the Kenyan delegation. I will send you on Wednesday next, after my return from London, a copy of the minutes of that meeting. Essentially, Mr. Jaycox indicated to the Kenyans, following the lines of his briefing, the macro-economic measures that were essential before tranches could be released.

Mr. Camdessus gave a similar message on the macro-economic program to the Kenyans.

FROM:	ROOM:	EXTENSION:
Francis X. Colaço	J10-157	34036

KEY TALKING POINTS

- Macroeconomic situation is now substantially worse that six months ago.

  Fiscal deficit for FY93 is expected to miss the target of 2 percent of GDP (including grants) by a wide margin. At this stage, it will be difficult to bring it below 4.5 percent of GDP (including grants).

  Monetary expansion during July-December 1992 greatly exceeded targets resulting in an acceleration of inflation and inflationary expectations.

  External arrears increased from about $200 million at end-1991 to over $500 million presently.

- Government recently announced significant trade and exchange reforms.

  However, these will fail if not supported by much tighter fiscal and particularly monetary policies.

- Consequently, Government should be asked to fully implement the stabilization program recommended by the recent IMF mission.

- ***The critical deficiency at present compared to the measures asked for in your October letter and re-inforced by the recent IMF mission fall in the monetary/financial area.*** You should recommend the following actions:

  *** Immediately stop banks and non-bank financial institutions (NBFIs) which are in violation of the cash ratios from further lending.

  *** All delinquent institutions must be treated as potential candidates for closure and liquidation.

  *** New management should be installed in the institutions to be closed for the purpose of active collection of outstanding loans due, liquidation and eventual settlement with individual depositors.

  *** Tap the depositor protection fund to bail out qualified depositors (up to the limit set by law).

  *** Identify the owners of the banks, determine their equity losses as appropriate, and preclude them from obtaining licenses to operate banks or NBFIs in the future.

  *** Stop issuing licenses for new banks or NBFIs until July 1, 1994, by which time a review of the adequacy of both existing procedures for licensing and the prudential requirements under existing statutes will have been completed.

- To put fiscal policy back on track, the Authorities have announced a temporary freeze on all non-essential non-wage expenditures. In our view this is not a sustainable way to reduce the deficit. The recent IMF mission has recommended a series of structural measures (including civil service retrenchment). We support the broad thrust of the Fund's recommendations.

I. KEY POINTS

- The sectoral conditions for EDP have been met. We have agreed on the approach to be taken to meet the final sectoral condition for EDSAC (the student loan scheme) but are awaiting written confirmation from the Government.

- However, the macroeconomic situation is now substantially worse than in September/October when your letter to Prof. Saitoti was drafted: the money supply grew by 60 percent during July-December on an annualized basis compared with the expected figure of 32 percent; the fiscal deficit has risen from around 3.7 percent of GDP (commitment basis, including grants) in FY92 to a preliminary projection of between 4.5 percent for FY93; and external arrears now stand at about $500 million compared with about $200 million at end 1992. The measures outlined in your October letter would, therefore, not be adequate to restore macroeconomic stability which was the objective.

- Recently, the Government implemented substantial trade reforms but their success is seriously threatened by macroeconomic instability associated particularly with expansionary monetary policy. The Government should therefore be asked to implement fully all stabilization measures recommended by the recent IMF mission.

- Kenyan Authorities have a serious credibility problem created by a tradition of policy back-tracking. One example is the failure to continue the restructuring of weak financial institutions as agreed under the Financial Sector Adjustment Operation (FSAC). As a result, financial distress is now worse than before FSAC began. Another example is the reversal of maize movement decontrol which was undertaken under the first Agricultural Sector Adjustment Operation (ASAO I) and for the first tranche of ASAO II. Because of this back-tracking, we recommend that the dialogue on agricultural sector reforms resume only after maize liberalization is implemented and remains in place for awhile.

- Kenya's problems are due to domestic policy failure. In particular, there has been gross neglect of the supervisory and regulatory function of the Central Bank, and the fiscal situation has not been kept under control. External sector policies have also been inadequate. These problems have contributed to significant capital flight. In sum, it is poor economic policies, not withheld quick-disbursing balance of payments support, which is at the heart of Kenya's economic woes.

II. SOME DETAILS

1. **Introduction.** As you know, a delegation comprising the Hon. M. Mudavadi, Minister of Finance; Hon. S. Nyachae, Minister of Agriculture, Livestock Development and Marketing; Hon. D. Otieno, Minister of Transport and Communications; Dr. Koinange, Permanent Secretary, Ministry of Finance; Mr. Kotut, Governor of the Central Bank; Prof. Terry Ryan, Economic Secretary; and Mr. D. Afande, Kenyan Ambassador to the United States will call on you on Thursday, March 11, 1993 and on Mr. Camdessus, IMF, later that day. ***Their primary goal will be to persuade senior management that, notwithstanding the failure to reach an agreement with the recent IMF mission, the Government has taken several significant measures to stabilize and reform the economy, and that the tranches held by the Bank should now be released. This briefing note: (a) explains that Kenya's macroeconomic situation has deteriorated further in recent months largely because of the Government's failure to implement the monetary and financial sector policies outlined in your October letter to Professor Saitoti; and (b) recommends that the Government be asked to implement fully all stabilization measures suggested by the recent Fund mission prior to tranche release. It is the inappropriateness of the monetary policy stance that is the major threat to the success of recent trade reforms, not the lack of quick-disbursing balance of payments support as the Kenyan delegation is likely to argue.***

2. **Deteriorating Macroeconomic Framework.** The Kenyan macroeconomic framework deteriorated significantly since the Fund mission in September 1992. An IMF mission in February 1993 found inter alia that:

- the money supply grew by 60 percent on an annualized basis during June-December 1992 because: (a) large Central Bank overdrafts, loans and advances continued to be used to prop up weak financial institutions; (b) the Central Bank acquiesced in the abuse of the export pre-shipment scheme by a few private banks; and (c) the Central Bank sustained large losses in foreign exchange transactions on the interbank market as the spread with the official rate widened, and financed these losses with high-powered money;

- inflation climbed to 27 percent in 1992 (from 20 percent in 1991) under the impetus of the rapid monetary expansion and the erosion of the value of the shilling;

- the spread between the official exchange rate and the inter-bank rate was still large at about 15 shillings--Ksh45 shillings per US$ versus Ksh60 shillings per US$--even after the former rate was devalued by 25 percent on March 9, 1993; and

- the fiscal deficit for FY93 was running at approximately 4.5 percent of GDP (including grants) at mid-year (end-December 1992) compared with a target of 2.0 percent of GDP for the full year, and could rise even higher unless urgent steps are taken to curb expenditure and strengthen revenue.

3. **Need to Consolidate Trade Policies and Immediately Tighten Monetary Stance Further.** Since receiving your letter of October 1992 and particularly just prior to the recent IMF mission, the Government made significant steps towards liberalizing the foreign trade and payments system. They included:

- the introduction of foreign exchange retention accounts covering 100 percent of non-traditional merchandise exports (August 1992), 50 percent of traditional merchandise exports (October 1992), and 50 percent of services e.g. tourism (February 1993);

- creation and strengthening of an inter-bank foreign exchange market (October 1992, February 1993);

- the elimination of import licensing (February 1993);

- the application of the inter-bank exchange rate to PTA transactions;

- restricting access to foreign exchange from the Central Bank at the official rate to only Government of Kenya (Central Government) imports and debt service, and to Government-guaranteed debt service (February and March 1993); and

- abolition of the parastatal monopoly in the coffee auction and broadening private sector participation in the export of tea (October 1992).

4. The Government should be commended for these actions but we should continue to express our concern about the wide spread between the official and inter-bank exchange rates. The gap is likely to get even wider because of the large monetary overhang, and increase the pressure for the Central Bank to back-track on its commitment to provide only foreign exchange at the official rate to Central Government imports and debt service, and to Government-guaranteed debt service. ***You should further emphasize that back-tracking on this or any other reform will aggravate Kenya's credibility problem and would not be viewed favorably.***

5. One effective way to deal with the excessive gap between the official rate and the inter-bank rate would be to:

- abolish the official exchange rate immediately, leaving the interbank rate as the only exchange rate;

- correspondingly, raise the retention rate for exporters of traditional export goods and services to 100 percent; and

- allow all residents and nonresidents to open fully-backed foreign exchange accounts at commercial banks in Kenya, with the use of funds limited to current transactions.

We should further emphasize that these trade reforms by themselves will not restore macroeconomic stability. They must be supported by appropriate monetary and fiscal policies.

6. **Substantial Monetary Tightening Needed Immediately Since Actions This Week Do Not Go Far Enough.** After largely disregarding the monetary and financial policies recommended in your letter of October 1992, the Government announced on March 9, 1993 that it was:

- increasing the cash reserve ratio to 8 percent, as recommended by the IMF mission. The Fund asked that commercial banks be given 30 days to meet the new requirement and that a delinquent bank should be denied access to the clearing house and placed under statutory management, with a view to its restructuring or liquidation;

- ceasing Central Bank overdrafts to commercial banks, as recommended by the IMF mission. ***But the announcement did not specify, as requested by the Fund, that Banks which failed to clear the overdrafts immediately should be denied access to the clearing house and placed under statutory management***;

- phasing out the pre-shipment financing facility ***but no timetable was given for this much abused scheme which the Fund requested be closed immediately;***

- abolishing the rediscount facilities at the Central Bank for non-government paper, as recommended by the Fund;

- to reflect inflationary expectations and achieve real positive interest rates, increasing the amount of treasury bills sold in the weekly auction ***but it did not specify that bids of less than 45 percent would not be accepted (until the rate of inflation subsided significantly) as required by the Fund to signal decisively the tightening of monetary policy***; and

- raising the margin on Central Bank discounts and advances to 5 percentage points over the average bill rate, but this rate was not the 45 percent anticipated in the IMF proposal.

7. While the actions taken this week are small, welcome steps in the right direction, they clearly are not decisive enough to deal with the problem and:

- ***ignore the failure of the Central Bank to enforce its circular of October 16, 1992 which promised to preclude commercial banks and non-bank financial institutions that did not meet the prescribed cash and liquidity ratios from further lending;*** and

- ***disregard the recommendation of the Fund that no licenses be issued for new commercial banks and NBFIs until July 1, 1994, by which time a review of the adequacy of both existing procedures for licensing and the prudential requirements under existing statutes will have been completed.***

8. **Fiscal Policy is Now Off-Track** and is further derailing the macroeconomic framework. The Government recently instructed line ministries to freeze all unnecessary non-wage expenditures until the end of the FY93. ***However, this approach is wholly inadequate and will not achieve sustained fiscal compression.*** At the same time, there is now very little scope for reaching the fiscal target for FY93 (2 percent of GDP) and beyond by merely increasing revenue or reducing development expenditure (as in the past). Seemingly unpalatable measures must now be taken even though their positive impact would only be felt in the medium-term. Specifically, ***cuts in civil service staff are necessary. Without early actions, the fiscal situation will worsen quickly as pressure builds for civil service salary increases to offset the erosion of real wages by inflation.*** The Fund has therefore asked for:

- retrenchment of 15,000 (largely unskilled) civil servants in grades A-G by end-July 1993, another 15,000 by end-September 1993, and a third batch of 15,000 by end-November 1993.

9. *We should recognize the difficulty of moving ahead on this front without an adequate safety net and extract a commitment from the Government to design a safety net by July 1993, begin the cuts by September 1993 and complete the remaining two phases by June 1994.*

THE WORLD BANK/IFC/M.I.G.A. CONFIDENTIAL

ROUTING SLIP	DATE: March 8, 1993

NAME	ROOM NO.
Mr. Karaosmanoglu	E-1227

	URGENT		PER YOUR REQUEST
	FOR COMMENT		PER OUR CONVERSATION
	FOR ACTION		SEE MY EMAIL
	FOR APPROVAL/CLEARANCE	X	FOR INFORMATION
	FOR SIGNATURE		LET'S DISCUSS
	NOTE AND CIRCULATE		NOTE AND RETURN

RE: KENYA

REMARKS:

FROM: Edward V.K. Jaycox	ROOM: J5-073	EXTENSION: 3-4000

THE WORLD BANK/IFC/MIGA
OFFICE MEMORANDUM

DATE: March 8, 1993

TO: Mr. Edward V.K. Jaycox, Vice President (AFR)

FROM: Francis X. Colaço, Director (AF2)

EXTENSION: 3-4036

SUBJECT: Kenya

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3/8 to Mr. Karaosmanoglu for info.

The IMF mission left Kenya on Saturday evening, March 7, without reaching an agreement with the Kenyan authorities who, however, have indicated that they will take some unspecified measures this week.

Kenya at present has foreign exchange arrears of well over $400 million and gross reserves of about $130 million. Repayments to the IMF for the rest or this calendar year are of $35-40 million. We have been in a negative net transfer position with Kenya of about $3 million per month over the past 12 months; contractual payments of principal and interest by Kenya to IBRD are $13 million per month and to IDA are $2 million per month for the rest of this calendar year. IBRD and IDA's estimated disbursements to Kenya are expected to average $12 million per month for the rest of this year (excluding the second tranche of the Education Sector Adjustment Credit and the Export Development Project which together total $71 million and to which are attached in addition $101 million of IDA reflows and co-financing by Japan of $75 million).

The IMF mission tabled a number of immediate stabilization measures which fundamentally called for: (a) significant tightening of monetary policy: monetary expansion for June - December 1992 was of KSh. 20 billion or 28%, including about KSh. 6 billion of foreign exchange losses (the Central Bank purchased foreign exchange worth $300 million at KSh. 55 and sold this amount at KSh. 36), about KSh. 8 billion of preshipment export financing (including the Goldenberg episode) and KSh. 4 billion in the form of overdrafts to commercial banks from the Central Bank, the bulk of which was to Pan African Bank for construction of the Meridien Hotel; and (b) unification of the exchange rate (at present the official rate of the dollar is KSh. 36 with the market rate at KSh. 56-58). Obviously, the monetary and exchange rate measures are complementary. In addition, the IMF mission also asked for progress on a number of structural measures which were already present in their April 1992 policy package including maize price and marketing liberalization, lifting of price controls on petroleum, actions on civil service reform and on KPTC.

Peter Heller of the IMF returned to Washington yesterday evening and is available to brief you on the details, if you wish. Unless the Kenyans take immediate stabilization measures to permit a period for observance of performance, according to the IMF, it seems that at best the April 1993 IMF Article IV mission will do no more than establish yet another "shadow" program to be monitored; this would mean that a new ESAF and PFP would be pushed into the more distant future. It is the IMF mission's current view that this is a likely scenario since there does not seem to be anyone with any experience really focusing on economic policy management. The focus seems to be more narrowly on meeting Bank and Fund requirements in order to get funds released by donors. The President did not meet with the IMF mission or with Ryrie.

We currently have two missions in Kenya -- one to review the financial sector that will also identify financial institutions that are in distress (and get an idea of the magnitude of this distress), and the other a public expanditure mission that would focus on the structure of expenditures to be included in the next year's budget as well as on some key medium-term expenditures and revenue issues.

Minister Pronk of the Netherlands is in Kenya today. The informal donors' meeting is scheduled for March 15 in London. The Kenyan Parliament is scheduled to reconvene on March 23.

Steve O'Brien will keep us abreast of developments in Kenya. We will keep you informed.

FXColaço:mcp

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: January 5, 1993

TO: Mr. Edward V.K. Jaycox, Vice President (AFR)

FROM: Francis X. Colaço, Director (AF2)

EXTENSION: 34036

SUBJECT: **KENYA - The Bank's Post-Election Approach**

1. Following the elections last week, we have been giving some thought to how we approach our agenda in Kenya. Considerable uncertainties remain, of course, particularly as to the composition of the new Government (likely to be appointed by early next week), and we will need to continue to keep developments under close review. Meanwhile, however, I thought it would be useful for us to share with you our current thinking and obtain your reaction.

2. Our primary preoccupation with the very poor quality of economic management and low commitment to structural reform in Kenya remains unchanged. If Kenya is to have any chance of returning to its position as a major IDA borrower, it must act decisively to address fundamental constraints to development, both in terms of short-term macroeconomic management and medium-term structural problems. We have prepared the attached paper which sets out our view of key immediate actions in these areas and which we are considering giving (after appropriate editing) to the new Government.

3. The attached paper includes (but is not limited to) immediate implementation of the specific actions needed to get the macro-economy back on track, which were set out in your letter of October 2 (also attached). In that letter we indicated that these specific actions were needed to help secure release of the outstanding tranches under the EDP and EDSAC. We have given thought to whether we should now indicate to the Government that we still believe that these actions are necessary for these tranche releases, and have concluded that we should. The Fund is planning to send a review mission to Kenya at the end of January. Their expectation and ours is that the mission will find that the just-completed Fund-monitored program that was agreed last April (and reviewed in September), failed to meet the performance criteria, notably concerning monetary expansion, by a wide margin. The Fund would, therefore, most likely allow the existing ESAF arrangement to lapse and seek to negotiate a new Fund-monitored program, in the hope that this could lead to a new ESAF arrangement later in the year. Against this background, we believe the appropriate position for us to take with the Kenyans regarding the release of the outstanding EDP and EDSAC tranches would be to reiterate the conditions set out in your letter of October 2. We would also make clear that we would review the need for supplementary actions once we have the results of the Fund mission.

4. It would clearly be appropriate for us to share our thinking on the above issues with the Kenyans at an early stage, particularly if a Government is put in place within the next few days. I could plan to stop in Nairobi for this purpose on my way back from Lusaka around January 18. I think that if this is possible, it would be best to communicate our views

directly to the President, both on the broad reform agenda and on the specific steps needed to restart disbursements under our existing adjustment credits. If you agree, I will ask Mr. O'Brien to explore this possibility. If this is not feasible, I would plan to meet with the new Minister of Finance.

5. We also need to give careful thought to how we play our donor coordination role over the coming weeks. We have informally shared our thinking with our counterparts at ODA and USAID, who agree that we should continue to hold to our position on economic issues. However, they clearly feel that, given that some bilaterals are likely to feel pressure to resume aid now that elections have been held, an early informal meeting of donors should be convened by the Bank; the SPA working group meets in late January, and may provide such an opportunity. No doubt some donors (and the Government) will raise the question of a possible full CG meeting. We suggest that we simply reiterate the points we have adopted over the past year: we are willing to convene such a meeting whenever the Government wishes, but we see little chance for its success unless it is convened after the obstacles for release of existing tranches have been removed and preferably after the Government has clearly initiated actions in the additional areas of parastatal reform, civil service reform, private sector development and public expenditure rationalization.

6. I would be grateful for your views.

Attachments

MCarter:lc

FROM CRISIS TO STRUCTURAL TRANSFORMATION

An Immediate Post-Election Economic Action Agenda for Kenya

Country Operations Division
Eastern Africa Department
January 7, 1993

Confidential Draft

AN AGENDA

A. Introduction

1. The Kenyan economy is in crisis. By October 1992, the money supply was growing at 32 percent (October over October), surpassing earlier increases of about 20 percent per annum during the previous two years. This has fuelled inflation (which reached 31 percent in November 1992 (November on November) 1/, rendered open market operations ineffective, increased pressures for large wage increases in the Central Government, turned real deposit interest rates negative and eroded real producer incentives.

2. In the **external sector**, Kenya's failure to improve macroeconomic management and meet all agreed sectoral conditions has virtually eliminated inflows of fast-disbursing balance of payments support. Bilateral donors have also withheld balance of payments support because of concern over increasingly poor governance and the wish to see political reforms that would re-inforce the benefits of economic reforms. At the same time, coffee prices remain depressed and the tourism sector appears to be having one of its worst years in recent memory. Scheduled debt service payments in 1992 and 1993 are at an all-time high (in nominal dollar terms), and arrears brought forward from 1991 are being added to unmet current obligations to several bilateral and commercial creditors. 2/ The gross international reserves of the Central Bank are also precariously low and net reserves are negative. In response, the Central Bank made a covert attempt in early December 1992 to discourage the redemption of Convertible Foreign Exchange Bearer Certificates (FOREX-Cs). But the commercial banks and the Stock Exchange stopped trading in these certificates. A reassuring letter from the Governor of the Central Bank restored a measure of confidence. At all events, the spread between the official exchange rate and the FOREX-Cs rate is wide (around 55 percent in early December 1992), suggesting fundamental disequilibrium in the foreign exchange market.

3. Kenya also appears to face a crisis of **confidence** within the business and international donor community. Recent public statements by the Vice President and Minister of Finance have expressed concern over an upsurge in the flight of capital abroad, which has made the balance of payments position even more difficult. Meanwhile, the embargo on new commitments of balance of payments support, which was imposed by donors in November 1991 to protest Kenya's poor economic management and structural reform effort and increasingly poor governance, remains in effect. Furthermore, IDA canceled the second tranche of the Second Agricultural Sector Adjustment Operation in December 1992 because of the Government's failure to reverse a ban on maize movements introduced in late October 1992. At the same time, the second tranches of the two remaining adjustment operations are being held by IDA because the Government has not fully implemented a number of agreed macro-economic conditions.

4. The current crisis significantly dampens Kenya's growth prospects, and thereby, severely limits the country's ability to meet its principal medium- and long-term development challenge

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1/ Using IMF weights. Inflation also rose because of food shortages and a shift in some imports to the secondary foreign exchange window.

2/ Kathleen B. Jordan and Beatriz Florendo, Debt and Debt Relief Options - Kenya, mimeo, December 1992.

of employment creation and poverty reduction. Indeed, the short-term economic problems are worrying precisely because of the serious longer-term crisis that Kenya faces. The country has the clear potential to emulate the performance of East Asia but on its present course is more likely to follow the path of distressed African economies. At best, the economy has created only about 90,000 jobs per annum in the modern sector for the over 400,000 persons who enter the labor force each year. Generally in the past, the public sector created jobs more quickly than the private sector. However, this was and is unsustainable because the associated fiscal imbalances created destabilizing pressures. Growth has also been inefficient, depending more on additional resources than increases in productivity. In addition, estimates made prior to this year's drought revealed that more than 20 percent of rural households could not afford a nutritionally adequate diet. Over one million children under five years of age are stunted because of undernourishment over an extended period, especially during the first two years of life.

5. In order to meet these challenges, Kenya's macroeconomic management must be improved markedly and its economic base must be transformed from agriculture to manufacturing. In addition, the public sector needs to adjust to provide an appropriate enabling environment for export-oriented private sector development, rather than participate directly in economic activity. And efforts to support a reduction in fertility must continue. Such a strategy is Kenya's best hope for sustained accelerated per capita income growth and, thereby, for employment creation and poverty reduction. The reasons are four-fold. **First**, although the agricultural sector currently employs about 80 percent of the labor force and contributes more than one quarter of GDP, the scope for the sector's rapid future growth, and thereby, significant employment generation is quite limited. One reason is that most of the high potential land in Kenya is already under cultivation. The scope is further limited by population pressures which are causing environmental degradation in these fertile areas as well as in the arid and semi-arid lands. A recent Bank study shows that intensification could sustain agricultural growth at about 4 percent per year and stimulate off-farm economic activity. 3/ However, this is largely constrained by factors such as price, production and marketing controls (cf. para. 22), the statutory monopolies enjoyed by a number of (agricultural) parastatals, and other generic issues which come under the umbrella of private sector development and public sector adjustment (cf. paras. 28-37).

6. **Second**, the scope for increasing the rate of labor absorption in agriculture and other sectors in Kenya is quite limited. Preliminary estimates of labor elasticities for Kenya (with respect to GDP) compare very favorably with those of the highly successful developing countries, including Thailand, Indonesia, Korea and Malaysia. The conclusion holds true for agricultural and non-agricultural employment. Therefore, accelerated employment creation in Kenya will depend much more on sustained, accelerated non-agricultural GDP growth than on increases in labor absorption.

7. **Third**, recent economic and sector work (ESW) done by the Bank identifies inefficiencies in the parastatal sector and destabilizing fiscal pressures as a major drag on productivity, private sector development across sectors--including the agricultural and service sectors--and GDP growth. For instance, data for 1986-90 show that the productivity of the parastatals worsened by about 2 percent annually while the productivity of the private sector improved by around 5 percent each year. Accordingly, bank estimates suggest that GDP growth during the period

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3/ World Bank, Kenya: Agricultural Growth Prospects and Strategy Options (Report No. 8155-KE) Eastern Africa Department, 1990.

could have been at least 2 percentage points higher per year if productivity growth in the parastatal sector were similar to that of the private sector. This would cut the time for doubling Kenya's per capita income from approximately 35 years (if GDP growth continues at 1986-90 levels) to around 17 years. 4/

8. **Fourth**, unlike many countries in Sub-Saharan Africa, Kenya has a large, buoyant and viable private sector which has considerable potential to expand and create jobs. Our recent ESW and the experiences of the most successful developing countries suggest that an export-oriented, private sector-led growth strategy would serve Kenya well. Of course, this would need to be complemented by targeted interventions to alleviate poverty among vulnerable groups who may be excluded initially from the growth process.

9. The agenda which is outlined below seeks therefore to deal with the current crisis while supporting the longer term strategy of accelerated growth through export-oriented private sector development. The measures have three specific and related objectives:

- to help the Government to clearly indicate the economic policy direction that Kenya will take, and thereby, to reduce uncertainty within the domestic and foreign business community, and restore the Government's credibility within the donor community;

- to quickly improve macroeconomic stability; and

- to provide an early stimulus to economic growth through outward-oriented private sector development.

10. **The rest of the paper identifies actions which should be implemented immediately and others which should be implemented within the first 3-6 months after the Government takes office, in pursuit of the foregoing objectives.** The areas covered are (a) the monetary/financial sector; (b) the external account; (c) pricing, production and marketing controls; (d) fiscal policy; (e) the organization of the civil service; (f) parastatal reform; and (g) alleged corruption. Each list of measures is followed by a short commentary on some of the recommended actions. **The agenda does not represent an exhaustive discussion of Kenya's economic problems or their solutions. Rather, it represents an immediate short-term agenda and an opportunity for the Government to make clear very quickly the economic strategy that it will follow. Still, the actions proposed do go together as a package. Failure to move decisively on any one could undermine the success of those that are implemented.**

11. Another important caveat should be stated. **The Government should move very quickly after it assumes office to 'clear the deck' by meeting the conditions for the release of tranches under on-going sectoral adjustment operations, which are being held by IDA. Naturally, the measures enumerated below are consistent with the objectives of the adjustment operations in question. However, they do not free the Government from any macroeconomic or sectoral conditionality agreed with IDA in the context of these operations or with the IMF under its Shadow Program. They also do not pre-empt any new formal agreements which the Government may wish to negotiate with IDA or the IMF.**

4/ See World Bank, Kenya: Re-investing in Stabilization and Growth Through Public Sector Adjustment (Report No. 9998-KE), Vol. I, 1992.

B. The Proposed Agenda

12. **Monetary/Financial Sector**. To reassert control over the money supply and the financial system, the Government should: 5/

Immediate Actions (1-2 months) -

(i) preclude from further lending all commercial banks and non-bank financial institutions (NBFIs) that do not meet the prescribed cash and liquidity ratios (estimated as monthly averages) as of September 30, 1992;

(ii) enforce the payment of the prescribed penalties by financial institutions which fail to meet required cash and liquidity ratios;

(iii) freeze all overdrafts, loans, and advances by the Central Bank to all financial institutions and to the Depositor Protection Fund at their levels as of September 30, 1992, and give banks notice that their overdrafts must be cleared by say March 31, 1993;

(iv) use the flexibility afforded by section 7 of the Banking Act to increase the entry level capital requirements at least five fold;

(v) issue asset classification, provisioning and capital rules as specified in sections 18 and 20 of the Banking Act and require all existing banks to meet these requirements by March 31, 1993; and

(vi) remove the authority of the Minister of Finance to license financial institutions which do not meet the minimum capital and other legal requirements.

Priority Actions (3-6 months)

To further strengthen the financial system, the Government should:

(i) identify and review all existing exemptions granted by the Minister of Finance under section 53 of the Banking Act for appropriateness in light of prudential regulations;

(ii) amend sections 10 and 11 of the Banking Act to reduce the large exposure limit (credit exposures to a single borrower or related group of borrowers) to 25 percent of capital, the recommended international standard. The definition of "officers" under section 3 should include shareholders with 10 percent or greater interests;

5/ The recommendations are consistent with those in the letter of Mr. Edward V.K. Jaycox to the Honorable Prof. George Saitoti, October 2, 1992, and the aide-memoire of the IDA Financial Sector Mission of September 3-10, 1992.

(iii) provide for the disclosure of the beneficial owners of banks and NBFIs and, thereby, facilitate the enforcement of prudential rules on lending to insiders, and on diversification of ownership;

(iv) review the functioning of the Banking Supervision Department of the Central Bank and initiate steps to strengthen it; and

(v) audit the Depositor Protection Fund and all statutory savings institutions, including the National Social Security Fund (NSSF) and the National Hospital Insurance Fund, and issue new regulations to eliminate the scope for abuse by the Government.

13. **Commentary.** The rapid monetary expansion has been driven largely by the access of a number of distressed banks to overdraft and rediscount facilities of the Central Bank, and signals a failure to enforce prudential regulations. The available information suggests that 12 banks and 27 NBFIs may be classified as weak, including 7 state-owned institutions. These institutions manage nearly half of the assets, advances, liabilities and deposits of all banks and NBFIs, and nearly 85 percent of parastatal deposits in the financial system. Urgent actions are required with respect to at least 13 institutions (5 banks and 8 NBFIs) in this group, where losses continue to mount rapidly, asset stripping has begun to surface, and illiquidity is severe.

14. The liquidity problem is a particular cause for concern. Over the last years, about 10 banks and 25 NBFIs have regularly failed to meet the liquidity requirements established by the Central Bank. In some cases, non-compliance reflects a profit-maximizing decision by the institution because of the Central Bank's failure to impose penalties. In other cases, the shortfall is a reflection of liquidity problems arising from structural weaknesses, owing mainly to inappropriate, and possibly illegal, practices. Immediate redress of this situation through rigorous enforcement of the liquidity guidelines will cause difficulties for some banks. However, the risk of systemic illiquidity in the future would be considerably reduced.

15. The extent of the weaknesses among financial institutions raises questions about the adequacy of the Central Bank's implementation of its supervision program. Many of the weaknesses that became visible in the financial system during recent years have been allowed to grow. The Central Bank needs to be forceful about (a) enforcement of capital adequacy requirements; (b) timely collection of information on the asset quality of institutions which, in some cases, may require special investigative audits; (c) enforcement of legal powers to reconstitute the ownership and management of insolvent institutions; (d) halting inappropriate steps to shore-up illiquid and insolvent institutions, such as use of the NSSF, parastatal funds, and purchases of overvalued assets; and (e) resolution of possible conflicts of interests between staff of the Central Bank and financial institutions supervised by them.

16. Over the longer-term, the Government needs to develop a strategic view for the restructuring and development of the financial sector. Initial implementation steps should begin in the period immediately ahead.

17. **External Account**. Building on the reforms introduced over the last fifteen months, the Government should eliminate all remaining controls on access to and use of foreign exchange. In practice, this means:

Immediate Actions (1-2 months) -

(i) permitting full retention of foreign exchange earnings by all exporters, including those in tourism;

(ii) abolishing import licenses and foreign exchange allocation licenses for all goods and services except for a short negative list of items on Schedule 3C for health, environmental and security reasons;

(iii) removing all export licenses, except for a short negative list of items which are prohibited by international conventions or for security reasons; and

(iv) applying the inter-bank equivalent exchange rates to PTA transactions.

Priority Actions (3-6 months) -

(i) clearing arrears on external public and publicly-guaranteed debts; and

(ii) redefining the role of the Foreign Exchange Department of the Central Bank and the Ministry of Commerce (which previously issued import licenses).

18. **Commentary.** As a result of recent reform efforts, quantitative restrictions on Kenya's imports, which in 1987/88 covered 24 percent of all imported items, now only cover items restricted for security, environmental and health reasons (less than one percent). The import licensing system has been liberalized in principle, although long administrative delays occurred during most of 1992. The level and dispersion of tariff rates have been lowered substantially. Since 1987/88 maximum tariffs have also fallen from 170 percent to 60 percent, while the number of tariff rates has been reduced from 24 to 10. As a result, nominal protection fell although not uniformly across sectors. In June 1989, for instance, the reduction occurred mainly in the paper and steel sub-sectors; in June 1990 it focussed on food manufacturing while in June 1991, it concentrated on textiles and automobiles. Furthermore, tariffs on competitive imports fell much more than the average, suggesting the actual change in nominal protection relevant to domestic manufacturing was even greater. The evidence is the reduction in production-weighted tariffs which fell from 61.8 percent in 1989/90 to 55.5 percent in 1990/91 and 45.5 percent in 1991/92.

19. However, four facts should be noted. **First**, even if Kenya had implemented the liberalization measures in already agreed adjustment programs, a number of restrictions on tradable goods and services would remain. **Second**, even though the anti-export bias has been reduced, several important impediments to export growth are still in place. **In a recent survey, private firms in Kenya were asked to indicate which of the following--purchasing/sales, technology, finance, regulation, business services, infrastructure, politics, inflation, and foreign exchange--most severely constrained their development. Large firms ranked access to foreign exchange as the most serious constraint.** This was especially true of firms involved

in agro-processing and commerce. 6/ **Third**, the progress that has been made so far toward liberalization is very vulnerable to reversal. Experience in many countries indicates that strong programs of trade liberalization have a significantly better chance of enduring than do weak or hesitant programs. This especially applies to countries, like Kenya, that have a long history of severe trade restrictions and unsuccessful attempts at reform. 7/ **Fourth**, many of the complementary policies which are germane to the success of trade liberalization are not in place. They include measures to: achieve macroeconomic stability, including monetary contraction and sustained reductions in the fiscal deficit; liberalize domestic prices, production and marketing; improve the flexibility of the labor 8/ and capital markets; and create a regulatory environment which enhances private sector development. 9/ The policy challenge for Kenya is to adopt sustainable reforms which send decisive signals to the private sector to embrace export expansion and diversification. The short-term actions recommended above are a step in this direction.

20. In relaxing controls, the Government may find that while asset markets clear almost instantaneously, equilibrium in the goods market takes more time. In Chile, for instance, the capital inflows which came into the country after liberalization (to equilibrate the asset market) contributed to real exchange rate appreciation. The appreciation helped to stifle the supply response of exports and encouraged imports. A similar result may occur if the complementary sectoral reforms are not credible. For instance, if the sustainability of trade reform is in doubt, the public may use the inflows in the capital account to finance larger amounts of imports, especially of consumer durables, than would be the case if the trade reform were credible. **One practical implication for Kenya is that the trade reforms should be forceful, unambiguous, transparent, well-publicized, permanent, and supported by appropriate complementary policies--including monetary and fiscal policies--which are implemented rigorously.**

21. While not immediately feasible, the Government should seek to achieve an overall fiscal surplus (including official grants) in the years ahead. Experience in a number of developing countries in the Southern Cone of Latin America and East Asia indicates that liberalization has a better chance of succeeding if undertaken with a fiscal surplus both because of its effect on inflation (and hence the real exchange rate) as well as to help to release resources for investment by the private sector. In most country situations, a favorable export supply response and appropriate import allocation requires a depreciated real effective exchange rate and a reduction in inflation. Furthermore, additional tariff reform--reduction in the average rate, simplification,

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6/ World Bank, Draft Private Sector Development Report, 1992.

7/ See Papageorgiou, et al., 1990, p. 13.

8/ A major restriction in the labor market in Kenya is the legal provision for redundancy embodied in the Trade Disputes Act. Temporary redundancies which are agreed with the affected workers or negotiated with the union do not require government approval. In contrast, all cases of permanent layoffs, even those agreed with the affected workers and unions, require the approval of the Minister of Labor.

9/ As soon as possible after implementing the measures in the agenda, the Government should eliminate the barriers to entry, expansion, and restrictions on ownership. Barriers to exit such as anti-closure regulations, inadequate bankruptcy and foreclosure regulations, government subsidies for failing enterprises, constraints on asset transfer and financial restructuring should be removed. There is also a need to foster institution building through improved access to industrial technology, upgraded managerial and marketing systems, and infrastructure.

reduction of dispersal--which is usually integral to the realignment of export incentives, is more likely to be implemented when the fiscal position is strong. This is especially true in Kenya where import duties account for a significant share of recurrent government revenue. In addition, a fiscal surplus would reduce pressure on domestic interest rates, and discourage real appreciation of the exchange rate which could undermine the trade account of the balance of payments.

22. **Pricing, Production and Marketing Controls.** Measures taken to liberalize the foreign exchange regime should be complemented by actions on price, production and marketing controls across sectors. Toward this end, the Government should:

Immediate Actions (1-2 months) -

(i) abolish all remaining price controls;

(ii) eliminate all movement controls on maize, administered producer and consumer prices and the quota system for maize allocations to mills; and indicate that the National Cereals and Produce Board will become only a buyer of last resort and holder of strategic stocks;

(iii) decontrol wheat marketing;

(iv) decontrol the export of beans; and

(v) remove all restrictive provisions of the Trade Licensing Act, thereby deregulating retail and wholesale trade.

Priority Actions (3-6 months) -

(i) design interventions for income support for vulnerable groups;

(ii) abolish all parastatal monopolies of a statutory nature. At present, many of the Acts establishing parastatals allow them to restrict and regulate the movement, use, storage, packaging and pricing of the product or service in question; 10/

(iii) study the existing coffee and tea arrangements and complete actions to open up these sectors to multi-processing and multi-marketing channels;

(iv) separate their commercial and regulatory functions, and eliminate the semi-monopoly positions (in commercial activities) of the Kenya Planters Cooperative Union, the Coffee Board of Kenya, the Kenya Tea Development Authority and the coffee primary cooperative societies (in coffee processing);

(v) remove the monopoly of the Kenya Tea Packers Ltd. in packaging tea for domestic consumption; and

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10/ Examples include the Kenya Power and Lighting, National Water Conservation and Pipeline Corporation, and Kenya Posts and Telecommunications Corporation.

(vi) re-examine fertilizer marketing and take necessary steps to make private sector marketing work.

23. **Commentary.** A broad range of prices have been decontrolled since 1986. The number of controlled products under the General Order fell from 56 to 6, and those under the Specific Order from 87 to 27. However, among the remaining price-controlled items are sugar, beer (excepting class D), tires and tubes, cold rolled steel coils, galvanized iron sheets, fats and edible oils (except deep frying fats, multiwall paper balers, bags for grain, cereal and flour, salt, bread, maize and maizemeal, sifted maizemeal, wheat flour, paper, edible oils, pharmaceuticals, petroleum and petroleum products, and metal cans and tins for fats).

24. These controls have no overriding economic justification. Concern about monopoly or oligopolistic market power should be addressed through import liberalization and strict enforcement of anti-monopolies legislation. As one Bank document puts it, "a cabinet decision on ... prices is likely to be the least attractive [way of setting prices] since what cabinets have given cabinets can take away. It may be better to seek a competitive market structure, because of the efficiency that brings." 11/ However, because prices serve not only to allocate resources but also income, it may be necessary to design interventions for income support for vulnerable groups. But targeted programs for poverty reduction should be used here, not price controls.

25. An amendment in 1976 to the Trade Licensing Act (1967) stipulates that all goods manufactured by foreign firms in Kenya should be distributed by citizens appointed by the Kenya National Trading Company. In some cases, this has been applied to all producers of consumer goods, not just the foreign-owned firms, and has contributed to inefficiencies and corruption. The problem should be tackled swiftly as recommended above.

26. Until agricultural reform began in 1986, the supply of fertilizers in Kenya was constrained by: excessive Government controls which limited the role of the private sector in distribution; inappropriate pricing levels and structure; delayed pricing announcements; inadequate distribution margins; restrictive and arbitrary allocation of fertilizers and foreign exchange licenses for its importation; lack of coordination of fertilizer aid; and the inadequacy of location-specific and profitable fertilizer packages at the farm level. Several reform measures have since been implemented. They include: full decontrol of fertilizer prices and the introduction of smaller fertilizer packages. But many problems remain, including low fertilizer use; inefficiencies in distribution arising from congestion at the port and the limited capacity of the railways; and a mismatch between the available fertilizers, the nutrient deficiencies of the land and extension support. The quick study mentioned above (as a medium-term, 3-6 month, priority action) will recommend corrective measures for this important aspect of agriculture.

27. **Fiscal Policy.** Because import duties are an important source of budgetary revenue in Kenya, successful and sustained trade reform will require stepped-up efforts to strengthen the Customs Department and to improve tax administration. The Government should also aim to greatly improve the efficiency of public expenditure. As a start, it should:

11/ World Bank. 1988. Conditionality in World Bank Lending: Its Relation to Agricultural Pricing Policies. Operations Evaluation Department. Report No. 7357, p. 66.

Immediate Action (1-2 months) -

Revenue Enhancement

(i) utilize the market exchange rate for levying import duties;

(ii) insist that all public enterprises remit taxes which they collect on behalf of the Government; and

(iii) remove the discretionary authority of the Minister of Finance to waive import duties.

Expenditure Control

(i) restrict the use of supplementary budgets only to national emergencies; and

(ii) curtail the ability of Ministries to run overdrafts in the Paymaster General's Account and to incur unauthorized expenditures.

Priority Actions (3-6 months) -

(i) review the public investment program, inviting major donors to collaborate in reviewing the projects funded by them and in identifying ways to improve implementation performance; and

(ii) reach agreement with IDA on the policy framework, strategy and investment program for the energy sector.

28. **Commentary.** Preliminary data suggest that Kenya's fiscal deficit for FY92 contracted to 3.8 percent of GDP (commitment basis, including official grants), from 7.1 percent of GDP (including official grants) in FY91. The improvement occurred because the monitoring of unauthorized overdrafts by Ministries was tightened, and higher VAT rates were levied on oil products, soft drinks, beer and tobacco products. A panel of senior permanent secretaries also undertook a review of own-financed development projects and stopped several low-priority investments which were not at an advanced stage of implementation. During the last six weeks of FY92, the Government froze all expenditure (commitment and cash), except wages, salaries and essential services.

29. In addition to these short-term measures, the Government should quickly begin tackling the structural problems that have led to increasing expenditures. A comprehensive civil service reform effort should be mounted to: (i) streamline the functions and organizational structure of government to avoid duplication and redundancies, and achieve better organizational synergy; (ii) downsize staff in line with the rationalized functions and organizational structure; and (iii) reform the pay structure and personnel procedures so as to achieve an appropriate mix of staff at all levels, who are motivated and equipped to function effectively and efficiently. Other issues such as improving training, accountability, and capacity utilization are important. Independently, however, none of these would address the immediate and longer-term need to generate budgetary savings, improve productivity and enable government structures to better support the economic and social aspirations of the private and voluntary sectors. Along with fiscal compression and

organizational restructuring, the Government needs to increase significantly its allocation of resources for non-wage operations and maintenance.

30. **Organizational Structure of the Civil Service.** While the implementation of several aspects of the civil service reform would require large resources and a longer timetable, the formation of a new government is a unique opportunity to jump-start the process by bringing order to the organizational structure at the ministerial level. While there are several ways to delineate portfolios, the Government should seek to avoid over-specialization and duplication of ministerial functions. As part of this effort, the Government should:

Immediate Actions (1-2 months) -

(i) reduce the number of ministerial portfolios by about one-half; and

(ii) create a high-powered Development Policy Coordinating Committee within Government--comprising key Cabinet ministers--with oversight over the design and implementation of economic policy.

Priority Actions (3-6 months) -

(i) design an overall program to rationalize the civil service, including its organization at the regional and district levels; and

(ii) develop an overall policy regarding safety nets for workers affected by civil service and parastatal reforms, and engage in intensive discussions with the donor community to mobilize support.

31. **Commentary.** The organizational structures of the Central Government have proliferated substantially since independence and now consist of about 28 ministries, 148 functional departments and 550 divisions. One consequence of this proliferation is that effective coordination has become difficult and jurisdictional disputes between ministries occur from time to time. In addition, the Government has become fragmented and multi-layered. As an example, an investor with an agricultural project in an arid area of the country may have five ministries to deal with: the Ministry of Agriculture, the Ministry of Reclamation and Development of Arid, Semi-Arid and Waste Land, the Ministry of Regional Development, the Ministry of Livestock Development, and the Ministry of Planning and National Development (MPND). Similarly, a research project in the agricultural sector may require contacts with the Ministries of Agriculture, Reclamation and Development of Arid, Semi-Arid and Waste Lands, Livestock, Water Development, Cooperatives, and Supplies and Marketing. And if either project touches environment-related matters, visits may also be required to the Ministries of Environment and Natural Resources, the permanent Presidential Commission on Soil Conservation and Afforestation, and any number of the 42 districts, each of which has a District Officer responsible for the environment. But these District Officers are usually not trained to deal with environmental matters.

32. Another example of the complexity of Government is the six ministries and departments responsible for various (or the same) aspects of manpower development and employment: the Department of Personnel Management, the Public Service Commission, the Ministry of Labour, the Ministry of Manpower Development and Employment, MPND, and the Ministry of Technical Training and Applied Technology (MTTAT). Prior to the creation of the last two ministries in

1988, employment issues were handled by the Ministry of Labour and the Department of Industrial Training. The latter is now in MTTAT. What is worse is that although manpower planning and the coordination of manpower development programs have been stressed in successive Five-year Development Plans and in some reports of ad hoc committees and commissions, there is no evidence that these overlapping structures have assured better performance of these tasks. On the contrary, the impact has been particularly adverse on staff costs and the quality of services rendered. The policy and institutional changes enumerated above would be a necessary although insufficient step toward correcting this situation.

33. In recommending the creation of a high-powered Development Policy Coordinating Committee within Government, this document is confronting a problem which has significantly hampered economic policy design and implementation in Kenya in recent years. During this period, the Treasury has been the focal point for economic dialogue and coordination but it often appeared not to have had the clout, expertise or the political will for the task. This was especially true on very important but difficult issues such as financial discipline in key government ministries and major parastatals, civil service reform, and even agricultural pricing and marketing. Strengthening the expertise within the Treasury would help. But building consensus for reform, liaising with the donor community and monitoring policy implementation would require a more diverse and broad-based team such as the one envisaged for the Development Policy Coordinating Committee.

34. **Parastatal Reform.** To further advance public sector adjustment, the Government should:

Immediate Action (1-2 months) -

(i) publicly state its intention to continue privatization and, in the first instance, to divest specified commercial activities which are carried out by the following strategic parastatals: the Kenya Posts and Telecommunication Corporation, the National Cereals and Produce Board, the Kenya Ports Authority, and Kenya Railways.

Priority Actions (3-6 months) -

(i) finalize plans and initiate implementation of the divestiture of the commercial activities of the parastatals mentioned at (i) above.

35. **Commentary.** Parastatal reform is crucial if Kenya is to attain its immediate macroeconomic and longer-term development objectives. The reasons are three-fold. **First,** as indicated in para. 7, the parastatal sector, unlike the private sector, is a drag on productivity and economic growth. **Second**, the parastatal sector is a drain on the Government's budget. For instance, the net outflows from the Central Government budget to parastatals were equivalent to at least one percent of GDP in FY91, mainly reflecting debt service payments assumed by the Government and taxes collected but not remitted to the Treasury. **Third**, releasing resources which are being used inefficiently, reducing the pressures on the fiscal deficit and eliminating statutory parastatal monopolies would all support private sector development (cf. para. 22).

36. The Government's past attempts at reform have focussed on strengthening control mechanisms and the accountability of managers. Lacking an overall policy framework for the parastatal sector, efforts to improve efficiency have tended to follow a case-by-case approach,

most often in response to a deteriorating situation in an individual enterprise or the emergence of a crisis which focuses the public's attention or begins to impact noticeably on the Government's budget. In such circumstances, the Government has generally responded by changing management and issuing a set of instructions to deal with the immediate problem. As a result, progress in parastatal reform has been slow and ad hoc. Moreover, because the Government's corrective measures have not dealt adequately with the underlying causes of parastatal inefficiency, reforms have been short term in nature and constantly in danger of being reversed.

37. In 1991 the Government announced its intention to carry out a comprehensive parastatal reform program. On July 1, 1992, the Government made public its Policy Paper on Public Enterprise Reform and Privatization. It has also established a Parastatal Reform Policy Committee (PRPC) to guide the divestiture process, a technical secretariat to support the work of the PRPC and the Department of Government Investment and Public Enterprises which will design and implement the reform of public enterprises. To date, divestiture and liquidation of a few enterprises is near completion and agreement has been reached on a target of at least 20 firms to be divested over the next two years. Other enterprises have been identified for privatization. The Government has also defined major restructuring plans for five of the largest "strategic" parastatals. The proposed actions will focus inter alia on: (a) organizational and operational restructuring, including the divestiture of 'non-core' activities; (b) market liberalization to encourage competition; and (c) the introduction of performance contracts. In addition, the Government has outlined a new system of corporate governance to rationalize the relationship between the Government and the parastatal sector. The system requires that senior appointments and compensation should be linked to ability and performance. IDA recently approved a technical assistance credit to assist the Government in carrying out these tasks. All that remains is for the Government to act.

38. **Alleged Corruption.** There is a growing perception within Kenya and abroad that corruption within the Kenyan Government is destroying the economy, particularly because it has raised uncertainty, increased the cost of doing business and discouraged private investment. The immediate post-election agenda developed above attempts to deal with the problem by pursuing a strategy which reduces the direct involvement of the Government in economic activity, and thus restricting the opportunities for corruption. But the problem does not lend itself to quick fixes or a single solution. Instead, there should be a sustained attempt to use all legitimate avenues, including courts of law. With this in mind, the Government should take highly visible steps to begin the process. One suggestion is that it:

Immediate Action (1-2 months) -

(i) act on the findings of recent reports of the Auditor General.

39. **Summary**. The current crisis significantly dampens Kenya's long-term development prospects. However, with better economic management and aggressive structural reforms aimed at redefining and rationalizing the role of the public sector and stimulating export-oriented private sector activity, the Kenyan economy can become an outstanding performer. Indeed, such performance is necessary if Kenya is to create enough jobs for its rapidly growing labor force. Fortunately, unlike many countries in Sub-Saharan Africa, Kenya has a large, buoyant and viable private sector which has considerable potential to achieve this objective. The agenda presented above is intended to help set the economy on this course before much more time is wasted.

40. As indicated in para. 10, the proposed actions do not form an exhaustive list. In the months to come the Government will no doubt need and want to go beyond the proposals made here. Identification of the specific additional measures will take time. Meanwhile, to help bolster private sector confidence from its present low level, the Government might wish to move quickly to issue a short statement which makes clear the overall direction of policy it intends to follow. Such a statement should make clear an appreciation of the extent of the longer-term economic challenges facing Kenya, and the need for an accelerated and sustained reform effort if these challenges are to be met successfully. It should emphasize the primary role of the private sector in production, and the need to streamline the public sector to allow it to support the provision of basic economic and social infrastructure as efficiently as possible.

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EDWARD V. K. JAYCOX
Vice President,
Africa Region

October 2, 1992

Honorable Prof. George Saitoti
Vice President and Minister for Finance
Ministry of Finance
Nairobi
Kenya

Dear Mr. Vice President:

It was a pleasure to meet you and your delegation at the Annual Meetings and to have the opportunity to discuss recent economic developments in Kenya. As I said to you, the World Bank remains committed to supporting your Government in its efforts to reform the economy so as to meet Kenya's development challenge. We share the Government's long-term development objectives (as stated in the Sessional Paper No. 1 of 1986), and fully endorse your announced strategy of promoting the private sector as the principal means of achieving rapid economic growth, with the Government focusing on providing an appropriate enabling environment for economic activity. World Bank assistance to Kenya is designed with a view to helping the Government implement this strategy. We have just finished reviewing implementation progress on the three sectoral adjustment operations--the Second Agricultural Sector Adjustment Operation (ASAOII), the Export Development Program (EDP), and the Education Sector Adjustment Operation (EDSAC)--that we are currently supporting in Kenya, and this letter presents our findings and actions we propose should be taken before we can recommend second tranche releases to our Board.

As you know, release of the second tranche of each of these operations requires that an appropriate macroeconomic framework be in place, in addition to sectoral conditions specific to each operation being met. The main objectives of ASAOII and EDP are rapid growth in production and exports. This growth requires a stable macroeconomic environment which is conducive to savings and productive investment by the private sector, and which provides incentives to export. The major objective of EDSAC is to expand and improve education, while at the same time easing the heavy financial burden that education currently imposes on the Government's budget. Attaining the goals of EDSAC depends, inter alia, on reasonable price stability, to avoid unsustainable pressures on the budget. Our reviews indicate that on the macroeconomic policy framework, additional measures are needed to further liberalize the trade and exchange rate system, and strong measures are needed to reduce the excessive rate of monetary expansion. On the sectoral conditions, satisfactory progress has been made on EDP and EDSAC, although there are a few outstanding issues that can be quickly resolved. Unfortunately, the same cannot be said for ASAOII, where major conditions have yet to be met. The details of our assessment, and what we think needs to be done are given below.

Macroeconomic framework

Fiscal policy. We are encouraged by the preliminary indications of greater fiscal discipline during the latter half of FY92, which helped reduce the fiscal deficit to within striking distance of the 3.5 percent (of GDP) revised target agreed with the Fund (although this target is significantly higher than the goal of 2 percent of GDP originally agreed). We think the Government needs to aggressively pursue measures that will help it to consolidate and improve on this achievement in a systematic and efficient manner, and in particular help it to attain the 2 percent deficit (including grants) target set for FY93; no doubt this is an aspect that the Fund will monitor carefully.

Exchange rate and trade policy. On the trade and exchange rate systems, we generally welcome the introduction of the convertible foreign exchange bearer certificates (FOREX-Cs) and retention accounts for exporters of non-traditional commodity exports. Unfortunately, while introducing these partial liberalizations, the Government has allowed the official exchange rate, which applies to the bulk of both imports and exports, to appreciate in real terms. The spread between the official rate and the FOREX-C rate is now substantial. We strongly believe that in order to achieve the objective of the EDP, the trade and exchange system should provide much better incentives to all exporters, as well as streamlined and transparent processes for all importers as clear steps towards a fully liberalized trade and exchange system. Hence, we think the retention scheme needs to be expanded quickly to cover in a progressive and phased manner all exports of goods and services, and that, concurrently, the import regime should be liberalized. There are, of course, alternative ways of achieving these objectives, but we would suggest the following, which broadly coincide with the recent recommendations you received from the Fund, as macroeconomic action towards release of second tranches:

(a) include "traditional" exports of goods and services in the export retention scheme with a retention rate of, say, 60 percent for these exports, while keeping the rate for "non-traditional" exporters at 100 percent;

(b) restrict access to foreign exchange from the Central Bank (CBK) at the official rate to only Government of Kenya (central Government) imports and debt-service and to government-guaranteed debt service;

(c) abolish import licenses and foreign exchange allocation licenses for all goods and services except for a short negative list of items on Schedule 3C for health, environmental and security reasons, and allow all importers free access to the inter-bank market for foreign exchange;

(d) in order not to discriminate against exports to and imports from PTA countries, have the CBK apply inter-bank equivalent exchange rates to PTA transactions; and

(e) take steps to ensure that the Coffee Board and the Kenya Tea Development Authority pass on the full exchange rate benefits of the retention scheme to coffee and tea farmers.

Monetary and financial policies. We are troubled by the continued rapid growth of money supply (at around 20 percent per annum at end-June 1992), and the serious weaknesses in the financial sector. As you are aware, this monetary expansion has been driven largely by non-compliance with prudential requirements and by the access of a number of distressed banks to the overdraft facility of the Central Bank. This has fuelled inflation, rendered open market operations ineffective, increased pressures for large wage increases in the Central Government, turned real deposit interest rates negative and eroded real producer price incentives. In turn, higher inflation has seriously undermined some of the recent positive developments in the foreign exchange regime by causing the real effective official exchange rate to appreciate and widening the spread between this rate and the premium on FOREX-Cs. We would also like to draw attention to the likely adverse effects of the excessive monetary expansion on the successful implementation of the export pre-shipment financing scheme being introduced under EDP.

The serious weaknesses in monetary policy and the financial sector warrant decisive action. During their recent visit to Kenya, Messrs. Aleem and Scott held discussions with the Governor of the Central Bank and recommended remedial actions in their aide memoire dated September 10, 1992. I was pleased to hear from you in our meeting that this action plan has been endorsed by the Government. Given the serious problems facing the financial sector, we hope that all the recommended actions will be implemented expeditiously. They are all of great importance to Kenya's economic future, particularly given the failure of the Government to sustain the reforms undertaken under the FSAC. Implementation of the following actions are especially critical to reasserting control over monetary expansion, and would therefore be appropriate macroeconomic steps towards release of the second tranches:

(a) commercial banks and non-bank financial institutions that do not meet the prescribed cash and liquidity ratios (estimated as monthly averages) as of September 30, 1992, should be precluded from any further lending;

(b) all concerned financial institutions, without exception, should begin paying the prescribed penalties for failure to meet required cash and liquidity ratios; and

(c) overdrafts, loans, and advances by the Central Bank to all financial institutions and to the Deposit Protection Fund should be frozen immediately at their levels as of September 30 1992, and banks given notice that overdrafts must be cleared by December 31, 1992.

Following implementation of these measures, we would of course expect the CBK to use all instruments available to it to maintain systemic stability. It would also be helpful for CBK to increase the volume of Treasury Bill sales and accept bids at higher yields, thereby putting upward pressure on interest rates necessary to achieve real positive levels.

Sectoral Conditions

EDP

On this important operation, which underpins our efforts to help the Government provide the enabling environment for export development, we wish the Government had shown strong commitment early in the life of the project. Nevertheless, we are pleased to note the heightened sense of commitment to serious implementation since August. As a result of this commitment, almost all the sector specific conditions for second tranche release have been met. On the understanding that the specific trade and exchange reforms indicated above are implemented, the outstanding issues are:

(a) consolidation of registrations (Development Credit Agreement, Schedule 4, paragraph 4(a)). We have agreed on the remaining steps that need to be taken. These are: i) passage into law of the Miscellaneous Amendment Bill to amend the IPC Act; and ii) publication of the Ministerial Order to amend the annex tables to the IPC Act;

(b) elimination of licenses (Development Credit Agreement, Schedule 4, paragraph 4(c)). We await publication of the Ministerial Orders abolishing the licenses already identified as redundant by the Government; and

(c) agreement on action plans (Development Credit Agreement, Schedule 4, paragraph 5). We await confirmation of the Government's agreement to remove a number of items from the draft action plans submitted to IDA, and to the addition of dates to some actions, as proposed in Mr. Hindle's message to Dr. Koinange dated today.

I understand that there is agreement between your officials and my staff on steps to eliminate additional licenses. While this is not a condition for second tranche release, we would like to receive a letter from the Government listing the additional licenses that it has identified as redundant, and setting out the timetable for their abolition.

EDSAC

Overall performance under this operation is generally very good. We are impressed by the Government's commitment in this field, and we commend it on the implementation of bold policy reforms and actions such as cost sharing at the universities and the containment of primary and secondary school payroll numbers. There are four areas that require further action to meet the sector specific conditions of second tranche release:

(a) providing a written assurance to IDA that the Government will provide additional funding, within the overall expenditure ceiling of the FY93 budget, for primary school textbooks during FY93 (Development Credit Agreement, Schedule 3, paragraph A(1)(a));

(b) completing a review of mechanisms to improve the student loan scheme, and implementing a plan of action to improve the recovery rate of student loans, acceptable to IDA (Development Credit Agreement, Schedule 3, paragraph A(3)(a));

(c) ensuring that admissions to public universities for the academic year 1992/93 have not exceeded 10,300 new undergraduates (Development Credit Agreement, Schedule 3, paragraph A(2)(c)); and

(d) implementing agreed cost-sharing arrangement for the public universities for the academic year 1992/93 (Development Credit Agreement, Schedule 3, paragraph A(2)(e)).

Since the start of the 1992/93 university academic year is delayed, we would be ready to recommend to our Board a waiver of the conditions relating to admissions and cost-sharing for that academic year (i.e. (c) and (d) above) and instead include them as third tranche release conditions provided that all other conditions for second tranche release are met, and provided that IDA receives a written assurance from the Government that the conditions will be implemented at the start of the 1992/93 academic year.

While not a condition for second tranche release, it would also be helpful if the Government could provide us with data on the exact number of trainee primary teachers in their second year at the primary teacher training colleges, together with information on how the Ministry of Education plans to deal with the excessive number when the trainees graduate.

ASAOII

Progress in implementing reforms under ASAOII has slowed down, and major actions are required on critical elements, in order to meet the sector specific conditions for second tranche release:

(a) instituting agreed changes to the methodology for determining maize prices (Development Credit Agreement, Schedule 3, para 1(a));

(b) signing of NCPB Contract for FY93, satisfactory to IDA (Development Credit Agreement, Schedule 3, para 1(e)); and

(c) completing a review of staffing norms and adopting and starting implementation of an action plan, satisfactory to IDA (Development Credit Agreement, Schedule 3, para 3(c)).

We are confident that it is possible for the Government to quickly complete the macroeconomic actions (relating to trade and exchange and monetary policies) outlined above, as well as the outstanding sector specific conditions of both the EDP and EDSAC, so as to allow us to recommend release of the second tranches of EDP and EDSAC to our Board. However, I must express particular concern about the lack of progress on implementation of the ASAOII. If the situation does not improve significantly by the end of December, 1992, by which time an NCPB contract would be of little residual value, we will be forced to envisage cancellation of the second tranche. However, I remain hopeful that the Government will find ways to rectify this situation very soon. My staff will be monitoring progress on all three operations on a continuous basis.

Finally, to follow up on our discussion of this matter in Washington, I would like to confirm that we will be happy to consider providing assistance to Kenya to help address the additional burden the country faces as a result of the recent drought conditions. My staff will contact yours shortly with proposals for initiating work on a project for this purpose.

Sincerely,

Edward V.K. Jaycox
Vice-President
Africa Region

clrd with and cc: Messrs. E. Bornemann, P. Heller, IMF; R. Soopramanien, LEGAF; M. Carter, R. Hindle, S. Weissman, J. Shivakumar, J. Maas, F. Lethem, P. Miovic (AF2)

/mc