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Kenya

Structural Adjustment in the 1980s

Gurushri Swamy

Structural adjustment loans in Kenya have supported trade liberalization, exchange rate depreciation, and, to some extent, export development. But World Bank funds may have helped Kenya postpone critical reform of the civil service and social sectors and divestiture of parastatals.



Summary findings

Did the World Bank's policy-based lending to Kenya in the 1980s allow Kenya to undertake adjustment, or to postpone it? The answer is mixed, says Swamy. Success was greatest in trade liberalization (and exchange rate depreciation), and to a lesser extent in export development — and these reforms would probably not have occurred without steady Bank lending. But one could argue that budget support through funds from the International Development Association may have helped Kenya postpone critical public sector reform — in the civil service and social sectors and in divestiture of parastatals (including the National Cereals and Produce Board).

Was aid to Kenya (including the Bank's) overgenerous? Swamy concludes that, based on reform behavior and performance, Kenya may deserve aid less than Ghana (Africa's best performer) but it does not exhibit the same aid dependency as other donor favorites in the region. But its public investment program did a poor job in ranking priorities, and growing reliance on grants and counterpart funds undoubtedly contributed to more consumption spending by government, particularly on the civil service and parastatals.

Implementation of structural adjustment in Kenya was often lethargic and sometimes even contrary to stated policies, says Swamy. And despite a fairly stable political climate, commitment to the adjustment program was patchy and intermittent. Reforms ostensibly undertaken

were in fact not always implemented. In principle, for example, an auction market for government paper was created, but in practice financial institutions typically took up most of that paper "by arrangement." And restrictions on movements of maize were removed but reimposed.

Moreover, the design of the structural adjustment loans appears, in retrospect, to have been faulty. Too many conditions — too general, and based on dated sectoral information — were attached to each loan, in part because of political considerations. And the Bank released credit tranches when conditions were met in letter but not in spirit.

The adjustment program benefited in the second half of the 1980s from lessons learned in the first half of the decade, particularly concerning trade liberalization and export development. But the design and dimensions of reform in the agricultural sector were too limited to achieve significant restructuring of the sector, and political interests effectively sabotaged the program. The second attempt at adjustment was also undermined by increasing financial laxity. The experience in Kenya underlines the difficulty of implementing structural adjustment under either financial laxity or extreme financial stringency.

Note, too, that many things have changed in Kenya since this study was completed in the early 1990s.

This paper — a product of the Chief Economist's Office, Africa Regional Office — is part of a larger effort in the region to study the process and impact of structural adjustment. Copies of the paper are available free from the World Bank, 181 H Street NW, Washington, DC 20433. Please contact Vanessa Saldanha, room J10-206, extension 35742 (75 pages January 1994).

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**Kenya:
Structural Adjustment
in the 1980s**

Gurushri Swamy

Kenya: Structural Adjustment in the Eighties

Introduction and Overview

Kenya started the decade of the eighties with many economic features that were remarkably more favorable than those in other Sub-Saharan countries. The structure and dynamism of the economy in the late 1970s reflected the favorable policy environment of the past. But economic management deteriorated in the late 1970s which witnessed, inter alia the intensification or emergence of a number of major distortions. During the 1980s progress was measurable and significant only in a few areas and the economy's momentum of the first two decades of Independence slowed considerably. As one commentator writes, "Few country lending experiences have given the Bank so much cause for frustration" (Mosley and others, 1991). Whatever the merit of that judgement, there were, no doubt some frustrations stemming from three sources.

First, the stated policies—which were broadly in line with the Bank's recommendations—were undermined by implementation which was often lethargic and sometimes even completely contrary to the stated policies. Thus, the fourth plan document (1979) enunciated a more open strategy for the industrial sector. In 1982, the Kenya Government Commission on Government Expenditures clearly indicated that greater discipline and efficiency were necessary, and that the gross misuse of government resources should be curbed. The Sessional Paper of 1986 contained policy

statements on reforming agricultural marketing, reducing protection to industry, and controlling public spending. But the first adjustment attempt (1980-84) was marked by a virtually total lack of compliance, partly because of design and timing problems but also because the commitment to the stated policy changes was limited to a small coterie of top civil servants. Trade reforms were not carried out, and grain marketing was not liberalized. Even in the second period of adjustment (1985-91), when much more effort went into building a broader consensus, the pace was "incremental," and the commitment of top officials waxed and waned. Overall, despite a fairly stable political climate, commitment was patchy and intermittent throughout.

Second, the lack of transparency in the implementation of reforms often dampened or nullified the structural reforms that were undertaken. Although almost all imports were in principle liberalized, i.e. "automatically licensed," supervisory reports indicate that in practice there was, in fact, lack of automaticity and transparency reflected in undue influences that restricted imports that competed with domestic production. Although an auction market for government paper was created, financial institutions typically took up most of that paper by "arrangement." And although the banking laws and the supervision apparatus were strengthened, political considerations prevented effective prudential oversight leading to a banking crisis. Similarly, the process of budget rationalization was often bypassed, and controls on movement of grain reinstated after a period of relaxation.

Third, during the first phase of adjustment, the design of the structural adjustment loans in the early 1980s, and the first agricultural sector adjustment loan in 1986 were faulty, at least in retrospect. A fairly rapid pace of trade liberalization was

postulated when the country was attempting to control one of its worst financial crisis. In addition, the design of the grain marketing conditionality contained a basic flaw—market liberalization was seen to occur simultaneously with increases in official procurement prices. Each loan was fettered with too many conditions, which were too general, focusing on studies and action plans partly because there was inadequate sector understanding (sectoral work on industry and trade was dated) and partly because of political considerations. The Bank also released credit tranches when conditionalities were met more in letter but not in spirit.

The adjustment program in the second half of the 1980s benefitted from greater experience and preparation at least in some areas. Instead of grouping many reforms in one operation, the adjustment agenda was parceled into sectoral programs. The design of the reform programs in trade liberalization and export development was better based on updated information. In recognition that trade liberalization was not going to be completed within the time frame of a single credit, progress was monitored under the export development credit which followed. And moves on the exchange rate were monitored through IMF programs. The relative success of the trade liberalization program is attributable to these factors of better design and to intensive supervision.

The lessons of the early 1980s were not, however, fully internalized in the policy dialogue on agricultural sector reform, which remained an area of frustratingly slow progress. There was even some reversal, with the recent reinstatement of grain movement controls. The conditionality on reducing the role of the grain-marketing parastatal remained vague. In the second structural adjustment loan (1982), the

condition was to "undertake a review of maize marketing and implement its recommendations." In the agricultural sector adjustment loan (1986), the National Cereals and Produce Board (NCPB) was one of the three parastatals to be "restructured," including a write-off of debt to reduce its claims on the budget. Because this restructuring never happened, the second agricultural sector adjustment loan (1990) asked for "performance contracts" to raise the National Cereals and Produce Board's efficiency. And conditions continued to be imposed for studies, plans, and exchanges of views. The second agricultural sector adjustment loan had the following as second tranche conditions: the finalization of studies on increasing the efficiency of private fertilizer imports and on minimizing the distortions from aid-financed fertilizers, the completion of a food security plan (started under the first loan), and the preparation of a drought contingency plan. Perhaps, the Bank bought into a far too gradual pace of reform knowing that the government lacked conviction and political will. The design and dimensions of reforms in this area were too limited to achieve significant restructuring of the sector and political interests effectively sabotaged the program.

Another major flaw was that the second attempt at adjustment was made in the face of growing financial indiscipline. Fund programs were not adhered to; the fiscal balance deteriorated steadily and inflation accelerated. This had a different effect on adjustment than in the earlier period when reforms became hostage to a stringent stabilization program. Fiscal indiscipline in the later half of the eighties made trade and financial sector reform difficult in a different way: rather than fiscal policy defending a certain exchange rate, the exchange rate was forced to continuously catch

up with higher inflation. Independent monetary policy and the move toward indirect instruments of monetary control were made far more problematic because of the large financing requirements of the Government. In retrospect, this experience underlines the difficulties of implementing structural reforms in the context of either financial laxity or extreme stringency. A relatively stable environment seems essential. Such an environment was not present during much of the eighties.

Indeed, the lack of sufficient attention to the control of financial balances threatened to undercut the Bank's lending program altogether. In the late eighties, some second-tranche releases of sector credits were made, even though medium-term macroeconomic stability was clearly in question. But the Bank soon found itself in the position of being unable to justify such releases. At the consultative meeting of November 1991, donors also expressed concern with the lack of transparency and accountability in the use of public funds. In September 1992, the Bank decided to postpone disbursements of the second tranches of ongoing operations because several sector-specific conditions had not been met and most importantly, the macroeconomic program was completely off-track. In December 1992, it cancelled the second tranche of the second agricultural sector operation because of the reimposition of grain-movement controls.

In the first few months of 1993, the Kenyan government completed many of the structural reforms required under the sectoral loans, (with the important exception of removing grain-movement controls). But it was unable to maintain a satisfactory macroeconomic framework despite a "shadow-program" agreed with the IMF. Although growth in government expenditures and credit to the government slowed

temporarily, this was offset by a rapid increase in money supply because the central bank allowed many delinquent and distressed financial institutions to borrow heavily from it. It was not until April 1993 that a satisfactory agreement to control the deficit and the financial intermediaries was reached and the Bank could contemplate releasing the second tranches. By this time, the foreign exchange situation had become so strained that the government had reversed some of its earlier reforms. It is yet to be seen whether the government will implement the measures necessary to restore and maintain financial stability. But it is clear that the Bank and the country paid a price in terms of continuity of reform and country dialogue.

The Economy before adjustment

Good performance indicators

At the outset of the 1980s, Kenya had a distinctly more favorable economic structure, incentives, and institutions than did most other countries in Africa. In the nearly two decades since Kenya's Independence in 1963, both its political leadership and development strategy showed remarkable continuity. The strategy was based soundly on agricultural development, particularly of smallholder agriculture. It helped the GDP grow by 6.6 percent annually in the first decade after Independence, with agriculture growing at nearly 5 percent annually. Although the oil price shocks slowed growth in the 1970s to about 4 percent annually, GDP growth was still above the average for low-income countries. Savings and investment in Kenya were

relatively high for its per capita income levels; both had approximated 20 percent of GDP during the 1970s. The incremental capital output ratio, while having risen from 3 in the 1960s to 4 between 1972 and 1977, was not unreasonable, particularly given the oil price shock in the early 1970s. The tax revenue ratio had increased from about 12 percent in 1966-67 to 21 percent in 1979-80, and the current fiscal account had produced a surplus of 2.5 to 4 percent of GDP annually for the investment program. Public and private investment in human capital formation yielded educational and health indicators well above the average for Sub-Saharan Africa. Primary school enrollment was not far from being universal. A life expectancy of 55 years and an infant mortality rate of 83 per 1,000 live births were in 1980 significantly more favorable than the average for Sub-Saharan Africa.

The structure of production also changed significantly after Independence. The government had distributed to smaller farmers¹ a considerable amount of high-potential and medium-potential land that had belonged to large farmers, and had encouraged small farmers to cultivate tea, coffee, and hybrid maize, and to take up dairy farming. The smallholders' share of coffee and tea production had increased from practically nothing in 1955 to 40 and 70 percent respectively in the early 1980s. Between 1965 and 1979, the small-scale farm area under improved varieties of maize increased about forty fold. The impetus for smallholder activities helped rural income grow by 5.2 percent annually from 1974 to 1982, much of it in nonfarm activities. Growth of income was probably just as strong in the earlier years. Collier and Lall (1984) estimated that, in the Central Province, rural income per adult equivalent increased at 3.8% p.a. during 1963-74 and Crawford and Thorbeck (1984) estimated

that the incidence of poverty was reduced from 50% of small-holder population to 22%.

Although a dualistic farming sector continued to exist (about 3,500 large farms accounted for 39 percent of cultivable area in 1979) as influential Africans bought large farms, ranches, and estates from departing Europeans, small farmers were not neglected or taxed. Because the large farmer lobby was influential, prices paid for major export crops, maize, and wheat were near world prices and crop development support was extensive. Smaller farmers benefitted from both. Moreover, traditional export crops were not taxed explicitly², and a diversified tax structure supported a sustained and high tax effort. All in all, in this largest sector of the economy—the livelihood of the majority of Kenyans—there had been remarkable transformation and growth. In this, Kenya was unlike most countries in the region.

The economy was also beginning to see favorable demographic trends. Buoyed by favorable income growth in rural areas, and improved health conditions, the rate of population growth initially increased from 3.0 percent annually at Independence to 3.8 percent by the end of the 1970s, and the fertility rate increased from 6.8 to 7.9 percent. However, during the 1980s unfolded, fertility began to decline, falling to 7.7 by 1984 and 6.7 by 1989. Because the government did not offer extensive family planning services until the mid eighties, the demographic transition should be attributed to other factors, such as the increase in education of females, the rising private costs of education, and the modernization of Kenyan society and economic growth that took place in the 1960s and 1970s. Of course, given the dynamics of population growth, the full effects of a fertility decline will not be felt

for many decades. The government must in the meantime address the pressures imposed by the growth of population on arable land, social services, and productive employment. Nevertheless, Kenya is one of the few countries in Africa in which the demographic transition had started in the early 1980s.

Less favorable performance indicators

Performance in other areas of the Kenyan economy was less buoyant, and the economic structure had become badly distorted. An uneasy yet mutually accommodating relationship between Asian-Kenyan entrepreneurs and African-Kenyans in political power had created a highly protected, uncompetitive, and oligopolistic industrial structure. The structure served the economy well shortly after Independence, and, fueled by the rise in rural income and by regional trading arrangements, industry grew at a rate of nearly 10 percent annually between 1964 and 1978. But the custom union with Tanzania and Uganda began to collapse in the mid-to late 1970s and as the sector became more insular, industrial growth decelerated in the 1980s. By 1985, the share of imports in domestic supply had fallen from its 1972 level of 44 percent to 19 percent, accompanied by a decline in the share of exports in gross output. Import substitution came to account for two thirds of growth in the expanding subsectors, while several industries actually contracted. Gross investment in manufacturing fell heavily, declining in real terms to less than half of its 1978 level by 1985—suggesting in fact disinvestment. The limits to import substitution, the collapse of the regional trading arrangements, and the surge of

vandalism against Asian-Kenyans in the wake of the attempted coup in 1982—all hastened the decline in investment. And inside the sector, the growing pervasiveness of the import licensing system and regulations on business activities in Kenya created enormous opportunities for rent-seeking and for executive discretion.

By the early 1980s, the public sector had become overextended. The "Kenyanization" of industry and the desire to industrialize rapidly had led to the creation of massive public sector ownership, not only in such traditional activities as utilities and transport, but also in distribution and manufacturing. Traditional suspicion of Asian traders and the interest of large farmers had combined to create marketing parastatals, most notably the National Cereals and Produce Board, which could support high producer prices in good times and in bad. Over the years, these parastatals drained the budget and, indirectly, the banking system. Meanwhile, controls on grain movements generated rents for those who granted and obtained licenses. At the same time, the civil service had expanded tremendously, primarily at the lower grade levels. Although real wages stagnated or fell, the sheer increase in numbers meant that the total wage bill remained high. With its protected industrial structure and bloated public sector, the Kenyan economy was not unlike many others in the region.

The over-extension of the public sector was reflected in several indicators of economic inefficiency. The government had changed in the early eighties from being a net provider of investment funds to being a net user of private savings to finance its investment and consumption expenditures. The surplus in the current budget dwindled to zero and the economic classification of the budget showed that a large

share was taken up by wages and salaries with little left to fund non-wage operational and maintenance expenditures. At the same time, the ICOR increased dramatically from 3-4 in the early seventies to 9 and 15 by the early eighties, suggesting that proliferation of the public sector role in the economy, including the support of poorly justified projects by government financial institutions, had been highly unproductive.

Several other macroeconomic indicators were also poor throughout the 1970s and into the 1980s. Kenya suffered severe external terms of trade shocks—a decline of 22 percent during 1972–75 (the first oil price shock), an increase of 53 percent in the next two years (a coffee boom), and a drop of 28 percent by 1980 (the end of the coffee boom and the second oil price shock). These shocks were compounded by poor macroeconomic management, breaking the tradition of fiscal responsibility and prudent monetary policy followed during the first ten years after Independence. By 1979–80, the public expenditures to GDP ratio had increased from its 1973–74 level of 24 percent to more than 31 percent, fueled largely by increases in school enrollment, defense expenditures, and investment in national entities, such as Kenya Airways and Kenya Railways. The budget deficit increased—from a range of 3 to 4 percent in the early 1970s to around 10 percent by 1981. Inflation, which had averaged 3 percent in the first ten years after Independence, accelerated to 13 percent in 1981 and 22 percent in 1982. Kenya had adjusted its administered interest rate structure only marginally since 1973, and interest rates ranged from mildly to strongly negative. The current account deficit as a percentage of GDP increased from about 4 percent in the early 1970s to 14 percent in 1980. Although the deficits were filled largely by long-term concessional capital flows, borrowing on relatively hard

commercial terms expanded sharply, increasing the debt–service ratio from less than 4 percent in 1977 to 13.2 percent in 1980. Macroeconomic management was quite aggressive in exchange rate depreciation. The Kenya shilling was linked to the dollar from 1971 to 1975 and to the special drawing rights (IMF basket of currencies) since then; with discrete periodic devaluations, the real effective rate, as calculated by the IMF, depreciated nearly 30 percent from 1972 to 1980.

The structural adjustment program

Evolution of Bank Lending

It was almost by accident that Kenya came to the Bank for quick–disbursing money. Although several structural distortions were building up throughout the 1970s, the critical trigger point was the financial imbalances created by the terms of trade shocks and by fiscal undiscipline. The country first sought out the IMF, as it had on two occasions since 1975. Terms for a stand–by agreement were agreed upon in August 1979, but disbursements were delayed for a year because the ceilings on government borrowing from the central bank proved untenable. With this delay, the government needed quick–disbursing money urgently—which happened to coincide with the Bank’s own decision to move into medium–term balance of payments support, essentially to help countries adjust to the oil price shock. A planned industrial sector loan was converted into a structural adjustment loan in the expectation that it would effect a quick response in exports. The response did not

materialize. Worsening economic conditions forced the government to return to the IMF in 1982 and to request a second structural adjustment loan from the Bank. Despite the fact that reform under the first structural adjustment loan was proceeding slower than planned, the second structural adjustment loan was ambitious—picking up the largely unfinished agenda on trade reform, and addressing reforms in grain marketing, interest rates, energy, and even family planning.

Although the economy stabilized between 1982 and 1984 (at the expense of growth and consumption), little or no progress was made toward structural adjustment. While there were design and timing problems, the lack of compliance can also be traced to the absence of commitment among all but a small cadre of top civil servants.³ They clearly underestimated the strength of the vested interests. Perhaps they also overestimated the Bank's willingness to enforce its conditionalities - the second tranche of the second adjustment loan, although delayed nine months, was released despite questionable implementation of the agreed program. The unsatisfactory implementation led to a pause in adjustment lending and nearly four years passed before another attempt. Given the limited implementation capacity of the government, and in the hopes of building a greater consensus, it was decided that adjustment should proceed on a sectoral basis with support from the Bank, while the IMF would monitor the macroeconomic balances.

Accordingly, adjustment programs were developed in agriculture (supported by two sector loans in 1986 and 1990), industry (1988), financial sector (1989), export development (1990), and education (1991). The period from 1986 to 1991 (extended

to 1992 when relevant) constitutes the core adjustment program as discussed in this chapter (box 1).

Summary of progress

The most notable success has been the slow but definite progress toward reducing the protection given to the industrial sector. Automatic licensing was extended progressively to different import schedules and tariffs lowered significantly. These measures were supported by a substantial real exchange rate depreciation that more than reflected terms of trade changes and by the decontrol of prices on most nonfood commodities. With the introduction of foreign exchange bearer certificates and export retention schemes in 1991-92, a legal parallel market for foreign exchange was created—and Kenya reached a stage where it could delicense import and foreign exchange transactions completely. Indeed, with progressive import liberalization and the evolution of foreign exchange markets, premiums in the parallel markets for foreign exchange reached an historical low by late 1991, and deposits abroad grew rapidly. These developments suggest that the rents generated earlier by the licensing system were reduced substantially. (However, the official exchange rate was allowed to appreciate in 1992, and the premium in the legal parallel markets increased). Several export development efforts began or intensified around 1988—an export compensation scheme, a manufacturing in bond scheme, and most recently, an import duty/value added tax exemption scheme. An export processing zone is also currently being built near Nairobi. On the whole, it is too early to assess the impact of these

efforts. But a 10 percent annual increase in the quantum index of manufactured exports between 1985 and 1991 on the heels of a decade of stagnation can reasonably be attributed to import liberalization measures and currency depreciation that undoubtedly reduced the anti-export bias.

Even in industrial sector reform—in which the reduction of protection was one successful component of the adjustment program—three large lacunae remained. First, tariffs on imports of some competing goods were still quite high. More importantly perhaps, the existence of import licensing, even when "automatic," created delays, uncertainties, and too much discretion. In particular, parastatals continued to be unofficially protected by their monopoly position, higher tariffs, and/or prohibitions on competing imports and ad hoc duty exemptions on raw materials. Even with these advantages, all indicators of efficiency and growth show that the parastatal sector lagged well behind the rest of the economy. Third, fundamental legal and regulatory constraints affected private entrepreneurs, including nebulous property rights and unclear procedural recourse. Laws and regulations on competition were poorly enforced, encouraging the buildup of market power.

In the agricultural sector, the commercial import of fertilizers was de-licensed, and fertilizer prices throughout the distribution chain decontrolled. But aid-financed fertilizers continued to be allocated in nontransparent ways. Furthermore, government disengaged from output marketing in only a few minor crops. The National Cereals and Produce Board continued to be a major drain on the budget, despite direct and indirect efforts to reduce its scale of operations; its pricing policies enabled it to outbid private traders in the primary markets and undercut them in the secondary

market. The retail prices of food commodities were still controlled, primarily in the urban areas, conferring an undifferentiated subsidy on urban consumers. Efforts to increase the share of nonwage expenditures in the sector were largely unsuccessful, threatening the effectiveness of such programs as the training and visit extension system—which is critical to increasing land yields in a country where the population pressure on available arable land is increasing.

Fiscal management was uneven; by the late eighties, the stabilization trend of the early years of the decade was completely reversed. By FY91, the budget deficit was as high as in FY81, and the financing of large deficits that reemerged through domestic borrowing and money creation was inflationary and progressively crowded out the private sector. Despite the initiation of a "budget rationalization" program in 1985, the share of non-wage expenditures declined, primarily because of the claims made by civil service salaries and domestic debt servicing. The external accounts also deteriorated in the late eighties, partly because of a decline in terms of trade. The country's debt increased by 50% during this period, and despite a general softening of terms, the debt service ratio, reached 30%, compared with the 13% in 1980.

In the financial sector an increase in real interest rates was sustained, with a virtual liberalization in 1991. But this achievement turned into a mixed blessing by continuing fiscal laxity. The large budget deficits that reemerged were financed essentially by "arranged" placement of government securities with financial institutions at increasing interest rates. Consequently, the government's domestic interest payments grew nearly twice as fast as its domestic debt, doubling the share of

interest payments relative to GDP. At the same time, the formal credit markets remained segmented—credit ceilings continued for the private sector, a real secondary market for government paper did not develop, parastatals continued to have priority access to credit, and development finance institutions, including the agricultural credit agencies, remained insulated from the rest of the financial sector. Thus, liberalization of interest rates in one sector did not ensure that financial resources were allocated efficiently. Further, distressed banks were not restructured successfully—and in fact their list grew. While prudential and regulatory mechanisms were strengthened, political interference stifled their implementation, and led the country into a banking crisis in the early nineties.

In the social sectors, reform, although headed in the right direction had barely begun. As mentioned earlier, these sectors received relatively high funding by the government. Thus, social sector reform was focused on how resources can be allocated equitably and efficiently as the demands of a growing population increase, and on improving cost recovery.

Macroeconomic Reform: Policy and Implementation

Due to the two oil crises in the seventies, there was a sharp deterioration in terms of trade. Additionally, in the wake of the coffee boom of 1977-78, fiscal discipline eroded. As a result of these developments in the early eighties, Kenya was characterized by large financial imbalances. In 1981, the excess of domestic demand over domestic product was 11.4 percent of GDP, and the current account deficit was

12.5 percent of GDP. The total absorption of foreign savings (including grants) was 13.3 percent of GDP, which financed over 40 percent of domestic investment. The budget deficit was 10 percent of GDP, and inflation was over 20 percent. The high current account deficits of the late 70s and early 80s were financed by a record level of borrowing from private sources which caused the debt service ratio to increase by more than 10 percentage points to over 25 percent during 1980-83. These financial imbalances were unprecedented and unsustainable.

The period 1980-84 was characterized by a steady reduction in excess demand - the excess of domestic expenditures over income fell from 11 percent to less than 2 percent. This reduction was achieved mainly by reducing the budget deficit (see figure 1) by sharply reducing expenditures, including public investment. The reduction in excess demand was supported by decelerating monetary growth, rising interest rates, and tightening of import controls. As a result, by 1984, real domestic demand was 5 percent less than in 1980 despite a population increase of 17 percent, and the further deterioration of external terms of trade. The budget deficit and the current account deficit declined to about 4 percent of GDP, and inflation decelerated to 10 percent and interest rates turned positive in real terms. This was achieved without any significant increase in revenues or exports; in fact the revenue/GDP ratio declined as did export volume. Kenya was among the minority of countries which successfully reduced financial imbalances toward sustainable levels although at considerable cost, namely the reduction of consumption, investment and imports.

Macroeconomic management in the latter half of the 1980s was uneven—essentially reversing the progress made from 1980 to 1984. The ratio of the

budget deficit to GDP clearly increased (figure 1), reaching by 1991 the level of the early 1980s. The inflationary policy of financing large deficits through domestic borrowing and money creation crowded out the private sector. Inflation accelerated to 20 percent in 1991 from its 1986 rate of less than 7 percent. Because banks continued to finance the government's generally loose fiscal stance, the share of domestic credit available to the private sector fell steadily from 75.4 percent in 1980 to 56.6 percent in 1990. This was achieved mainly through credit ceilings on lending to the private sector, and involuntary finance to the government through de facto requirements that bank and nonbank institutions invest heavily in government paper.

A similar picture emerges from an examination of the external accounts. After falling to less than 3 percent in 1986, the current account deficit to GDP ratio increased in 1989 to levels nearly comparable to the early eighties before declining again (see figure 1). Part of explanation is to be found in the external terms of trade, which despite substantial improvements in a few years, declined for most of the eighties. These trends increased the country's outstanding debt by 50 percent during the period. The reduction in the share of borrowing from private sources during the stabilization period was reversed in the latter half of the 1980s—its share increased from 20 percent to 25 percent. Nevertheless, the debt service ratio remained fairly constant, due to a general softening of terms (especially from bilateral donors), an increase in maturity, the grace period, and debt forgiveness totalling \$752 million.

Fiscal policy: expenditure control and composition

Fiscal policy has been the single most critical variable in macroeconomic management yet it is also its Achilles heel. At the heart of Kenya's fiscal problem is its inability to control expenditures, rather than its inability to generate sufficient revenue. The tax to GDP ratio hovered around 22 to 23 percent for most of the decade, while the ratio of recurrent expenditures increased quite dramatically (figure 1). The inability to control expenditures was due in part to how the composition of expenditures was structured, but also in part to a general lack of discipline in expenditure allocation and execution.

The structural components caused either downward inflexibility in expenditures or an upward pressure. Downward inflexibility characterized, for example, the civil service wage bill, which accounted for 6 percent of GDP during the 1980s. Upward pressure came from the growing demands of teacher salaries and interest payments, particularly on domestic debt of the central government and the parastatals (table 1). These problems cannot be resolved quickly or easily—but the government did not make even the smallest dent in the eighties. The escalating share of these payments severely reduced the share of the nondefense, nonwage expenditures, as well as limited the allocations to the education and health sectors.

Fiscal policy was also thwarted by the absence of clear expenditure priorities and the political will to control expenditures. One result was that expenditure ceilings set by the Treasury were repeatedly violated. Government functions also proliferated; with a sharp increase in the number of departments and divisions, coordination

became unwieldy. Much of the proliferation came after the district focus program was adopted in 1983, whereby all central government functions were fully represented at the district level.

The structural problems associated with expenditure control in the government were pervasive. Yet the government focussed only on budgetary *processes*. In 1985, it launched the budget rationalization program to introduce better planning and discipline into resource programming and expenditure, seeking a greater balance between developmental and current spending, and between wage and nonwage expenditures. The budget rationalization program also sought to target scarce managerial and financial resources on a smaller number of critical "core" investment projects.

The budget rationalization program achieved some success in procedural areas. For example, ministries began to issue a forward budget circular that requests submissions well in advance of the forward budget period, and imposes ceilings on expenditures, including on wages and salaries. One provision of these circulars attempts to impose planning and budgetary discipline—that "projects and programs not included in the first year of the forward budget will not be considered for inclusion in the draft estimates for the next fiscal year." Within these parameters, ministries prioritized their submissions to the treasury. In turn, the treasury began to monitor central government expenditures more effectively.

Yet the budget rationalization program did not improve resource allocation. Between 1981 and 1986, nonwage operations and maintenance expenditures as a percentage of total recurrent expenditures declined from 36 percent to 26 percent. After the budget rationalization program was introduced, it declined further to 22

percent (table 1). Lacking nonwage funds, the ministries relied increasingly on the development budget—particularly its donor-financed component—to finance their recurrent expenditures. The share of recurrent expenditures going to civil service payments remained high and that of interest payments, and teacher salaries increased. It became clear that without more fundamental reforms, merely procedural reform was not effective. Also coming up short was investment targeting at "core" projects to ensure that they are fully funded. One of the problems was determining what a core is, particularly given that much of the investment budget was donor-financed. But even when a core program was "defined", allocations were substantially less than agreed upon.⁴

Fiscal policy: revenue generation and composition

As mentioned earlier, Kenya's revenue-generation effort compares favorably to those in lower-to middle-income countries. The structure of taxes is more mature than in most Sub-Saharan countries—it is more diversified and does not rely heavily on international and production taxes. The elasticity of revenues with GDP has been estimated to range between 0.8 and 1.1, which is relatively good, although the government has often introduced discretionary measures to maintain the high ratio of revenue to GDP.

Rather than to raise additional revenue relative to GDP, the tax reform program sought primarily to simplify the tax structure, lower high tax rates that may

encourage evasion and discourage investment, strengthen tax administration, and increase the use of user charges, particularly in health and education.

Efforts to simplify the tax structure and reduce unduly high rates focused on the import tax structure and on company taxation. The government was successful in both reducing the company income tax from 52% in 1989 to 37.5% in 1992, and the average unweighted import tariff as part of the trade liberalization process (Box 2). In 1990, the government also introduced a uniform 18 percent value added tax on the output and inputs for several products. The coverage was broadened to cover more products and services as well. Also in 1990, the government sought to improve tax collection by introducing the tax modernization program, attempting to strengthen the analytical capacity and operational efficiency of the tax departments and to computerize the tax system.

Monetary policy and deficit financing.

As in many developing countries, the central bank of Kenya has limited scope for designing and implementing monetary policies independently of the treasury's financing needs. It is forced to accept such financing requirements and then to discharge its remaining responsibilities residually.

During the stabilization period of 1981–1984, the sharp decline in deficit financing requirements was reflected primarily in a decline in foreign borrowing; domestic financing changed only slightly (table 2). The share of the private sector in domestic credit fell sharply (from 67 percent to 61 percent); part of the stabilization

was thus made possible by "crowding out" the private sector. During the latter half of the 1980s, when large budgetary deficits reemerged, all forms of financing increased, and credit to the economy expanded at a much faster rate. And, still, the share of the private sector continued to decline. Thus, the increase in domestic financing had predictable effects—an acceleration of inflation and the continued tightening of access to credit by the private sector. Econometric work (covering the period 1965-88) substantiate the crowding out effect. Killick and Mwege (1990) estimated that an increase of KSh 1 million in banking system credit to the public sector resulted in a reduction in credit to the private sector of KSh 0.36 million.

From 1986, monetary policy reform sought to move from direct instruments of control (credit ceilings on private sector credit, fixed interest rates on government paper, and compulsory secondary liquidity requirements) to more indirect instruments—reserve ratios, variable liquidity ratios, and liberalized, market-based interest rates. Reform was also targeted at improving the central bank's control over the growing number of near bank financial intermediaries that were able to circumvent restrictions on interest rate and credit ceilings. In conjunction, coordination between the treasury and the central bank was to be improved—both to implement monetary policy and stabilize external shocks more effectively.

The successful reforms were in the area of interest rate liberalization. From 1984, maximum rates on commercial loans were positive in real terms. Over the years, the interest rate ceilings on commercial loans moved closer to the near bank financial intermediaries' rates. In April 1990, the government went a step further, abolishing all charges and fees from the ceiling on commercial bank loan rates;

effective rates could thus exceed the ceiling significantly. In July 1991 an auction market for government bills and bonds was established.

Other reform measures include the introduction of cash reserve ratios (6 percent since 1986), and the imposition of 20 and 24 percent liquidity ratios on commercial banks and near bank financial intermediaries respectively, consisting of cash, deposits with the central bank and other domestic banks, and treasury bills—the latter must constitute at least 50 percent of liquidity requirements. The government also instituted a rediscount window that allowed treasury bills and other government paper with three months or less to maturity to be discounted. The central bank discount rate was set at 1.5 to 2.5 points above the latest treasury bill rate.

It appears that progress in monetary policy reform was a mix of old and new measures but direct controls on private credit, pressure on commercial banks and near bank financial intermediaries to hold treasury bills above the liquidity requirement, and pressure on government-owned funds such as pension and social security funds and insurance companies to buy long-term government paper, remained the main instruments. The "arranged" placement of securities hindered the emergence of a true secondary market for government paper. The only market was for bonds nearing maturity (which can be used as bank reserves) traded by a few large banks as part of their money market activities. While this policy probably enabled the government to pay a lower interest rate on its borrowing than would have been necessary in a truly open market, large fiscal deficits contributed to an increase in the government's domestic interest burden, which tripled as a share of GDP during the 1980s (table 1).

Trade Reform

Import liberalization

Import liberalization has a checkered history in Kenya and arguably, significant and sustained progress was made only in the past few years. Import substitution behind protective barriers and "Kenyanization" through state participation were the main principles of industrialization in Kenya. The beginnings of industrial protection (particularly for manufacturing) date back to after the war, when the government erected a structure of protective tariffs that were tailor-made to the needs of the particular transnational which it was trying to attract. In 1963, Kenya became part of the customs union with Uganda and Tanzania, straining the perpetuation of the system of favors through tariffs. Rather, selective import quotas replaced tariffs as the primary instrument of protection. The system continued even after the dissolution of the customs union in 1977. The fourth development plan (1979-84), subsequently recognized that the industrialization strategy would have to move to a more outward-oriented approach. To that end it called for removing quantitative restrictions, reducing tariffs and their dispersion, and establishing a flexibly managed exchange rate to support import liberalization and export promotion.

Between 1980 and 1984, the fourth plan strategy formed the immediate basis for attempting two trade reforms—the phased replacement of quantitative restrictions with equivalent tariffs, and the subsequent tariff rationalization to provide a more uniform and moderate structure of tariff protection. Yet after an initial round of

liberalization, the government halted its reform progress and actually regressed, reintroducing import controls for some items when the balance of payments deteriorated. Moreover, to the extent that quantitative restrictions were removed, tariffs were raised on restricted items, some to over 100 percent. In addition, during the extreme foreign exchange crisis of 1982–84, tariffs were increased by 10 percent across the board.

This episode of import liberalization was not successful for several reasons. First, the attempts at liberalization coincided with a macroeconomic crisis and later, a period of rapid stabilization, and trade policy became hostage to the needs of stabilization. The Central Bank was justifiably concerned that the removal of QRs would result in loss of control over the balance of payments, given a low level of reserves. Second, there was no movement on the real exchange rate: small nominal devaluations were overwhelmed by high inflation during this period. An increase in the rate of export compensation (see Export Promotion), designed to compensate for lack of improvement on the real exchange rate, did not function very well. In terms of design, there was a paucity of data; the most recent estimates of effective protection were for 1968, and the program was launched before completing the necessary homework. As a result, the imposition of high tariffs on some goods and reduction on others were all done in an ad hoc manner.

Yet the government did make some progress. The share of imports under the quota-free category increased from 24 percent in 1980 to 48 percent in 1985: the average tariff rate was lowered by about 8 percent, and a more transparent, less

arbitrary system of import licensing was established, in which import items were allocated to either an unrestricted list (schedule I) or a restricted list (schedule II).

In 1988, another attempt was made to liberalize imports. The reform program sought first to reclassify imports into five categories: schedule I (unrestricted licensing), II, and IIIA, B, and C, reflecting progressively strict licensing requirements. Over the years, progress toward de-licensing imports was fairly dramatic. Automatic or unrestricted licensing was extended to schedules II, IIIA, and IIIB. By 1991, quantitative restrictions affected only 22 percent of all importable items, compared with 40 percent in 1987, and only 5 percent of imports, compared with 12 percent in 1987. These shares fell further when several items were moved from IIIC to IIIB in July 1991, so that the only goods left in IIIC were those restricted for health or public safety reasons. Moreover, while quantitative restrictions covered most of the manufacturing production in 1985–86, they covered only 28 percent in 1990–91. Thus, the reform effort to remove licensing controls was more far-reaching than during the earlier attempt at liberalization. (box 2)

Tariff reform was also generally impressive: the highest tariff rate was reduced from 135 percent to 60 percent, the number of tariff categories was reduced from 25 to 12, and tariff rates on noncompeting imports were lowered. These measures were somewhat counterbalanced by the increase in some tariffs to ensure protection when automatic licensing was introduced, and when items were moved from the most restricted list to automatic licensing. Overall, production-weighted tariffs fell from 62% in 1989-90 to 45.5% in 1991-92.

The second attempt at import liberalization was relatively successful for several reasons. In the intervening three years between the two attempts, a sector study by the Bank developed a solid understanding of the structure of industry and its effective protection, and yielded a detailed design of components of reform, based on discussions with an inter.ministerial committee. Considerable effort went into building a more genuine commitment on the part of the Government. The reforms were sequenced and implemented with careful coordination with exchange rate changes. Later, the liberalization process was complemented by other initiatives in export promotion, and by an improved incentive structure resulting from price decontrol.

But the liberalization process was not complete. Although the tariff rates introduced with automatic licensing were generally less than the estimated equivalent tariffs, they were on the higher end, and needed to be lowered to reduce effective protection further. Moreover the import licensing system was not entirely dismantled and was subject to considerable executive discretion. For example, even for items eligible for automatic licensing, foreign exchange authorizations were to be obtained, and foreign exchange was actually released only with a lag. From time to time, depending on the level of reserves, these licenses and authorizations took longer to obtain or were denied.⁵ A 1992 Bank survey on the costs to firms of annual licensing requirements (equivalent of a 5 percent tax on turnover) indicated that import licenses were the main determinant of licensing burden. Equally vexing were the continued ad hoc import duty exemptions to nonexporters—encouraging favoritism and discrimination, and creating revenue losses.

Exchange rate management

The management of the exchange rate in Kenya in the latter half of the 1980s was effective. The Kenya shilling was pegged to the special drawing rights basket of currencies, with weights reflecting Kenya's trading pattern. Since the outset of stabilization in the early 1980s, the government pursued a flexible exchange rate policy (table 3). Although the real exchange rate remained relatively constant between 1982 and 1985, it depreciated by more than 40 percent in the latter half of the eighties (by more than the decline in the terms of trade), and the black market premium declined from 110 percent in late 1987 to 17 percent in the third quarter of 1991 (figure 2). In October 1991, taking a significant step towards creating a legal free market for foreign exchange, the government issued foreign exchange bearer certificates. Under the system, anyone changing foreign currency not derived from exports was entitled to a certificate which could be exchanged for foreign exchange in the future at the ruling exchange rate. In addition, if it had been held for more than 3 months, additional foreign exchange equivalent to the LIBOR rate applied to the face value of the certificate could be bought. In August 1992, a 100 percent export retention scheme was introduced for exporters of nontraditional goods; in November 1992, this was expanded to cover exporters of traditional crops at a rate of retention of 50 percent. The retained foreign exchange was freely tradeable but had to be used for "approved transactions" and had to take place within the banking system.

The markets for foreign exchange certificates and export-retention earnings were clearly an alternative to the official market, particularly for repatriation of

dividends and other transfers. But they have also created anomalies. In 1992, for example, the real official exchange rate was allowed to appreciate, and both the alternate markets displayed premiums from 30 to 50 percent, creating opportunities for speculation. More important, many importers were reluctant to buy foreign exchange in these markets, fearing that those who had access to the official market would undercut them in price, and because of a lack of confidence that the central bank would in fact be in a position to redeem the foreign exchange certificates.

Perhaps the most significant constraint on the expansion of free foreign exchange markets was the persistence of import controls despite significant trade liberalization. Even importers who used their own foreign exchange were required to obtain import licenses under a "green channel" that supposedly was quicker than the normal channel—and a letter of release from the Ministry of Commerce. This structure allowed for manipulation, uncertainty, and discretion.

Export promotion

During much of the 1980s, a significant anti-export bias for nontraditional goods prevailed, essentially for manufactures i.e. the effective duty on imports was significantly higher than the subsidy given to non-traditional exports. The export compensation scheme that had been operational since 1974 was largely ineffective, marred by frequent changes and delays, and benefiting only a few large exporters. Four top exporters received the lion's share of payments. The flat 20 percent rebate

overcompensated or undercompensated various exporters, and because the rebate was made arbitrarily, it left out a large number of potential exporters.

In 1988, the government introduced the manufacturing under bond scheme, allowing customs authorities to waive import duties and taxes on imported materials used as input for the production of export goods. Yet the fact that this facility was available only to export-specialty firms limited its attractiveness, as did its cumbersome procedures and high costs. In 1990, a more general import duty/value added tax exemption scheme based on a negative list was introduced, whereby eligibility would be expanded and exemptions be based on specific export contracts or previous export performance.

These specific tax exemption measures were complemented by regulatory reform to centralize and consolidate several licensing procedures for exports and general trade, and by simplified procedures for new investments. In 1990, construction of an export processing zone near Nairobi began. Its users will receive other advantages—an exemption from income tax for ten years, unrestricted foreign ownership and employment of foreigners, and complete control over foreign exchange earnings.

It is too early to assess the impact of these measures. A greater number of firms began to use the manufacturing under bond scheme, and the demand for the tax exemption scheme increased. The export processing zone was not yet operational, but three other privately owned export processing zones emerged and became operational.

The import liberalization measures of recent years reduced the antiexport bias; also, the more aggressive management of the exchange rate probably increased the absolute profitability of exports. These developments—rather than the more recently introduced export promotion measures—are likely to have been the prime determinants of the 10 percent growth in the quantum index of manufactured exports between 1985 and 1990.⁶

Price decontrol and regulatory policy

Price controls in Kenya predate World War II. However, the first formal legislation was the Price Control Ordinance of 1956, later renamed the Price Control Act of 1972—which also served as the model for the current price control framework. Although the range of price-controlled commodities was revised, its procedures and regulations were incorporated largely "as is" into the Restrictive Trade Practices, Monopolies and Price Control Act of 1988. This act applied to both the private and public sector enterprises, but did not cover infrastructure services, the prices of which were controlled by the relevant line ministries. Price controls operated both at the production and the retail level, depending on the commodity. Price controls on staple foods were imposed to protect lower income groups, while the main reason for price controls on manufactures was to protect against monopolistic pricing practices.

Prices have been decontrolled extensively, especially since 1986. Between 1983 and 1991, the number of controlled products under the general order fell from 56 to 6, and those under the specific order fell from 87 to 29. Price decontrol was a

continuous process, and the government nimbly seized the right market and political opportunities. Price decontrols were geared primarily towards manufactured goods, while controls on consumer prices of staples continued to exist, except on some items as sugar and milk. However, cost-plus pricing (based on outdated data) continued to guide price setting for prices still controlled in the manufacturing sector, and there was no provision for the automatic adjustment for inflation or in price changes for intermediate inputs. Nor had a procedure been established for appeal. Prices were set for each enterprise, and delays in price changes increased during the 1980s.

A legal and regulatory framework that provides clarity, certainty, and predictability is necessary to give the private sector enough confidence to enter economic activities. In addition, laws must be framed and enforced whereby the transaction cost of arriving at and renegotiating various contracts are reasonable. The minority population of entrepreneurs of Asian origin in Kenya should perceive that they have access to a "level playing field." Welcome but muted efforts have been made since 1986 to improve the legal and regulatory setting—establishing a one-stop office in the Investment Promotion Center to simplify and hasten approval of new investments, simplifying trading (including export) procedures, and allocating foreign exchange for repatriation. But these measures—modifications, really—have not addressed the fundamental legal and regulatory constraints that affect private entrepreneurs. For example, in approving the acquisition and subdivision of urban land, local authorities often asked for the surrender of the freehold title in exchange for 99-year leasehold titles. Moreover, the minister of finance could arbitrarily approve takeovers, set prices, order divestitures, appoint or dismiss board members

and trustees, and overturn the decisions of regulatory bodies. Guidelines for determining violations of labor and employment laws were also absent—and the arbitrariness of import duty exemptions has already been referred to.

But the most critical constraints on private sector competition and economic efficiency were the laws governing entry, exit, and operational flexibility. Although competition policy had been set in legislation, the existence of market power, extensive vertical integration, and a highly concentrated wholesaling system suggest that enforcement was weak. Important market segments in the Kenyan economy were controlled by single monopolies, generally parastatals, or by just a few producers. Nearly 60 percent of sales in the economy was estimated to occur in oligopolistic markets; in manufacturing, it was about 40 to 50 percent. Moreover, most manufacturers were prohibited from marketing directly to retailers or the public, thus protecting the marketing power of parastatals—and nowhere was this more pervasive than in the agricultural sector. Exit laws were essentially "winding up" policy—focusing on the disposition of assets without any provision for interim legal protection to reorganize. In practice, adjudication took four to ten years, placing enterprises in limbo as their operation came to a standstill and their assets were tied up.

Finally, empirical work indicates that licensing requirements imposed significant monetary and transactions costs on firms (table 4). A survey of enterprises showed that the cost of annual licenses—including direct license fees, agent fees and bribes, and transaction costs for enterprise staff time—was very high both as an absolute amount and as a proportion of sales; moreover, the relative cost of licenses

varied inversely with the size of the enterprise, with small firms paying as much as 9.4 percent of their turnover. Compounding these costs was the proliferation of business licenses required by local authorities.

Financial sector policy and reform

The financial system in Kenya in the mid-1980s was fairly well developed, comprising 24 commercial banks, 54 near bank financial intermediaries, 207 hire purchase companies, 32 societies, 53 insurance companies, and more than 1,000 savings and credit cooperative societies. In addition, there were ten development finance institutions, a large post-office savings bank, and a national social security fund. The formal financial system had mobilized domestic financial resources effectively: M2/GDP was around 30 percent, about the same as in other medium-growth developing countries, and representing an increase from 24 percent in 1968.

In the early 1980s, concerns about a large foreign presence in the system prompted a relaxation in licensing requirements, and small locally owned banks, building societies and near bank financial intermediaries proliferated. Anomalies in the banking law also made it possible for commercial banks to set up near bank financial intermediaries, and thus to circumvent restrictions on banking activities and interest-rate ceilings. Indeed, because near bank financial intermediaries were not subject to statutory reserve requirements and were allowed to borrow and lend at higher rates, they attracted deposits away from commercial banks. Many of these new

institutions were promoted actively with funding deposits from the political and administrative elite, particularly those responsible for state-owned enterprises. In the absence of prudential regulation and with poorly enforced regulations on capital and reserves requirements, four commercial bank groups which owned prominent near bank financial intermediaries failed in 1986. By 1989, 4 other commercial banks and 24 near bank financial intermediaries were in trouble, 7 of which appeared to be insolvent. If liquidated, the losses of these 28 institutions would range between an estimated \$105 to \$178 million.

The credit market was more segmented than appeared, given the number and range of financial institutions.⁷ Four large commercial banks operated as a "gentleman's club," retaining strong ties to multinational and blue chip companies, and adhering to conservative lending practices. The rest were weak; to survive they sought out new, risky businesses. Under significantly weak prudential supervision and since the near bank financial intermediaries were subject to higher interest rate ceilings than were commercial banks, they could undertake riskier ventures. Six development finance institutions set up by the government in the 1960s and 1970s directed credit to specific sectors for long-term investment. They were largely unprofitable and unsustainable, suffering serious portfolio problems. In the agricultural sector, influential large farmers preempted the resources of the Agricultural Credit Corporation and rarely paid them back—in essence being subsidized heavily by the budget. And credit to the private sector was limited by the government's preemption of credit for financing its budget deficits and those of its parastatals, such as the National Cereals and Produce Board.

The government amended the Banking Laws in 1989—narrowing the regulatory gap between classes of institutions, imposing more stringent licensing requirements on banks and near bank financial intermediaries, increasing minimum capital requirements, establishing the Deposit Insurance Fund, setting guidelines for loan provisioning and minimum financial disclosure requirements, and increasing penalties for violation. The government sought to strengthen the central bank's technical and managerial capacity to inspect, monitor, and supervise the financial system. And, in the first phase of the reform initiative, nine small banks were restructured.

The legislative reform measures had little impact. The technical capacity of the supervisory department of central bank was improved, but political forces continued to weaken its enforcement, even as the number of banks and institutions in difficulty grew. It was estimated that 11 banks and 20 near bank financial intermediaries, accounting for about 25 to 50 percent of nonperforming loans, and for about 60 percent of total assets, were in distress in 1992. The consolidation and restructuring of nine banks was delayed and undercut by political factors to a point at which the institutions were stripped of their assets. The consolidated bank itself became a troubled institution. In retrospect, it appears that most depositors had already shifted their deposits to the stronger institutions, and the large depositors were paid off in equity or bonds. A large number of banks and near bank financial intermediaries continued to operate with capital ratios well below the required minimum, and required cash and liquid-asset ratios were widely ignored. with supervisory penalties conspicuously absent.⁸

The effects of interest rate liberalization in the banking sector on monetary policy has already been discussed. In a broader sense, the reform program did not reduce the rigidities in the allocation of credit; thus, interest rate liberalization had little effect on improving the efficiency of credit allocation, which would be the primary objective. As discussed earlier, there is no clear evidence that interest rate liberalization generally increased either the profitability or solvency of financial institutions. It probably did help improve the profitability of a few already solvent banks, but higher interest rates did not support the profitability of the large number of distressed commercial banks and near bank financial intermediaries because their clients were not servicing their debts anyway.

Agricultural Marketing Reform

Kenya was one of the few African colonies in which Europeans became involved in land ownership, agricultural production, and exports. The pattern of land ownership and produce marketing from colonial days continued in some ways—for example, dualistic land ownership and marketing structures. Between 1931 and 1959, about 3 million hectares of high-potential and medium-potential land were set aside for exclusive European occupation and cultivation, and these farmers provided most of the country's exports of food and beverage crops. Under pressure from white settler farmers, the government established a system of marketing boards that paid at least export realization—and often well above—for all crops. African farmers limited to nonscheduled areas were not allowed to grow cash crops or keep grade cattle. The

net effect was a rigid dualistic agricultural system of land ownership, production, and marketing.

Of course some of the features of this system changed. Before Independence the colonial government began to encourage smallholder production of cash crops, a process that the government hastened considerably after Independence. The government bought, subdivided, and settled smaller farmers on about a half million hectares in settlement schemes. Indeed, the distribution of land to and support for smallholder farming was the basis for the excellent performance of Kenyan agriculture in the 1960s and 1970s. Nevertheless, the strongly dualistic nature remained with two attendant features. First, with a few exceptional years, the prices paid to producers of the major food and export crops were maintained in real terms and at close to import or export parity as appropriate (table 5). There was little discrimination against agriculture in this respect, although the protection given to industry and an overvalued exchange rate in some years meant that the terms of trade for agriculture were less favorable than they would have been otherwise.

Second, the presence of the grain marketing parastatal—the National Cereals and Produce Board—continued to be pervasive, despite the recommendations of at least seven commissions since 1942 to reduce the role of the state in grain marketing. Inter-district movement of grain continued to be controlled. Large maize farmers benefited from guaranteed high prices, while many bureaucrats gained rents from issuing permits for grain movement. Direct state participation in and restrictions on private sector marketing and production extended to other agricultural commodities as well. The government directly marketed several import substitution crops

monopolistically: wheat, rice, cotton, sugar, and milk. In all cases, restrictions or outright bans were imposed on private sector participation.

The sustained, relatively high producer prices for maize, together with smaller increases in the price at which the National Cereals and Produce Board could sell to millers and the high marketing costs of the parastatal, had predictable effects on the budget (table 6). It is also worth noting the sevenfold increase in the deficit per ton of maize handled—explained in part by the rapid expansion of National Cereals and Produce Board depots in the late 1970s and early 1980s, and a threefold increase in staff between 1980 and 1987. In addition by 1987, the National Cereals and Produce Board accumulated debt exceeding 5 percent of GDP, which was "written-off" or taken over and paid off by the government in 1988–89.

As with output pricing, controlled input prices reflected import parity. For example, the pricing formula for fertilizer added margins and transport costs to a reference price based on import prices, seed prices were based on the costs of production, and the price of agricultural chemicals was not controlled. The licensing of fertilizer imports was the main problem—in the guise of administering technical standards and coordination with donor-financed imports, the government restricted import licenses to a fairly small number of importers. The result was uncertainty over supplies and poor timing. In addition, price controls down to the retail level reduced supplies and penalized cereal-producing smallholders, who did not have access to institutional suppliers such as the coffee cooperatives.

Output marketing

The reform program sought to disengage the government from marketing (and in some cases, processing). Unfortunately, the process was slow and tangled; only dubious success was achieved, and that with minor crops. Milk prices were decontrolled, and restrictions on private sector processing and marketing removed. In 1987–88, the government eliminated the cotton marketing board's monopoly on paper, and approved the divestiture of its gins and its restructuring as a regulatory agency. No further progress was made. The government also decided to divest its bacon factory and the Kenya meat commission. While staff were laid off initially, the commission returned to operations in 1989. In the sugar sector, no decisions were reached, pending the completion of a subsectoral study.

The saga of attempts to reform the marketing of maize, the most important food crop, could fill many pages. Grain market reform had the stated aim of having all domestic trade managed by private merchants with deregulated prices. Various studies indicated that the National Cereals and Produce Board had a role—one limited to holding minimal amounts of strategic reserves for smoothing sharp increases in consumer prices in poor harvest years. In addition, the National Cereals and Produce Board would be a buyer of last resort, maintaining floor prices for producers. The food security and stabilization role thus envisaged for the National Cereals and Produce Board would be quite limited—if its monopoly on internal trade and on imports and exports were removed, private trade would be able to assume most of these functions.

Both design flaws and a lack of commitment impeded reform. The design flaw was the inconsistency between fixing the purchase price close to the import parity price and reducing the role of the National Cereals and Produce Board to a buyer of last resort. A price set close to import parity is likely to encourage most farmers to choose to sell to the National Cereals and Produce Board. Indeed, the parastatal then becomes a purchaser of (the farmers') first choice, leading to the accumulation of stocks, purchased at prices too high to make export profitable. This infact occurred repeatedly in the 1980s. In the early 1980s, grain reserves for several years were 40 percent to 60 percent higher than the desired level of 270,000 tons. Later in the decade, when the desired level was increased to 560,000 tons, actual stocks were still often 60 to 70 percent higher, even after significant exports. If the reform program sought to reduce the role of National Cereals and Produce Board, the most potent instrument was the reduction in the purchase price, perhaps closer to export parity. Although terms such as "flexible pricing" and "improved pricing methodology" were cited in policy documents, purchase price reduction was never an explicitly stated objective.

Instead, other solutions to the problem were attempted—the quantity of maize allowed to be moved without permit was raised from 2 bags to 44 bags, 70 percent of the board's buying centers were closed, and millers were allowed to buy an increasing share of their requirements directly from traders rather than from the National Cereals and Produce Board. The National Cereals and Produce Board was also "restructured," which included a debt write-off in 1988.

Evaluating the effects of these efforts is problematic, since defining and measuring what is actually happening in practice is difficult. Some preliminary evidence does seem to indicate that during 1988–91 when movement controls were eased, private trade was able to equalize interregional price disparities, by raising prices in surplus areas and by reducing them in deficit areas. The operating margins of private trade were clearly lower than those of the National Cereals and Produce Board. At the same time, the National Cereals and Produce Board purchases were lower than in previous years, suggesting that its role in the market declined. But the trend was quickly reversed when movement controls were reimposed in 1992 and the procurement price was jacked up to 110 percent of import parity. At the same time, by reopening buying centers and offering maize to millers at a subsidized price, the government undercut its own decision to encourage millers to buy directly from the market.

The impact on the National Cereals and Produce Board's finances is also unclear. Despite the debt write-off and closing of buying centers, the average cost of a bag of maize handled by the National Cereals and Produce Board remained high. Staff-reduction targets were not met, and the National Cereals and Produce Board was still unable to cover its cost of operation, as indicated by growing deficits. In addition to a programmed transfer from the central budget of K£720 million in 1991–92, for example, a further subsidy of K£200 to 250 million became necessary—about 2 percent of all current expenditures.

Fertilizer marketing

Complete decontrol of prices at all levels since 1990 has increased the number of fertilizer retailers at interior locations—thus increasing availability, particularly at the retail level, where margins had been badly squeezed in the past. In 1991, fertilizer imports were transferred from schedule II to schedule I and became unrestricted. It is unclear whether this move increased the number of licensed importers. Estimated fertilizer use declined between 1989 and 1991. Donor-financed fertilizers, which account for about 50 percent of annual imports, continued to be "allocated" in a process that was neither transparent nor coordinated with private demand for fertilizers. This, together with continued uncertainties about import licensing and foreign exchange allocation and the continued domination of the market by government-owned distributors, appears to have discouraged private traders.

Public enterprise reform

The government held equity in about 250 commercially oriented enterprises producing goods and services for profit; in over half, the government was the majority equity holder. Equity was held directly in about 50 enterprises; equity in the rest was held through government-owned development finance institutions. The single largest economic activity of parastatals was manufacturing; in 1990, 60 percent of the enterprises were in manufacturing and mining, 18 percent in distribution, 15 percent

in finance, and the rest in transport, other services, and electricity. Between 1986 and 1990, the parastatal sector accounted for 11 percent of GDP.

While GDP grew overall by 5 percent between 1986 and 1990, value added in the parastatal sector grew at only 0.5 percent annually—with negative growth in the manufacturing and mining sectors. (Table 7 provides indicators of the economic and financial performance of the public enterprise sector and its relationship to the rest of the economy.) Based on a sample of parastatals and private enterprises, it is estimated that total factor productivity growth during this period was negative for the parastatal sector, compared with 5.4 percent for the private sector; the growth of labor inputs was half that of the private sector, while the growth of capital inputs was twice as high, indicating an inefficient use of resources. Excluding the profits of the central bank, net inflows to the central government budget were either significantly negative (-0.9 to -1.1 percent of GDP) or near zero.

While economic inefficiency was the most disturbing characteristic of the parastatal sector, its effects on the budget and external accounts were not negligible. The sector accounted for more than a third of the government's net lending and equity operations and contributed little revenue: in fact, unremitted taxes—those collected but not remitted—estimated to have been K£45 million in 1991, or 0.5 percent of tax revenues. The sector ran a net trade deficit of 28 percent of the total trade deficit. While the sector did not greatly accentuate the external debt and debt service burden, the efficiency with which these funds were used is at issue. Furthermore, the government often assumed the debt and debt servicing obligations of parastatals (K£66

million of debt service payments were assumed in 1991), which often borrowed externally without clearance from the treasury.

Parastatals do not appear to be a burden on the banking system. But their demand on or lack of contribution to budgetary revenues indirectly increased the government's own budget deficits and its demands for credit. Too, close ties seemed to exist between parastatals and distressed banks—distressed banks held an estimated 85 percent of all parastatal deposits, due to a government directive that parastatals place their deposits in such banks and near bank financial intermediaries. Conversely, it also appeared that loans to parastatals were a source of losses for the distressed banks. Thus, although the aggregate figures did not exhibit a dangerous interdependence, the link between poorly performing parastatals and the subset of distressed banks was in fact quite close.

Finally, the parastatal sector strengthened the monopolistic and oligopolistic structure of industry. Monopolies were usually parastatal firms granted such power through legislation or administrative decree. They could exercise this power in sales or purchases, the latter through marketing institutions and boards. Oligopolies sometimes consisted of a combination of private and public firms. Parastatals were often protected by higher tariffs, effective (although not officially gazetted) prohibition on competing imports, and ad hoc exemptions on import duties on capital and intermediate goods.

Although several attempts were made to restructure the public enterprise sector, progress was made only recently. In late 1991, the government announced its intention to divest its interest in a preliminary list of 207 enterprises, while retaining

ownership of 33 "strategic" enterprises. Of the 207, it selected only ten for privatization by 1995. Five have actually been privatized or brought to the point of sale. Furthermore, five majority-owned public enterprises, which accounted for the bulk of government transfers, were to be restructured, including the railways, port authority, posts and telegraphs, the tea development agency, and, again, the National Cereals and Produce Board. This was a modest beginning. And, it is unclear that all the 33 enterprises to be retained in the public sector have "strategic" importance. But the greatest source of skepticism is the inclusion of the National Cereals and Produce Board in this list—that it is being targeted for yet another round of "restructuring."

Civil service reform

In 1990, the mainstream civil service employed more than a quarter of million people—or about a quarter of urban wage employment. In the 1980s civil service employment growth slowed to an average of 4.8 percent p.a. after a spurt of 10 percent p.a. during the 1970s. Several policy measures have reflected the strong pressures to create jobs—guaranteed employment for university graduates and the tripartite arrangements of 1964, 1970, and 1979–81, which called for employment increases in the public sector by 15 percent, 10 percent, and 10 percent, respectively. Further, ad hoc absorption of staff from the agencies of the East Africa Community, the census operations of 1979, and a large number "works paid" employees hired under development projects have increased employment. As may be expected, the

composition of the civil service is biased heavily toward low-skilled employees; only 11 percent are in the middle or upper management cadres.

It can be difficult sometimes to judge whether the expansion of public employment is justified by the corresponding increase in the real value of government services provided. However, if one takes GDP growth as a rough indicator of demand for government services and assumes no decline in average productivity of civil servants, then increases in government employment far exceed the increase in demand; the rate of increase in government employment was twice that of GDP.

This steady growth in civil service employment was, as usually happens accompanied by stagnation or regression in the salaries and wages paid to civil servants; during the 1980s, in particular, average real wages declined by over 15 percent, compared with a 7.3 percent decline in the private sector. The government's wage policies helped hold the total civil service wage bill in check even while employment expanded—and in fact served as the (moderate) wage leader for the entire modern sector. However, the slow growth in real wages was distributed unevenly—lower wage grades received larger percentage increases. Together with a "grade creep," this led to a compression of salary scales, reducing the attractiveness of government jobs for professionals and the highly skilled, as reflected in high vacancy rates at these levels.

In sum, overstaffing was not dealt with effectively. While the government occasionally declared hiring freezes and supposedly abandoned its practice of giving jobs to all university graduates and graduates of other training programs, these policies were not systematically implemented. In any case, overstaffing occurs

predominantly at the lower grade levels, so that reduction in size at this level is likely to be more important than restriction of intake of university graduates.

Social sector policies

Education

Kenya's educational system expanded rapidly—partly in reaction to the highly restrictive and unequal educational practices of the colonial government, in part to accommodate the extraordinary growth in the school-going population. And its basic indicators are some of the best in Africa: a 99 percent primary school enrollment rate, an enrollment rate of 48 percent among females, and an adult literacy rate of 60 percent for males and 40 percent for females. Relatedly public expenditures on education are also among the highest in Africa—at 6 percent of GDP. Some 57 percent of public recurrent expenditures go to primary education; the spirit of Harambee or "Let's pull together", has brought parents into the funding fold—they are bearing 56 and 73 percent shares of the capital (and some recurring) costs of education at the primary and secondary levels.

Despite the additional funds from parental sources, public expenditures on education grew as a share of GDP (table 1)—now comprising 40 percent of the budget by FY91. Public recurrent expenditures financed teacher salaries primarily—real salaries declined but the number of teacher grew at a faster rate than enrollments, so that the average class size was unusually small. At the same time, the dropout rate

was very high: roughly one half of all children who begin primary education failed to complete it. Thus, there is room for improvement in efficiency.

Only 1.3 percent of the eligible population were enrolled at the university level. Yet this subsector took up 72 percent of capital expenditures and 18 percent of recurrent expenditures in the late eighties, (an increase from 11.8 percent in 1985). Until recently, 30 percent of university spending went for student boarding and other allowances. Recent structural changes which made admission easier, and the fact that cost-sharing is substantially lower than in basic education, contributed to a very high private demand. In the last five years, the number of public universities increased from 1 to 6.

Kenya faces different financing issues than do most other African countries, where the scant public spending on education must be increased. In particular, Kenya must address the high and rising budget share of education, and its biased distribution toward universities. Three broad measures are paramount: limiting the growth of teachers at the primary level, lowering dropout and repeat rates, and containing the public resource demands of the secondary sectors, particularly universities. The first measure entails three reforms: increasing class size and teacher workloads, limiting the intake of teachers colleges, and halting the recruitment of untrained teachers. Allocating public resources more equitably would entail introducing direct costs and recovering the full cost of food and boarding, and reforming the student loan scheme at the university level. Public universities should also be consolidated, and new admissions restricted for a period of time.

In the year since the adjustment program was initiated, quantitative limits on the number of teachers on the payroll, and the number and mix of trainees accepted into training colleges, were exceeded. At the university level, admission targets were adhered to, direct charges were instituted along with need-based bursaries, and some aspects of the student loan scheme (still available to all students) were restructured to reduce the amount of personal allowances.

Health

As in education, health indicators improved dramatically after Independence—an increase in life expectancy from 42 to 58 years, a decline in the crude mortality rate from 20 to 11 per thousand population and a decline in infant mortality from more than 200 to 110 per thousand live births. The coverage of immunization programs has also grown and drop-out rates have declined. At the same time, AIDS has become a significant public health disease. About 200,000 Kenyans are now estimated to be HIV-positive and about 2,500 new AIDS cases are diagnosed annually.

Historically, the bulk of the ministry of health budget was allocated to secondary and tertiary hospital services, leaving few funds for rural health facilities. And although the allocated share of preventive services and rural health services increased in the late 1980s by 7 and 11 percentage points, it still remained low in relation to need. Furthermore, actual expenditures for preventive and rural services fell short of allocations—by about 19 percent to 24 percent—while actual spending for

curative services was well above 100 percent. The share of recurrent expenditures devoted to nonwage expenses such as medical supplies has also declined steadily, from about 28 percent in the 1970s to 20 percent in the late 1980s. Only limited user charges were in effect until 1989. Moreover, inadequate maintenance—a systemic problem—affects rural health facilities in particular. A survey in 1981 showed that less than half of Kenya's rural facilities had a reliable water supply and 65 to 70 percent were unacceptably run down.

To meet the increase in demand in the face of tight resources, the government has sought to mobilize additional resources and to ensure that facilities are used more efficiently. In December 1989, the government introduced outpatient and inpatient user charges at all public sector facilities except dispensaries; in July 1990 it introduced reforms to the national hospital insurance fund, a parastatal covering primarily wage earners and their families. User charges were accompanied by waivers based on ability to pay, and incentives to facilities to be able to keep part of the revenue they generated. The reforms to the insurance fund made contributions proportional to income and increased the coverage.

After the imposition of user charges, attendance at facilities fell, but they soon returned to their previous levels—with one important exception: attendance increased at dispensaries and health centers, and declined at hospitals. This was a desirable outcome. However, public concern about the continued inadequacy of facilities and the perceptions that the waiver system was not functioning properly forced the government to reduce or suspend some charges three months later. This withdrawal reduced cost-sharing revenues by about 50 percent and eliminated the incentive to

seek care first at a lower-level facility. Then, in 1992 fees were reintroduced progressively from the national hospital in Nairobi to district hospitals and health centers. And the waivers system was strengthened and expanded. The government also increased its budgeted and actual recurrent spending by 30 percent between FY89-92, and the share of total health expenditures increased from 7.6 percent to more than 8.5 percent.

The outcomes of structural adjustment

Impact on Intermediate Variables

As shown in table 8, much of the stabilization gains of the early 1980s were lost in the late 1980s—the budget deficit increased to almost the levels of the crisis period, and high inflation reemerged. While the gains in reducing the external deficit were not entirely reversed, the increased and high debt service ratios indicate the precariousness of the external balance.

Progress was made in maintaining positive interest rates and in real exchange rate depreciation. With the removal of price controls, and the maintenance of producer incentives in agriculture, the overall incentive structure was reasonably undistorted in the later 1980s.

Macroeconomic and sectoral outcomes

As shown in table 9, from 1980 to 1984 the economy experienced a low growth rate due largely to stabilization policies that cut expenditures sharply—a decline in the excess of expenditures over income from 11 percent of GDP in 1980 to 1 percent in 1984 and 1985. Moreover, the low efficiency of investment in the late 1970s led to a high incremental capital output ratio and a negative rate of productivity growth during the early 1980s.

After the slowdown in the first half of the 1980s, growth resumed and investment reflected greater efficiency in the late 1980s. The increase in efficiency can be attributed to a decline in the rate of (unproductive) investment between 1980 and 1984—much of it in the public sector, where the public fixed investment to GDP ratio declined by 1.6 percent. The public sector maintained a lower rate of investment in the late 1980s.

Yet, despite the decline in the share of public investment, the sector's claims on private sector savings grew. By the early 1980s, the central government had changed from a net saver in the late 1970s to a consumer of private savings. By the late 1980s and early 1990s, the position deteriorated steadily. After a sharp decline in and prudence in the use of foreign savings in the mid-1980s, external resource use increased to 4.6 percent in the late 1980s. The conclusion is that while some public sector adjustment occurred primarily as a reduction in the rate of public investment, it was inadequate in terms of placing demands on both private sector and foreign savings.

A growth in private sector savings was directed into financing the government deficit rather than private investments; indeed the private investment effort slowed throughout the 1980s. This may be indicative of the stagnation to be expected in the early years of adjustment. Yet it may also reflect a continued reluctance to invest in the face of regulatory and other nonprice barriers, and, more recently, political uncertainties.

Adjustment focused heavily on the external sector. Import liberalization was substantial. The ratio of imports to GDP has increased since the mid-1980s, but not the share of imports in the domestic supply of manufactures (table 9). In fact, this latter share was lower in the latter part of the adjustment period than initially, suggesting that manufacturing sector imports were not liberalized to the same extent as have other imports.⁹ For exports the picture is less clear. The export to GDP ratio continued to decline, as did the ratio of manufactured exports to output—suggesting that a significant increase in export orientation did not occur. At best, exports grew at the same rate as GDP in the second half of the 1980s. But this overall result is due partly to the still relatively large share of primary commodities in the export structure, for which growth was modest. The rate of manufactured exports increased sharply, particularly in the past few years—suggesting that production may be shifting from supplying for mainly domestic markets to exports of manufacturing. But the small share of manufactures in merchandise exports—about 20 percent—has little impact on the export/GDP ratio.¹⁰

In agriculture, the rate of output growth, while lower than in the years following Independence, is still quite respectable. The delicensing of private fertilizer

imports and decontrol of its price could be expected to have a direct effect on production, although the direction of the effect is theoretically ambiguous: price decontrol and thus higher prices might suppress demand, wider availability may reduce prices and increase usage. So far, neither has occurred—usage showed an increase till 1990, and a significant decline in the next two years. The failure at rationalizing public expenditures (including a restructuring of the National Cereals and Produce Board) suggests that priority investments are underfunded, as are critical agricultural services.

Adjustment and aid

This discussion of the reform process brings us logically to another question about Kenya: whether aid (including the Bank's) has been overly generous, and encouraged the government to avoid substantial reform. This question is difficult to assess. At the aggregate level, the net disbursement of official development assistance per capita to Kenya in 1990—at \$41—was less than for other "favored" African countries, such as Tanzania (\$47.1), Burundi (\$48.8), and Malawi (\$56.3). Yet it was substantially higher than net disbursements to Ghana, (\$31.2), Africa's best performer. Much the same picture emerges for net official development assistance as a share of GDP. At 11.1 percent, Kenya's share is higher than Ghana's (7 percent), but much lower than in other countries (48 percent for Tanzania, and about 26 percent for Malawi and Burundi). Without making too much of these numbers, one can probably say that while the resource use and policy reform behavior of Kenya

makes it less deserving of the aid it obtained than say Ghana, Kenya does not exhibit the same extent of aid dependency as other donor favorites in the region. At the same time, it does appear that generous project funding by several donors has led to a public investment program which, while declining as share of GDP, is not well prioritized. Even more critical, the growing reliance on grants and counterpart funds has also undoubtedly contributed to higher consumption expenditures by the government, particularly on the civil service.

A more specific question: whether the Bank's policy-based lending to Kenya in the 1980s has allowed Kenya to undertake adjustment or postpone it. Here too, the answer is mixed. The most successful area of reform has been trade liberalization (and exchange rate depreciation)—and to a lesser extent export development. The link between trade reform and the increased demand for foreign exchange that it generates (at a given exchange rate) is quite direct, and it would be right to conclude that the reforms would not have occurred had the Bank not kept up steady lending. At the same time, it is arguable that the budget support provided by these funds helped postpone many critical reforms—the civil service, parastatal divestiture (including the National Cereals and Produce Board), and the social sectors.

POSTSCRIPT

Improvements in Stabilization and Structural Reform Policies in 1993

The text of this paper covers the period to the end of 1992, by which time macro-economic imbalances had become extremely severe and banking irregularities rampant. Earlier, in November 1991, bilateral donors had suspended new commitments of fast disbursing assistance, citing poor governance and economic mismanagement. In September 1992, because of continuing deterioration in macroeconomic and sectoral policies, the Bank decided to postpone disbursements of the second tranches of ongoing operations, and in December 1992, cancelled the second tranche of the second agricultural sector loan because of the reimposition of movement restrictions on maize. This strained the relationship between the government and the donors and multilateral institutions. This section of the paper briefly summarizes the developments in 1993, and describes the turn-around that appears to have occurred, both in the pace of economic reforms and country relations.

The areas of primary concern in 1992--the monetary, financial and external sectors--continued to be difficult during *early* 1993. Expansionary monetary policies --which allowed weak financial institutions to borrow heavily from the central bank -- further exacerbated inflation and created a widening spread between the market-determined inter-bank exchange rate and the official exchange rate. Negative real interest rates, excess liquidity in the banking system and the continuing impasse between the Government and multilateral financial institutions led to intensified speculation against the Kenya shilling. Instead of tightening its monetary and fiscal stance, the Government announced, on March 22, 1993, its intention to reverse previously adopted liberalization measures, in effect to abandon the adjustment program. Retention accounts were no longer allowed and all export earnings were to be remitted to the Central Bank of Kenya (CBK) at the official rate. The Government also indicated that it would reimpose price controls, although this did not occur.

Throughout this period, IDA continued to withhold the second tranches for the on-going operations. The Government soon recognized that while reimposed restrictions might temporarily relieve the shortage of foreign exchange, macroeconomic imbalances were aggravating inflation, weakening the Kenya shilling and most importantly, were further undermining confidence in Kenya's economic management. During April-May 1993 therefore, under a shadow-program with the IMF, the Government adopted measures aimed at tightening monetary and financial sector policies. They included: (a) open market operations to aggressively raise nominal interest rates on treasury bills; (b) increasing the cash ratio from 6 to 8 percent and stiffening substantially the penalties for noncompliance; (c) closing the export pre-shipment discount facility (one of the causes of excess liquidity); and (d) placing two bank with seriously impaired portfolios under statutory management and putting eight non-bank financial institutions in the hands of liquidators.

The Government also took initial steps to strengthen and enforce prudential regulations in order to prevent a recurrence of monetary mismanagement. Special audits were commissioned for selected financial institutions to determine their financial condition and soundness, with

particular emphasis on portfolio quality; these will form the basis for further remedial actions. In addition, most exemptions from prudential regulations granted by the previous Minister of Finance, were revoked. The institutions in receipt of these exemptions were given approximately one month to comply with all regulations from which they were exempted.

There was renewed effort to strengthen external sector policies. Several devaluations brought the official rate to within 10 percent of the market-determined interbank rate. The May 14 devaluation was accompanied by the abolition of import licenses for all but a small negative list of commodities, and the reintroduction of 50 percent retention of all export earnings (which must be used, however, or sold within 90 days). Separately, the Government stepped up its efforts to enhance fiscal performance, partly by freezing all unnecessary non-wage expenditures until the end of the FY93. Greater attention was also being paid to recovering uncollected taxes and debt service payments from parastatals.

On the basis of these actions, IDA released the second tranche of the export development credit. Later in May, the Government agreed on a formal IMF-monitored macroeconomic program for the remainder of 1993. However, following release of the second tranche of the export development credit, major irregularities in foreign exchange and interbank transactions began to undermine the macroeconomic program and weaken discipline in the financial sector. After another round of consultations with the multilateral institutions, the Government implemented additional measures intended to further tighten monetary and financial sector policies, including: (a) raising further the cash ratio for banks in two steps to 12 percent; (b) abolishing the Clearing House arrangements which allowed commercial banks to run overdrafts with CBK; and (c) reversing a series of illegal transactions between CBK and four commercial banks, and revoking the licenses of three of the four banks implicated in the transactions. Separately, the license of another bank, which failed to meet prudential regulations, was also revoked. In addition, senior managers of the Central Bank, including the Governor, were replaced. Section 53 of the Banking Act was formally amended to eliminate most of the discretionary exemptions from prudential regulations and all exemptions not consistent with the amendment were revoked.

The tightening of monetary and financial sector policies helped to reverse the rapid depreciation of the Kenya shilling, in fact the market rate appreciated. This paved the way for the unification of the official and market exchange rates on October 17, 1993. Arrears on private trade credit were cleared while arrears on public and public guaranteed debt began to decline. The tighter monetary stance also contributed to the reduction in inflation from around 100 percent (annualized rate) in the second quarter of 1993 to 55 percent in the third quarter. With this reduction in inflation, nominal short-term interest rates on Treasury bills have begun to decline but they remain positive in real terms. On the fiscal front, the June 1993 budget featured significant expenditure compression and rationalization of the tariff and VAT structures. When it appeared that budgetary targets were being threatened by higher than anticipated interest payments (to the tune of 2.7% of GDP), and a higher than budgeted subsidy to the NCPB, the Government agreed to additional revenue and expenditure control measures.

Further, all restrictions were removed on the importation of maize and on the domestic movement of imported maize, traders were once again allowed to move domestically produced maize in loads of up to eighty-eight 90 kilogram bags. A comprehensive civil service reform

program, involving the retrenchment of civil servants in lower grades and provision of a safety net for these retrenched workers, was launched officially. The Government also replaced the top management of the Kenya Posts and Telecommunications Corporation which is performing poorly and contributing to the fiscal deficit.

These improvements in the policy environment facilitated the successful negotiation of a PFP and a one-year ESAF arrangement with the IMF. Following this agreement, the Consultative Group of donors on Kenya also met on November 22 and 23, 1993 and indicated new commitments for 1994 totalling \$850 million, of which \$170 million is in the form of quick-disbursing balance of payments support. However, donors emphasized that the translation of these commitments into disbursements depended on the timely and decisive implementation by the Government of the economic reform agenda presented in the PFP. Separately, on December 3, 1993, IDA 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.

It is beyond the scope of this paper to fully evaluate these policy changes in full. It appears that little has changed in the structure of the expenditures. Interest payments are rising, and subsidies to the NCPB remain high. The problem of inadequate non-wage expenditures remains. The retrenchment program is a good beginning, but is unlikely to create savings in the short run; infact the retrenchment fund may well increase expenditures. The greatest success has been in the area of enforcing banking and prudential regulations and removing the worst offenders -- both in terms of institutions and personalities. Trade and foreign exchange markets appear to be essentially free; indeed in these areas, reforms are much further along than before the crisis. On grain marketing, the situation has not advanced much beyond what it was before the crisis, which as indicated in the text of the paper, was not satisfactory.

Perhaps the most important outcome was in terms of effective country assistance strategy. Donors and multilateral institutions held firm, for the first time perhaps. As a result, economic mismanagement and poor governance were put clearly on the agenda. In addition, the Government and the multilateral institutions learnt the value of consistency and clarity in dialogue over very difficult policy issues. It is too early to judge the sustainability of the outcome, but the developments deserve careful evaluation.

FOOTNOTES

1. The million acre settlement scheme introduced in 1961 and other minor settlement schemes settled over 34,000 families on 430,000 hectares. The Shirika program started in 1971 had settled more than 100,000 hectares by 1976. Altogether, about one-third of the large-scale mixed farm area was officially subdivided.

2. Coffee and tea farmers received about 90 percent of the world market prices on average. However, small coffee farmers received lower prices essentially because of deductions made by inefficient cooperatives. The price paid for maize has been about 75 percent of the import parity price in the eighties but well above the export parity price. Here too, late payments by the Cereal Marketing Board has caused delays in some years.

3. In the agricultural sector where attempts at budget rationalization have been most persistent, initially, the ministry of agriculture excluded about 10 percent of its projects which it judged as having lower priority while the ministry of livestock development discarded about 20 percent of its projects. A subset of 33 was then defined as "core projects" for priority full funding in 1991-92. However, actual allocations were substantially lower, i.e. 56 percent of the development budget as compared to 69 percent. On recurrent expenditures, there was a decrease of 6 percent compared to a targeted increase of 4.4 percent. Ironically, non-core projects fared better.

4. In FY92, a large number of discretionary measures were introduced to bring the deficit under control. These included extension of excise duties to an additional range of goods, a minimum import duty of 2 percent on many previously duty free items and the elimination of import duty exemptions.

5. The average lag from license application to allocation fell from six months in 1988 to about four weeks in early 1991. But soon, the time taken lengthened to more than ten weeks; importers reacted by submitting multiple applications, whereby the government returned all applications for resubmissions.

6. Among non-traditional exports, the rapid growth of horticultural exports preceded even the import liberalization program begun in 1988. Between 1981-88, the volume of horticultural exports grew more than sixfold, and by 1991 more than sevenfold. As a private sector initiative, this subsector is able to prosper essentially because of minimal regulation by the horticultural crops development authority, a parastatal that has concentrated on promotional efforts rather than actual involvement in marketing.

7. The Hirschmann index, which measures concentration on a scale of 0 to 1 (maximum concentration) was estimated for the bank and near bank sectors for end-1991. This statistic indicated that the strength of competition in the industry was similar to that in a market characterized by about five equal sized banks rather than the twenty-eight that actually exist. For the near bank financial intermediaries, it was as if there were thirteen equal sized institutions rather than the fifty-six that actually exist.

8. For example, during 1991, six to ten banks had liquidity ratios below the minimum, and as many as twenty-four to twenty-nine near bank financial intermediaries did not meet the requirements.

9. An examination of the annual ratios shows that after reaching a low of 19 percent in 1985, it increased slightly to an average of 20.3 percent during 1986-90, before declining to 17.3 percent in 1991.

10. It is more difficult to explain why the ratio of manufactured exports to output has fallen, despite a growth twice that of output. Again, an examination of annual ratios shows that after falling to a low of 5 percent in 1987, the ratio increased to 7.5 percent in 1991.

Table 1 The composition of current expenditures, 1981, 1985, and 1990
(percent of GDP)

<i>Economic classification</i> (current expenditures)	1981	1985	1990
Wages and salaries	6.0	6.1	6.0
Teachers' salaries	2.8	3.2	3.9
Total	8.8	9.3	9.9
Nonwage expenditures	8.5	6.7	6.3
Defense related	2.8	2.1	2.6
Nondefense related	5.7	4.6	3.7
Interest	2.4	4.1	5.4
Domestic	1.3	2.6	3.6
Foreign	1.1	1.6	1.8
Transfers to parastatals	0.8	..	..
Other	..	..	..
<i>Sectoral distribution</i> (total expenditure)			
Education	6.1	5.5	6.4
Health	2.3	1.7	1.7

.. Not available.

Source: Statistical Abstracts, Economic Surveys (various issues), IMF, and World Bank staff estimates.

Table 2 Financing of budget deficits, 1981-91

(change in ratio)

<i>Item</i>	1981-84	1984-91
Budget deficit/GDP (excluding grants)	-5.8	+4.5
Financing		
Grants/GDP	-0.1	+1.2
Foreign borrowing/GDP	-4.7	+1.7
Domestic financing/GDP	-1.0	+1.5
Inflation (change in rate) ^a	-11.1	+4.7
Growth of real domestic credit (annual percentage)	3.4	5.6
Change in share of private sector in total credit	-6.3	-2.8

a. From December to December.

Source: Statistical Abstracts, Economic Surveys (various issues), IMF, and World Bank staff estimates.

Table 3 Key incentive indicators, 1982-92*(Percentages and indices, 1982 = 100)*

Indicators	1982	1984	1986	1988	1990	1992
<i>External sector</i>						
Effective exchange rates ^a						
Nominal	100.0	97.4	82.9	73.6	69.3	55.1
Real	100.0	101.9	87.1	72.5	61.8	60.9
Terms of trade	100.0	109.9	103.4	88.4	71.0	..
<i>Average import tariffs (percent)</i>						
Unweighted	0.0	41.0	38.8	41.3	38.8	..
Import-weighted ^b	0.0	0.0	24.3	27.3	22.0	..
<i>Domestic Economy</i>						
<i>Real Wages^c</i>						
Private sector	100.0	83.8	83.9	89.0	83.7	..
Public sector	100.0	85.3	87.5	88.3	77.8	..
Inflation (annual percent) ^d	22.2	9.0	5.6	12.3	15.8	27.3
<i>Real interest rates (annual percent)</i>						
Deposits	10.0	2.7	5.6	-2.0	-2.1	-10.1
Loans	7.7	5.3	8.4	2.7	3.0	-6.6

.. Not available.

a. IMF index.

b. Weighted by 1989/80 import values; estimates are for fiscal years (e.g. 1987 refers to 1987/88).

c. Upper-ends of average commercial bank 3 to 6 months deposits and unsecured loans and deposits.

d. Revised Nairobi consumer price index since 1987.

Source: Statistical Abstracts, Economic Surveys (various issues), IMF, and World Bank staff estimates.

Table 4 Annual license requirements and costs

Item	Overall		Small		Medium		Large	
Number, regular	4.5	(1.3)	2.9	(0.6)	4.0	(0.5)	9.7	(1.3)
Number, specific (import/export)	10.2	(3.4)	1.2	(3.4)	3.8	(2.3)	38.9	(1.7)
Total	15.1	(2.4)	4.3	(1.2)	8.0	(1.2)	49.0	(1.4)
Full cost (thousands KSh)	124.3	(3.1)	16.1	(3.7)	95.0	(2.8)	450.4	(1.6)
Transaction cost (work hours)	223.0	(14.8)	69.0	(1.7)	89.7	(1.7)	816.0	(2.8)
Full cost/sales (percent)	5.2	(3.0)	9.4	(2.3)	1.8	(1.7)	1.2	(2.6)
License markup ^a (percent)	66.0	(4.9)	30.5	(2.1)	102.3	(5.1)	84.6	(2.1)

Note: The left entry in each cell is the mean value. The coefficient of variation is provided in parentheses. Mean values reported in the table are statistically significant at the .05 level unless otherwise noted.

a. Defined as full cost/direct cost.

Source: World Bank/GTZ firm level survey, 1992.

Table 5 Producer prices in Kenya*(percentage of import/export parity)*

Product	1984-85	1991-92
Maize		
Percent of import parity	73.2 ^a	69.9
Percent of export parity	155.7	128.8
Coffee ^b (percent of export price)	91.3	89.5
Tea ^b (percent of export prices)	84.4	88.6

a. Figure for 1983, since there were no exports in 1984.

b. These are average prices. Small holders obtained about 80 percent of the price obtained by estates, because of differences in quality, and, in the case of coffee growers, deductions by the co-operatives.

Source: World Bank data and estimates by Gurushri Swamy.

Table 6 National cereals and produce board operations

Item	1983-84	1991-92
Producer price of maize (KSh/ton)	144	300
Price to millers (KSh/ton)	208	359
Gross margin/producer price (percent)	53.5	19.7
National cereals and produce board deficits (K£ millions) ^a	12.8	70.9
Deficit/current government expenditures	1.3	2.3
Deficit per ton handled (K£ per ton) ^b	11.4	74.3

a. Before finance charges.

b. Sales and purchases.

Source: World Bank and Egerton University data, *Proceedings of Conference on Maize Supply and Marketing*, June 1992 and estimates by Gurushri Swamy.

Table 7 Performance indicators of the parastatal sector

<i>Efficiency indicators</i>	<i>1986-91</i>
Total value added (annual percent)	0.5
Value added in manufacturing (annual percent)	-0.1
Change in total factor productivity (annual percent)	-1.7
Growth rate of labor use/growth rate of labor in private sector (ratio)	0.6
Growth rate of capital inputs/growth rate of capital in private sector (ratio)	2.1
<i>Relationship to budget and external accounts</i>	<i>1986-91</i>
Net lending and equity to parastatals/overall net lending by government (percent)	35.4
Profits, interest and dividend payments/tax revenue	3.7
Parastatal external debt/public and publicly guaranteed debt (1990) (percent)	17.0
Parastatal external debt servicing/total (1990) (percent)	25.5
Net exports of parastatals/total net exports (percent)	-27.9
<i>Relationship to banking system and near bank financial intermediaries</i>	<i>1986-91</i>
Parastatal deposits/total commercial bank deposits	6.7
Parastatal deposits/total near bank financial intermediaries deposits	10.0
Parastatal credit/commercial bank credit	6.0
Parastatal credit/near bank financial intermediaries credit	1.3

Source: World Bank data

Table 8 The effects on intermediate variables

<i>Intermediate variable</i>	<i>Crisis period (1976-81)</i>	<i>The adjustment period</i>	
		<i>Phase I (1981-84)</i>	<i>Phase II (1985-91)</i>
Change in fiscal deficit/GDP (percentage points)	5.7	-5.8	4.5
Inflation rate* (change in rate)	3.3	-11.1	4.7
Real average interest rate (loans)	2.1	-0.3	4.6
Real effective exchange rate (percentage change)	16.9	5.7	-42.3
Change in current account/GDP (percentage points)	9.9	-8.2	4.0 ^b
Debt service/exports average (percent)	8.0	26.0-28.0	30.0

Note: A minus indicates a decline in deficit or rate.

a. December to December

b. 1984-90.

Source: Statistical Abstracts, Economic Surveys (various issues), IMF, and World Bank staff estimates.

Table 9 Macroeconomic and sectoral outcomes, 1975–80, 1980–84, and 1985–91

Item	Crisis period	The adjustment period	
	1975–80	Phase I (1980–84)	Phase II (1985–91)
GDP growth (annual percent)	5.6	2.1	5.0
Gross investment/GDP	28.8 ^a	23.8	20.0
Incremental capital output ratio (year averages) ^b	..	10.8	4.2
Total factor growth/productivity (annual percent)	..	-0.3	1.9 ^c
<i>Sectoral GDP Growth (annual percent)</i>			
Agriculture	2.6	2.8	3.5
Industry	..	2.1	5.0
Manufacturing	7.6	3.7	5.3
Services	..	4.1	5.1
<i>External trade</i>			
Export growth (annual percent)	0.5	-3.4	4.8
Growth of volume of manufacturing exports (annual percent)	-4.1	-8.7	10.5 ^c
Nonoil imports/GDP	22.5	18.0	19.1
Domestic exports/GDP	20.6	16.6	13.4
Manufacturing imports/domestic supply	44.3 ^d	26.8	19.1
Manufacturing exports/output	22.6 ^d	13.3	6.1
<i>Savings and investment (percent of GDP)</i>			
Fixed investment	23.2 ^a	21.6	19.4
Public	10.4 ^a	8.8	8.1
Private	12.6 ^a	12.8	11.3
<i>Financing</i>			
Central government savings	2.8 ^a	-1.1	-1.5
Private sector savings	18.2 ^a	20.2	21.9
Foreign savings (grants and net borrowing) ^f	9.0	1.4	4.6

.. Not available.

a. 1977–79.

b. Average of incremental capital output ratios for 1980–84, and 1985–90.

c. 1985–90.

d. 1972.

e. Shares base on 1979 data.

f. The data are averaged differently to sharpen the changes, the first period refers to 1978–81, the second to 1982–86, and the last to 1987–91.

Source: Statistical Abstracts, Economic Surveys (various issues), IMF, and World Bank staff estimates

Box 1
KENYA: Initial Distortions and Progress on Policy Reforms

<u>Policy Area</u>	<u>Initial Situation</u>	<u>Reforms</u>	<u>Assessment of Progress</u>
Policy Management	In early eighties, financial imbalances and inflation high. Budget deficit 9% of GDP, current account balance 12.5% of GDP, gross investment = 30% of GDP, financed half by foreign savings. Large expansion in public investment in 70s.	Sharp deflation during 1980-84, through reduction of budget deficit (4%), import compression, tight monetary policy and decline in public investment. Budget Rationalization Program introduced in 1985 to increase O&M expenditures and prioritize investment expenditures.	Reversal of deflationary trend during 1985-91. Financial imbalance increased to levels of early eighties. Budget Rationalization unsuccessful, proportion of funding for O&M fell from 36% in FY81 to 26% in FY86 and 22% in FY91.
Monetary Policy	In early eighties, banking system financed large budget deficits, direct controls on credit to private sector, negative interest rates.	Slower growth in credit during stabilization period, 1980-84, positive interest rates, but continued controls on private sector credit whose share declined by 6.3 percentage points. Attempt to shift to indirect instruments of monetary control, starting in 1989 - i.e. introduction of auction for government paper, activation of reserve and liquidity ratios.	Reversal of trends in monetary growth; continued decline in share of private sector credit (by 2.8 percentage points). Shift to indirect instruments not successful; auction market limited, direct credit controls and placement of government securities continue to be main instruments. Higher interest rates contributed to increased domestic debt service payments as share of GDP, from 1.3% in FY81 to 3.6% in FY90.
3. Exchange Rate Management	Tied to the US\$ during 1971-75 and to SDR since then, discrete devaluations had depreciated real exchange rate during 70s.	Active management of exchange rate through much of eighties. In 1992, tradeable foreign exchange certificates and export retention schemes introduced.	Except for 1980-84 when the real exchange rate appreciated, there has been real depreciation during 1985-91, compensating more than fully for terms of trade changes and domestic inflation. The black-market premium declined. A second legal free market for foreign exchange is functioning. In 1992, however, the official rate appreciated, and the legal parallel markets carried premiums of 30-50%.

4. Import Liberalization	Highly protected by QRs and high tariffs and bans. Break-up of EAC in 1977 intensified inward-orientation.	First attempt during 1980-84 to remove QRs and reduce tariffs. Second attempt from 1988-92 to remove QRs and reduce tariffs.	First attempt unsuccessful. Import liberalization became hostage to stabilization needs.
			Second attempt relatively successful. By July 1991, only items protected by QRs were for health or public safety, all other items were licensed "automatically".
			Average import weighted tariff reduced from 30% in 1984/85 to 20% in 1991/92. Tariffs on competing imports fell faster.
			In practice, even for items eligible for automatic licensing, permits are delayed and foreign exchange authorizations have to be obtained. This applies as well to imports financed with own funds. Nevertheless, the import/GDP ratio increased slightly.
4A. Export Promotion of Non-Traditional Goods	Anti-export bias despite export-compensation scheme which functioned poorly.	Introduction of MUB Scheme (1988), and import duty/VAT exemption scheme (1990), Export Processing Zone (to be completed in 1993).	MUB and import duty/VAT schemes are popular, but too early to assess impact.
			Manufactured export growth has picked up, 10% p.a. increase during 1985-91, mainly attributable to import liberalization and exchange rate depreciation.
5. Liberalization of Domestic Prices and Trade	Agricultural output and input, pricing <u>not</u> distortionary, but maize trade controlled by parastatal and movement controls. Retail prices controlled for basic commodities.	Prices for most manufactures decontrolled, and for many staple foods, except maize and wheat. Some relaxation of grain movement controls and controls on direct sales to millers.	Relaxation of food marketing controls has not resulted in true liberalization - the parastatal remains the major actor. Recently, movement controls were reimposed.
	Manufactured goods prices controlled, and parastatal control on wholesale trade in a number of goods.		Wholesale trade in some manufactures continues to be controlled by parastatal (Kenya National Trading Corporation, for example).
6. Financial Sector	Large number of banks and NBFIs, but concentration and segmentation high. Poor licensing and regulatory framework leading to financial distress. Critical unhealthy cross-relationship with parastatals.	Amendment of Banking Law to improve licensing and regulations, strengthening of central bank's technical and managerial capacity. Restructuring of 9 small institutions.	Poor implementation leading to a financial sector crisis in late eighties. Number of distressed institutions increased, restructuring unsuccessful. Excessive political interference and continued link to parastatals.

Public Enterprise reform	Large parastatal sector (about 250 enterprises) accounting for 11% of GDP, overwhelmingly in manufacturing. Economic inefficiency, monopoly status, and budgetary drains characterize sector.	None	None
8. Labor and Wage Policies	Labor policies towards private sector flexible and pragmatic despite extensive unionization, collective agreements. Only significant restriction is on permanent retrenchment. Public sector employment ___% of labor force, grew by 10% p.a. during the 70s, mainly at the lower grades. Guaranteed employment for university and training program graduates.	None	None
Social Sector Policies	High private and government spending (6% of GDP) on education. By early 80s, primary school enrollment universal. But public expenditures biased toward secondary levels and teachers' salaries. Low internal efficiency. Good health indicators - some of the best among low income countries. But tertiary care and large urban hospitals take up disproportionate share of resources, with poor cost recovery.	Reforms since 1991, attempt at limiting the growth of teaching force, increasing class size and increase cost recovery at the university level. In 1989, graduated user charges were introduced for certain services and amenities, facilities were allowed to keep 75% of collection, and waivers were allowed for those unable to pay.	The Government has maintained its expenditures (as a share of GDP) and has not discriminated against sector. But has not been able to restrain growth of teaching force. Cost recovery has increased. The program of user fees was poorly implemented, some features abandoned, others reintroduced. Impact unclear.

Box 2 : Progress In Trade Liberalization

During most of the post-Independence period, Kenya's trade regime was oriented toward import substitution. Domestic industries were protected by tariffs and import quotas, and several public sector enterprises enjoyed monopoly status in commercial activities which included international trade. Not surprisingly, manufacturing exports declined significantly as a share of total exports, even though external circumstances were generally favorable to these goods. Recent reforms have sought to encourage export development and improve the efficiency of domestic production by exposing domestic producers to foreign competition (Ndii, 1991).

Under the Industrial Sector Adjustment Program and the Export Development Program, protection has become more transparent by replacing quantitative restrictions with tariffs. There has also been a lowering of tariff rates, a reduction in tariff dispersion and consequently, a fall in protection. The table below shows the decline in economy-wide average tariffs. The reform-induced declines in average tariffs are greater when imports previously protected by quotas are excluded.

Economy-Wide Average Tariffs

All Schedules	1984/85	1987/88	1989/90	1989/90	1990/91	1991/92
Unweighted	40.0	39.6	41.3	41.0	38.8	34.0
Import-Weighted	..	29.6	27.3	24.5	22.0	20.4
89/90 Schedules I, II, IIIA & IIIB						
Unweighted	..	..	..	34.5	29.5	25.9
Import-Weighted	..	..	..	28.9	20.2	18.7

Source: *Kenya: Challenge of Promoting Exports A Trade Expansion Report*. Washington, D. C. World Bank, (forthcoming).

Though maximum tariff rates have fallen substantially, most of the reduction in the level of manufacturing protection has been accomplished through a reduction in the production coverage of quantitative import controls. For instance, the quantitative controls (Schedule III C) covered most of manufacturing production in 1985/86. This coverage fell to 79 percent in 1987/88, 45 percent in 1989/90 and 28 percent in 1990/91. The reduction in protection was not uniform across the manufacturing sector: in June 1989 they occurred mainly in the paper and iron/steel subsectors; in June 1990 they focussed on food manufacturing; in June 1991 they were concentrated in textiles and automobiles. However, these numbers understate the actual change in nominal protection relevant to domestic manufacturing. Tariffs on competitive imports fell by much more than the average. This is evident from the larger reductions in production-weighted tariffs which fell from 61.8% in 1989/90 to 55.5% in 1990/91 and to 45.5% in 1991/92.

FIGURE 1 : KENYA'S FISCAL AND EXTERNAL ACCOUNTS 1981-91

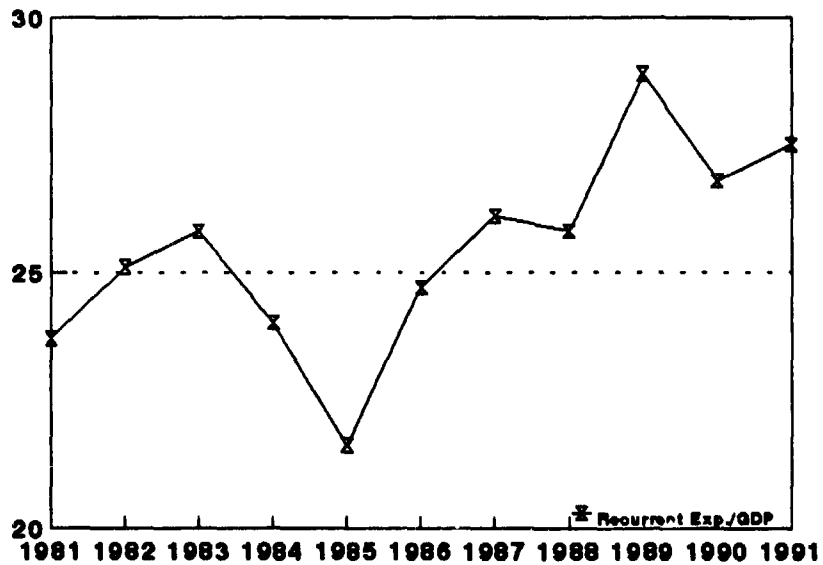
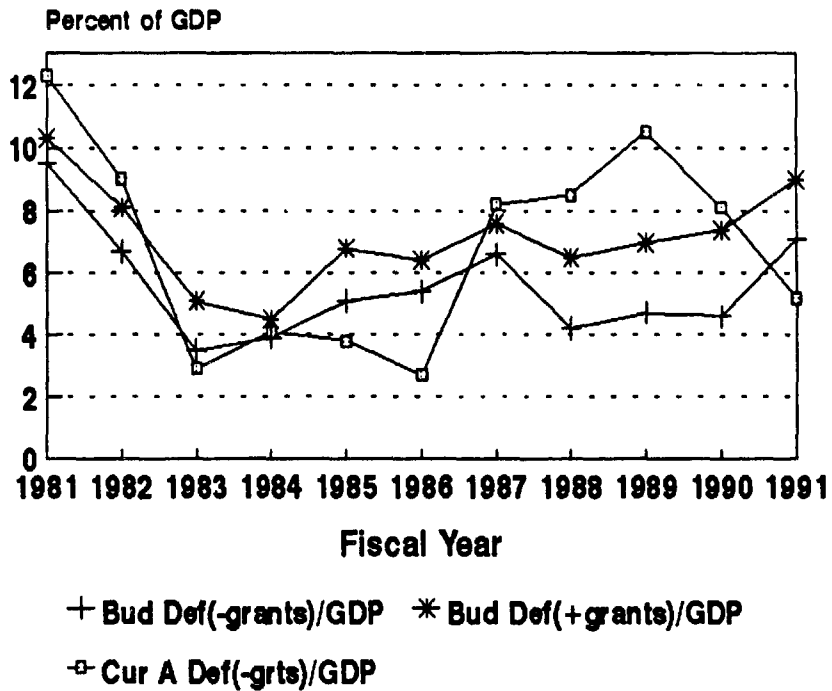
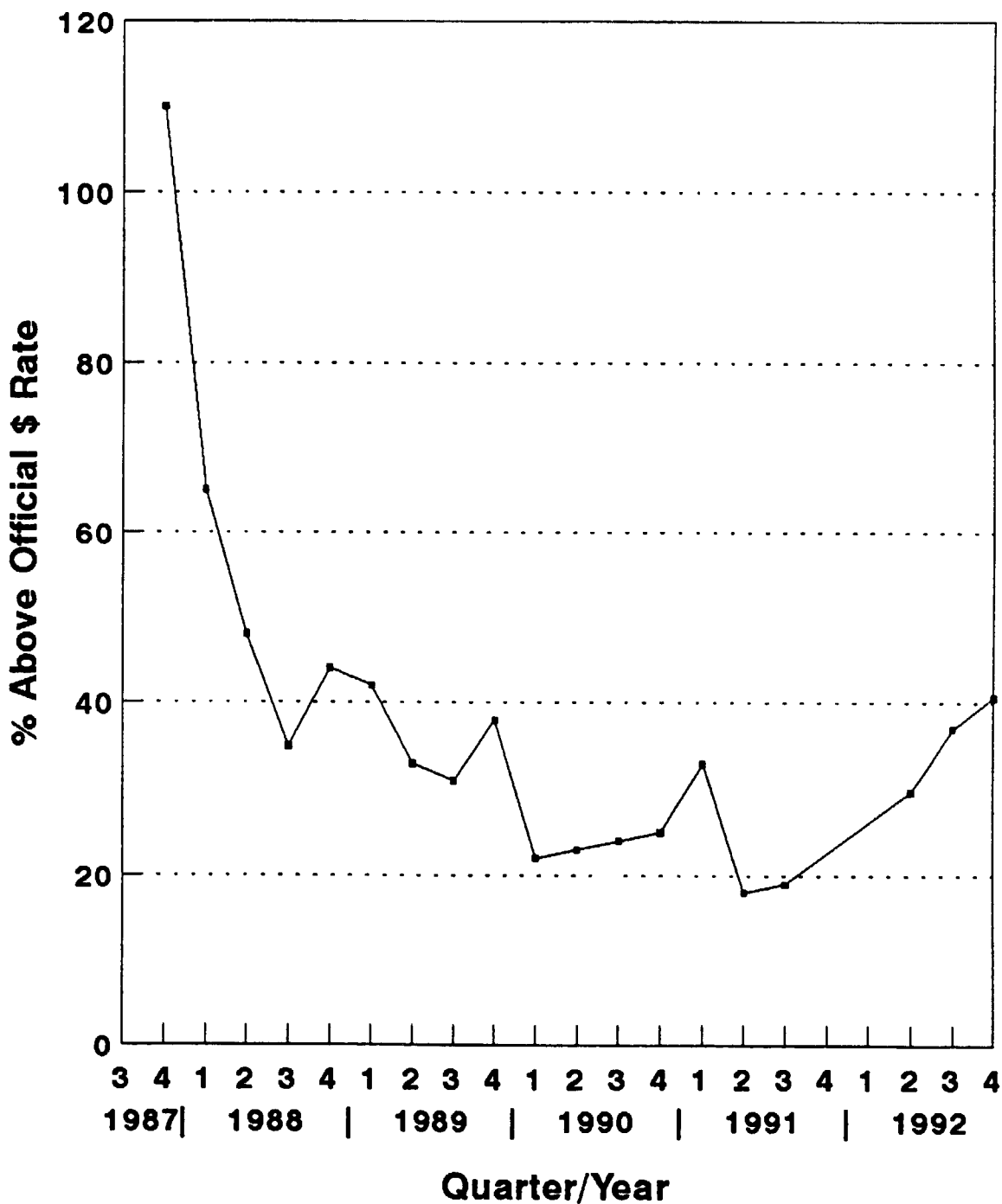


FIGURE 2
PARALLEL MARKET DOLLAR PREMIUM



Data not available for 4/1991 & 1/1992

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