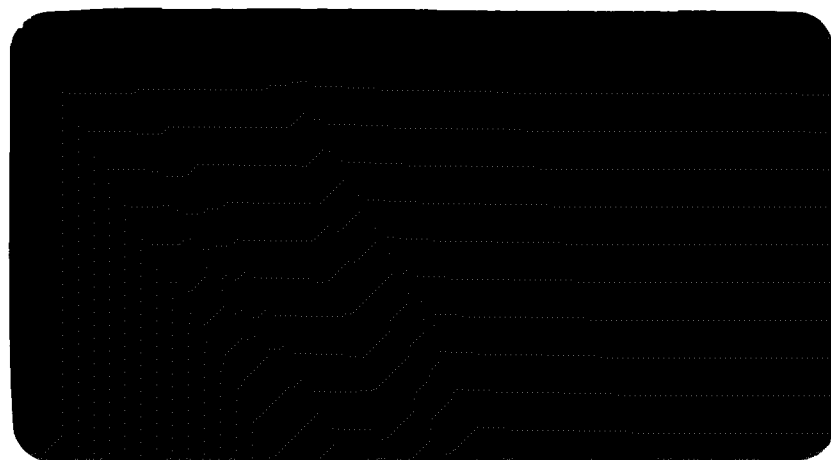


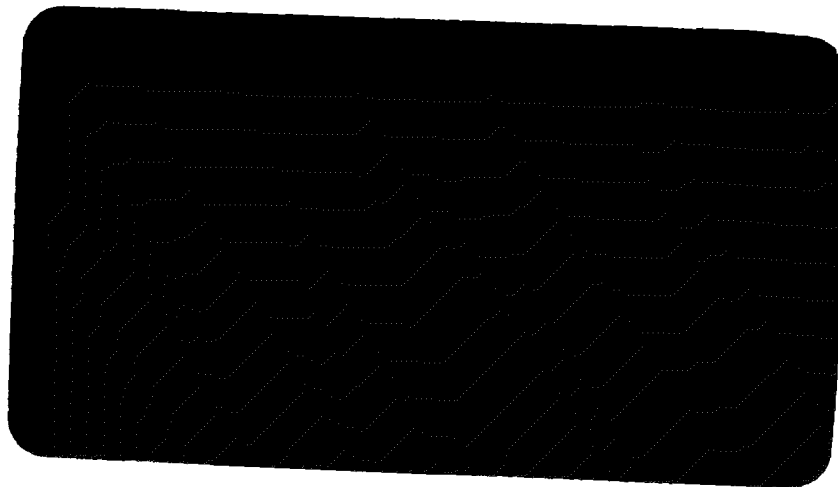
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ODI WORKING PAPER

No. 4

THE IMF AND  
ECONOMIC MANAGEMENT  
IN KENYA

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## THE IMF AND ECONOMIC MANAGEMENT IN KENYA<sup>1</sup>

As part of a broader study of the International Monetary Fund and economic management in developing countries, it is intended here to examine this theme as it relates to Kenya. Parts I to IV focus on the performance of the economy and the efficacy of government policies, especially as they relate to major disequilibria which emerged during the first half of the 1970s and have persisted since. Part V studies the role of the IMF in attempts to improve the balance of payments, concentrating particularly on Fund credits that were negotiated in 1975 and 1979-80, and offers some concluding remarks.

### I - ECONOMIC PERFORMANCE AND THE EMERGENCE OF DISEQUILIBRIA

#### The general orientation of economic policies

To attempt a characterisation of a government's economic objectives in anything more than banalities is a treacherous business. Official statements are invariably couched in general terms and carefully avoid explicit statements of priorities in the face of conflicts between desired goals. There is usually a gulf between the rhetoric and the objectives revealed in day-to-day decisions. So it is with Kenya.

Soon after it won political Independence at the end of 1963 the government issued a seminal statement of its economic objectives and development strategy, African Socialism and its Application to Planning in Kenya.<sup>2</sup> The intellectual climate at that time dictated a genuflection to the language of African socialism but, as Stewart (1976, pp. 85-86) has noted, it was a language which obscured rather than clarified the approach of the government:

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1. Draft chapter of a study of the IMF and economic management in developing countries being conducted under the auspices of the Overseas Development Institute. I should like to thank many officials and others for the great help they extended to me in preparing this paper; and Jennifer Sharpley and T.C.I. Ryan for helpful comments on an earlier draft.
  2. Kenya, 1965. Other official documents of particular importance include the third and fourth development plans, sessional papers on economic prospects and policies (Kenya, 1975 and 1980), the annual budget speeches, and economic surveys.

The political and economic strategy adopted by the Kenyan government since Independence was self-described as African Socialism. In more conventional terms it may be described as a capitalist strategy, both in domestic policy and in policy towards the world system, modified by the declared intention ... of redistributing some of the gains to the poorer sections of the community. While domestic and foreign private ownership has been encouraged, the public sector has simultaneously expanded rapidly, as has government intervention in the economy. In this respect, Kenyan development resembles that of many other economies, in being one of managed capitalism, or a mixed economy, as it is sometimes described.

'Managed capitalism' is an apt description. So far as the productive sectors are concerned, the general approach has been to work through the framework of a market system. But there has been no question of laissez faire: a substantial state sector and widespread interventionism was inherited from the colonial government and have since been extended.

In stating its attitude to development the Kenyatta government could scarcely have been more explicit in its acceptance of a 'trickle-down' view (Kenya, 1965, p. 18):

The ultimate objectives of African Socialism are clear ... The high priorities placed on political equality, social justice and human dignity mean that these principles will not be compromised in selecting policies designed to alleviate pressing and immediate problems. The most important of these policies is to provide a firm basis for rapid economic growth. Other immediate problems such as Africanization of the economy, education, unemployment, welfare services, and provincial policies must be handled in ways that will not jeopardize growth. The only permanent solution to all of these problems rests on rapid growth. If growth is given up in order to reduce unemployment, a growing population will quickly demonstrate how false that policy is; if Africanization is undertaken at the expense of growth, our reward will be a falling standard of living; if free primary education is achieved by sacrificing growth, no jobs will be available for the school-leavers.

This, however, was written before the upsurge of concern for distributional questions which so marked the literature on development during the 1970s. Heightened sensitivity to this and a dawning suspicion that the growth-maximising strategy might not be working as well as had been hoped led the government to commission what has since become a well-known ILO report on employment, incomes and equality (ILO, 1972).

This report drew an apparently favourable public response from the government, and the strategy of 'redistribution with growth' recommended by the ILO had a clear influence on development plans published successively in 1974 and 1979. The actual reorientation of public policies and services in the directions required by the strategy inevitably lagged behind the public pronouncements, however, and while important changes have occurred it is fair to say that there remains more emphasis on overall growth and less on poverty alleviation than the planners intended.<sup>3</sup>

The attitude of the government towards stabilisation will be examined in detail later but, viewing the post-Independence period overall, fiscal and monetary policies have been generally cautious, even though they have not been used actively for short-run economic management. As will be shown, the budgetary situation was considerably improved during the 1960s and has remained generally sound since then. Only exceptionally has significant monetary expansion been caused by large-scale deficit financing. And while the government has proved reluctant to vary the exchange rate, it would be impossible to say that at any time the official rate was more than moderately out of line with a notional equilibrium or market rate.

This sketch draws attention to one of the interests of the Kenyan case. As a country with a record of political stability under a rather conservative government and with an essentially market-oriented economy, we might predict that there would be a natural congruence between the type of stabilisation programme favoured by the IMF and the preferences of the Kenya government. If successful stabilisation and good working relationships with the Fund are not feasible in Kenya, it is unclear where else in Africa they might be achieved.

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3. Papers by the present writer have examined this issue in some detail - see Killick, 1976; a detailed examination of the fourth development plan and joint essays with Kinyua and House, all in Killick 1981A. See also Stewart, 1976; and Hazlewood, 1979.

#### Economic performance prior to 1973-74

The national product delivered the growth that was sought by official policy after Independence and Kenya gradually built up a reputation as having one of the fastest-growing and most stable economies in Africa.<sup>4</sup> By and large, it was a well-merited reputation. The GDP grew in real terms at about 6½% p.a. in 1964-73 and, even though the population is among the fastest-growing in the world, per capita incomes rose by an average of about 30% in real terms over this period. However, large inequalities and continuing widespread poverty reduce the welfare significance of average income data; many have benefitted little from the growth, and income disparities within the African population have probably widened. But it is beyond question that large numbers of Kenyans today enjoy living standards which would have been impossible without a rapidly expanding economy.<sup>5</sup> One guarantee that the benefits of growth were not confined to a small urban elite was that, at least until recently, agriculture played a fairly full part in the growth process, with an increasing share of the output of this sector coming from smallholders. In 1964-73 value-added in agriculture expanded at 4.0% p.a. and the share of marketed output attributed to smallholders (almost certainly an understatement) rose from 41% to 51%.<sup>6</sup> Nevertheless, there was also considerable industrialisation, with manufacturing industry growing at 9.0% p.a. during the same period.

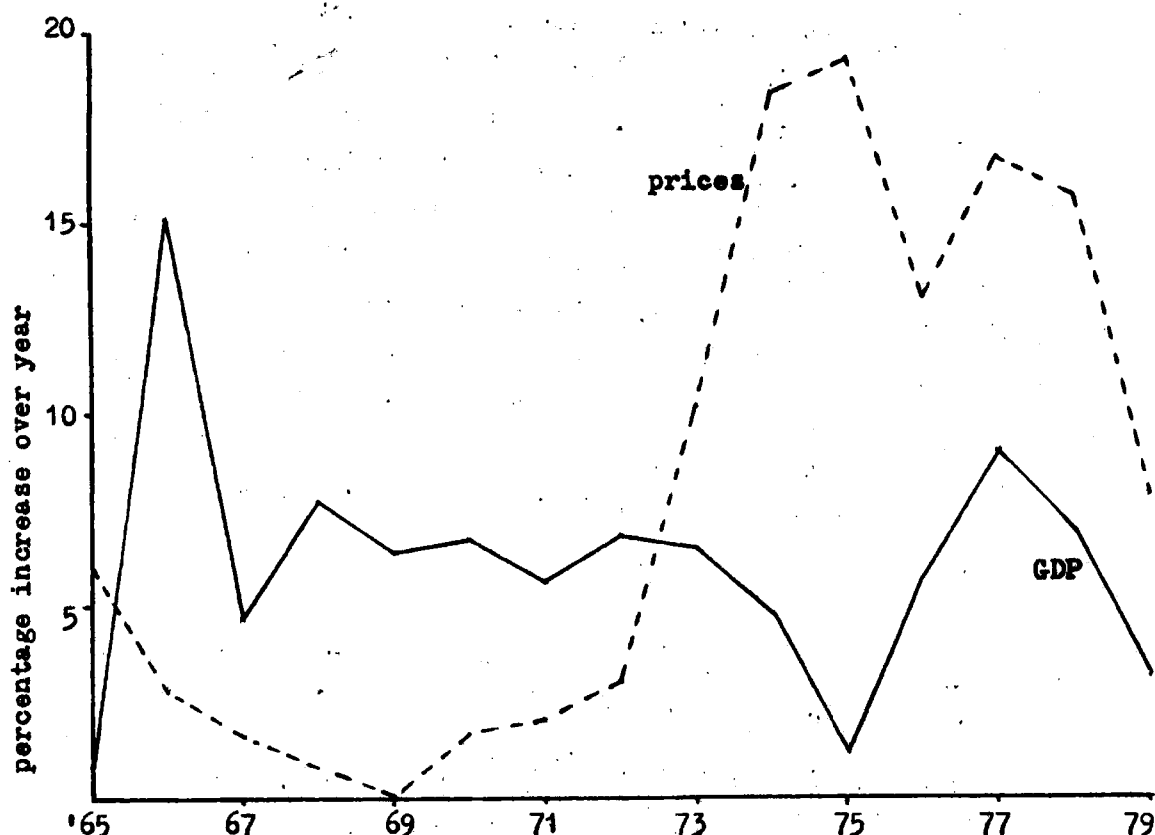
In another aspect, however, the structure remained unchanged - as a very open economy. In 1964 the trade ratio (exports plus imports of goods and non-factor services as a proportion of GDP) stood at 63.4%; in 1973 it was 66.2%; and in 1979 it was 66.7%. Throughout the post-Independence period coffee and tea have remained the dominant

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4. Killick, 1981A, provides an extensive introduction to Kenya's economic performance, problems and policies, with the first two chapters providing a general survey of post-Independence performance. Hazlewood, 1979, offers a concise general introduction to economic performance and policies.
  5. The distributional aspect of the country's economic record is examined in some detail in Part IV of Killick 1981A.
  6. Heyer et al, 1976, provide an excellent treatment of the development of the agricultural sector.

export commodities.<sup>7</sup> This heavy reliance on international trade and a few key export crops exposes the economy to exogenous shocks emanating from the outside world.

Given this and the still predominantly rural nature of the economy, it is remarkable that the economy grew in a steady fashion during most of the years under review. As can be seen from Figure 10-1, the annual growth rate fluctuated within the range of about 5½% to 7½% throughout 1968-73. Underlying

**Figure 10-1. Growth Rates of Constant-price GDP and Nairobi Lower-income Consumer Price Index, 1964-79**



7 See Ikiara, 1981, Tables 14 and 15. The 1979 ratio was calculated from Kenya, Economic Survey, 1980, Table 2.5. Strictly speaking, petroleum products are the second-most important export earner but this is misleading because it is based on the refining of imported crude oil.



the buoyant growth was an excellent saving and investment record. Starting from 14% in 1964, the gross investment ratio had risen to between 20% and 24% in the early 1970s. Moreover, the bulk of the investment was throughout financed by domestic saving: typically only about a tenth of gross investment was met by capital inflows from the rest of the world. And while there may have been some tendency for the marginal productivity of investment to decline<sup>8</sup> this was only gradual, and it must be rated as an achievement of the economic system that it facilitated productive investment decisions.

The absence of a foreign exchange constraint also contributed importantly to the growth of the economy.<sup>9</sup> Until 1974 deficits on the balance of payments current account were generally modest and little difficulty was encountered in meeting these with inflows of long-term capital. In fact, the basic balance showed a surplus in most years prior to 1974; and from 1966 (when national records of reserves were first compiled) until 1973 the official foreign exchange reserves increased during all except two years. At the end of 1973 reserves were equivalent to about 5 months imports; the exchange rate had been stable; with certain exceptions, exchange and import controls were either not restrictive or not enforced; and external debt servicing costs were equivalent in 1973 only to about 3% of that year's export earnings. That record was to change dramatically after 1973, however, as also was the growth of the economy.

The first decade of Independence was also remarkable for the virtual absence of inflation. Figure 10-1 also records the annual increase in the Nairobi lower-income index of consumer prices. As can be seen, it shows inflation rates of 0-3% throughout 1966-72 but much higher rates thereafter. The period 1966-72 was remarkable both for the absence of a steeper trend and for the year-to-year stability of the price index.

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8. See World Bank, 1975, pp. 93-94 and *passim*.

9. The most detailed examination of the balance of payments is provided in Maitha, Killick and Ikiara, 1978. See also Grubel and Ryan, 1979; and Killick, 1981D.

The performance of the fiscal and monetary systems had much to do with the absence of payments and price disequilibria. During the 1960s and into the early '70s the government was able simultaneously to greatly expand the services and capital formation undertaken by the central government while improving the budgetary balance and reducing dependence on foreign grants and loans.<sup>10</sup> From being heavily reliant on grants-in-aid from the UK in 1963, the budget was by 1973/4 showing a substantial surplus on current account and use of foreign grants and loans amounted only to 8.5% of total spending, against 20.4% in 1964/5. Throughout almost all this period the state made minimal use of bank borrowing. The financial system developed and expanded, with the real value of total domestic credit increasing two-and-a-half-fold in 1964-72 without, as we have shown, generating significant inflation.<sup>11</sup>

As is immediately apparent from Figure 10-1, and as will shortly be demonstrated for the balance of payments, this picture of stable expansion was radically altered from 1973-74. For present purposes the economic record becomes most interesting from 1973-74 and it is on this period that the remainder of this paper will concentrate.

#### Economic performance from 1973-74

While there had been a brief alarm in 1971 and some economists had begun to draw attention to underlying weaknesses, no-one could have forecast the abrupt deterioration in the balance of payments that occurred in 1974. The import bill shot up, the current deficit more than doubled to a record size and the basic balance moved from approximate equality into a deficit of K£41 million. Despite substantial use of IMF resources and other short-term borrowings, reserves were run down, so that by the end of 1974 they were equivalent to only 2.7 months of imports, compared with 5.1 months twelve months earlier.

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10. See Brough and Curtin, 1981, on this.

11. In 1968 prices, domestic credit went up from £37 mm in 1964 to £132 mm in 1972, a growth rate of nearly 16% p.a. (c.f. Killick, 1981E, table 4).

Key payments indicators are marshalled in Table 10-1, showing the worsening in 1973-74 but then a recovery in the following three years. By 1977 the current account was actually in surplus (for the first time in 12 years) and foreign exchange reserves were so large as to be an embarrassment to the government in its requests for continuing development aid. This did not last, however. There was a second dramatic deterioration during 1978 and a diminished but still large current deficit in the following year. A current account deficit of Kf250 million was forecast for 1980, with similarly bleak prospects for 1981. Exceptionally large inflows of capital in 1978-79 cushioned the impact on the basic and overall balances so that, surprisingly, reserves at end-1979 were actually in excess of the previous record level of 1977.

Table 10-1. Kenya: Selected Balance of Payments Indicators, 1970-79  
(Kf million)

	Balance on current a/c (1)	Net long-term capital inflows (2)	Basic balance (1+2) (3)	External reserves <sup>a</sup> (4)	External debt <sup>c</sup> (5)
1970	-17.5	30.9	+13.4	73.3	76.7
1971	-39.9	15.2	-24.7	51.8	75.7
1972	-24.3	30.6	+6.3	66.4	84.6
1973	-46.8	48.1	+1.3	76.3	105.3
1974	-112.0	71.0	-41.0	68.4	115.1
1975	-83.9	57.4	-26.5	70.6	146.3
1976	-51.9	90.7	+38.8	114.0	188.7
1977	+11.4	84.9	+96.3	208.6	209.3
1978	-252.5	163.4	-89.1	133.3	239.5
1979 <sup>b</sup>	-178.3	181.0	+2.7	234.5	255.9

Sources: Kenya, Economic Surveys and Statistical Abstracts.

Note:

- (a) Year-end figures. There is a break in the series between 1971 and 1972, so figures for those years are not strictly comparable.
- (b) Provisional.
- (c) Mid-year figures.

The inevitable price of increased dependence on capital receipts, of course, was an accelerated accumulation of external debt. The foreign-owned public debt rose from Kf115 mn in mid-1974 to Kf256 mn five years later (Table 10-1, col. 5), while the cost of servicing it rose from f8 mn to nearly Kf26 mn by 1979. This was still easily manageable because even in 1979 the ratio of debt servicing costs to exports was only 4.4%, but the trend of debt servicing costs was steeper than for export earnings and there were fears that Kenya could build up a genuine debt problem during the 1980s.

As can be seen from Figure 10-1, it was not only the payments situation which lost its relative tranquility in these years. During 1973 (ie, before the payments crisis) the inflation rate suddenly went up into double figures and stayed there for practically the remainder of the decade. There were, moreover, substantial oscillations about the 12-14% norm that established itself in 1973-79, by contrast with the relative absence of major fluctuations in 1964-72. Figure 10-1 also reveals a destabilisation of GDP growth after 1973. There was a major slump in 1974-75, a spectacular recovery in 1976-77 but then a further slowing-down in 1978-79. Taking 1973-79 as a whole, total GDP in constant prices expanded at a little over 5% p.a., as against 6½% in the earlier period. This was not too drastic a deterioration in the circumstances (although it meant that the growth of per capita income was at least halved); it was the great variability about the average which contrasted most strikingly with the preceding years. Ominously, perhaps, agriculture almost entirely ran out of steam in the years after 1973, averaging only a 1.0% p.a. growth to 1979. This sharply diminished the country's ability to feed itself and large food imports were necessary in 1979 and 1980.

So much, then, for this bald statement of the chief developments. We must turn now to look at them more analytically, to seek their causes, starting with the balance of payments.

## II - EXPLAINING THE BALANCE OF PAYMENTS EXPERIENCES

In seeking to explain the swings that have occurred in Kenya's payments situation it is convenient, if ultimately artificial, to isolate three types of explanation: (a) those which stress the influence of exogenous shocks; (b) those which emphasise the underlying fiscal and monetary forces; and (c) those focussing upon structural factors. It will also be useful to keep in mind some key year-to-year changes in various balance of payments magnitudes, summarised in Table 10-2.

Table 10-2. Year-to-year Changes in Kenya's Balance of Payments Magnitudes<sup>a</sup>

	(K£ mn)					
	<u>1973-74</u>	<u>1974-75</u>	<u>1975-76</u>	<u>1976-77</u>	<u>1977-78</u>	<u>1978-79<sup>b</sup></u>
Imports (cif)	-165.6	+23.8	-28.4	-139.9	-194.0	+58.3
Exports (fob)	+61.6	+6.3	+79.7	+155.9	-101.5	+13.8
Invisibles & transfers	+38.8	-2.0	-19.3	+47.3	+31.6	+2.3
TOTAL CURRENT ACCOUNT	-65.2	+28.1	+32.0	+63.3	-263.9	+74.4
Long-term capital	+22.9	-13.6	+33.3	-5.8	+78.5	+17.6
BASIC BALANCE	-42.3	+14.5	+65.3	+57.5	-185.4	+92.0
Foreign reserves	-7.9	+2.2	+43.4	+94.6	-75.3	+101.2

Sources: Kenya, Economic Surveys (various issues).

Notes: (a) The figures measure changes from one year to the next, with a minus sign indicating a change that worsens the balance of payments outcome and a plus sign indicating a change that improves it.

(b) Provisional.

### (a) Exogenous shocks

It was obviously no coincidence that 1974 was the year in which the current account plunged suddenly into a large deficit, for we have already shown in chapter 2 (Pt. III) that this was a year in which many oil-importing ldc's were thrust heavily into the red. Having no mineral oil of her own, Kenya depends entirely upon imports for her supplies so that the quadrupling of oil prices at the end of 1973

had a major impact. Prior to 1974 the country usually had an approximately zero balance in her trade in petroleum products, with the value added on crude oil which was imported, refined and sold to neighbouring countries roughly meeting the cost of the crude used within the domestic economy. In 1974, however, the petroleum products account swung into a K£35 mn deficit (against a deficit of only K£1 mn in the previous year), with an average deficit in the following three years of the same magnitude. In 1978 the deficit went up to K£47 mn, by 1979 it was K£69 mn and was expected to be yet bigger in 1980.<sup>12</sup> Given total export earnings in 1974 of K£218, such a large increase in net oil import costs could scarcely fail to have serious consequences.

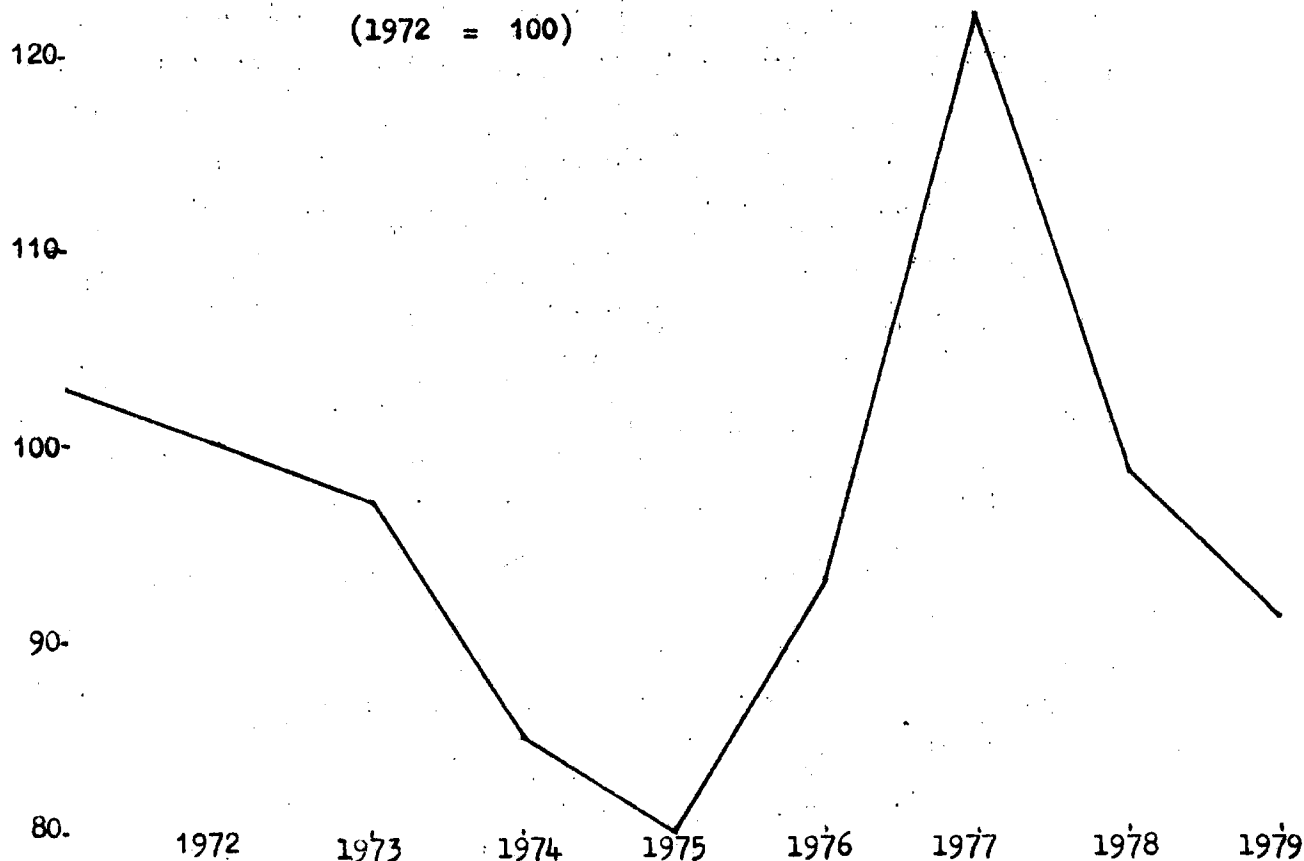
As is evident from the top left-hand entry in Table 10-2, however, the rising cost of oil could explain only part of the rise in the total import bill (indicated by a negative sign - see note (a) of the table). Associated with this, however, was an acceleration of the already rapid inflation in non-oil import prices, which rose by an average of 31% in 1974. Although there were also increases in the prices of some of the country's exports these were insufficient to prevent a massive deterioration in the commodity terms of trade, the index of which fell from 97 in 1973 to 85 a year later (see Figure 10-2). An admittedly rather crude quantification of the payments effects of changes in the terms of trade in 1973-74 has concluded that they explain a total of K£72 mn of the K£104 mn total deterioration in the balance of trade in that year, or more than the entire deterioration in the current account recorded in Table 10-2 (Killick 1981D, Table 5).

As can also be inferred from Figure 10-2, the terms of trade continued thereafter to exert a major influence. 1976 and 1977 were dominated by a quite unprecedented boom in the world prices of the country's two chief export commodities, coffee and tea. Following a severe frost in Brazil in July 1975 and difficulties in other producing countries, the world price of coffee escalated from

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12. These figures are calculated from Kenya, Economic Survey, 1980, Table 10.1 and similar tables in earlier Surveys.

Figure 10-2. Commodity Terms of Trade, 1971-79



an average of around 65 US cents per pound in 1973-74 to £142 in 1976 and £229 in 1977. These traumatic events spilled over into the tea market, where the price went up from £65 per pound in 1974-75 to £121 in 1976. With buoyant export volumes as well, the country's foreign export earnings rose dramatically in 1976 and 1977, as can be seen from Table 10-2, resulting in the major improvements on current account, basic balance and external reserves already observed from Table 10-1. An estimate of the payments impact of the higher export prices put the total gain in 1976-77 at K£264 mm (Killick, 1981D, p ). In 1978-80 export prices fell back to more normal levels and combined with further substantial rises in import prices to contribute to the worsening payments situation of those years, which was also aggravated in this case by adverse movements in the quantities of both imports and exports.

Not all the exogenous shocks came from the outside world, however. The vagaries of the weather also played their part. In particular, adverse conditions caused serious food deficiencies in 1980 in a

country which normally feeds itself. This added to the already rising trend in basic food imports, with another large food deficit predicted for 1981.<sup>13</sup> Changing weather conditions also contributed to the variability of export volumes in these years.

Clearly, then, Kenya's is an economy exceedingly vulnerable to destabilising influences beyond the control of its government. Note two points, however. First, there are swings as well as roundabouts: if Kenya was the loser from the inflation of oil and other import prices, she was massively the gainer from the coffee/tea boom. Second, while reference to the terms of trade provides a strong proximate explanation of trends in the balance of payments they by no means tell all the story. Indeed, monetarist analyses tend instead to attribute virtually all the problems to domestic policies so we proceed now to examine this line of explanation.

(b) Monetarist explanations

For the purposes of this volume, not the least interesting aspect of the Kenyan case is the existence of a serious literature placing a monetarist interpretation on payments trends. Although we are here mainly interested in developments from 1974, King's (1979) analysis of the 1967-73 period provides a natural starting point. He is concerned with the relative merits of Keynesian and monetarist models in explaining the macroeconomic behaviour of economies like Kenya's, concluding firmly in favour of the latter. He presents a 'financial flows' model which is a Polak model of the type reviewed in Chapter 3 and which he interprets as "open-economy monetarism" (p. 51).<sup>14</sup>

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13. African Economic Digest, 14 November 1980, quotes estimates of the cost of food import requirements in 1981 of equivalent to Kf44-73 mn, against about Kf15 mn in 1979.

14. By no means all economists would agree with this interpretation, however. Bolnick, 1975B, has shown close similarities between the Polak and Keynesian models. See also Newlyn, 1969; Drake, 1980; and Furness, 1975, who argues that the Polak model is an amalgam of simple monetarist and Keynesian models.



Symbolically, his financial flows model is summarised in the following five equations:

$$(1) \quad Y = A + \bar{X} - M$$

$$(2) \quad MO = kY$$

$$(3) \quad M = mY$$

$$(4) \quad \Delta MO = FR + \Delta \bar{DA}$$

$$(5) \quad \Delta FR = \bar{X} - M + \bar{F}$$

where

A	domestic absorption
M	imports of goods and services
X	exports of goods and services
Y	domestic output
F	net foreign capital receipts
FR	foreign reserve assets of the monetary system
DA	domestic assets of the monetary system
MO	the stock of money
k	income velocity of MO, assumed constant at the margin
m	marginal propensity to import, assumed constant

a bar over a variable shows it is assumed to be determined exogeneously.

Note here the conventional Polakian assumptions of constant values of  $k$  and  $m$ , with  $m$  (the propensity to import) as the only leakage out of the circular flow of income - implying that the marginal propensity to save and the income elasticity of the tax system are sufficiently near to zero that they can be disregarded without a crucial loss of realism. As is well known, the most important policy implication of this model is that, in equilibrium, changes in the value of the foreign exchange reserves ( $\Delta FR$ ) are inversely determined by changes in domestic credit ( $\Delta DA$ ), with a £1 increase in DA being associated with a £1 reduction in FR: "... in equilibrium, the balance of payments is determined by  $\Delta DA$  and nothing else" (King, p. 35). As he goes on to point out, however, an economy will not normally be in equilibrium and this readmits the influence of exports and capital flows upon the payments situation.

Applying the model to Kenyan data, King argues that it tracks the actual behaviour of the economy in 1967-73 quite well and that the relationships postulated in the model appear valid. The policy interest of his results is unfortunately limited by the fact that there was a relative absence of major disequilibria in his period. There was, however, a significant, if short-lived, loss of reserves in 1971 which King argues (pp. 80-81) to have been caused by a parallel increase in

domestic credit. Given the values derived in his model and a legal requirement for the Central Bank of Kenya to maintain foreign reserves equivalent to at least four months-worth of imports, he concludes (p. 99) that "the only safe rule for credit expansion to the Kenya government in the long run is that none should be undertaken. Any systematic infringement of this rule is bound to lead to balance of payments 'crises'". The focus is upon credit to government because that usually takes forms which add to the liquid asset base of the banking system and thus sustains the system's ability to lend to the private sector. He adds, however, that there would be scope for a 'safe' expansion in credit to the government to the extent that this was offset by reductions in private credit.

Before proceeding to examine analyses of the post-1973 period we can note that IMF staff members were also drawing attention to the strong connections between domestic credit and the balance of payments during the period analysed by King, and have continued to do so since. Their contention, however, is that in Kenya bank credit affects the payments situation essentially through a strong positive correlation between credit to and imports by the private sector, with most other payments items relatively independent of credit changes. The correlation is strong because much credit to private borrowers is to finance importing, with changes in lending having a particularly strong impact on inventory holdings. They derive the following demand function for private sector non-oil imports:<sup>15</sup>

$$IM = 12.78 + .067 CR + .214Y$$

$$R^2 = 0.99 \quad DW = 1.7$$

(where IM = private non-oil imports; CR = private commercial bank credit; Y = monetary GDP). An earlier IMF paper also noted that the payments crisis of 1971 was associated with a large upsurge in domestic credit.

Later work by Grubel and Ryan (1979 - hereafter G & R) is of even greater interest because it places an explicitly monetarist interpretation

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15. From an IMF paper of August 1980. The regression reported is the one which gave the highest  $R^2$  and is based on 1966-78 data. The results reported are after the regression had been re-run correcting for autocorrelation using the Cochran-Orcutt method. The significance of the results was much reduced, however, when 1979 data were included.

on payments trends up to 1978. While their work is clearly in the same tradition as King's and also focusses particularly on credit to the government, their model differs from his in isolating the domestic component of the high-powered money base as the key variable. They present a conventional demand function for money and a money supply function of the form:

$$MO = bH$$

(where MO is as before, b = a money multiplier and H = high-powered money, i.e. the reserve base of the monetary authority). For computational purposes, however, the money supply function was estimated in the form

$$MO = e^{at} H^{\beta}$$

where e is an exponential and a and  $\beta$  are constant growth rates. H in turn is given by the identity:

$$H = FR + D$$

(where FR is as before and D = the net domestic asset component of the high-powered money base of the monetary authority). Reading from the balance sheet of the Central Bank of Kenya, D appears to be made up of the following items (with values as at end-June 1980):

	<u>Kf million</u>
1. Securities issued or guaranteed by the government	42.4
2. Direct central bank advances to the government	10.0
3. Treasury bills	1.0
4. Advances and discounts	13.2
5. Uncleared effects	24.0
6. Other assets	4.7
<u>less</u>	
7. Government share of central bank profits	-23.3
8. Other liabilities and provisions	-8.6
9. Capital	-1.3
10. General reserve fund	-5.9
11. Revaluation account	<u>-11.1</u>
12. NET TOTAL (D)	<u>45.1</u>

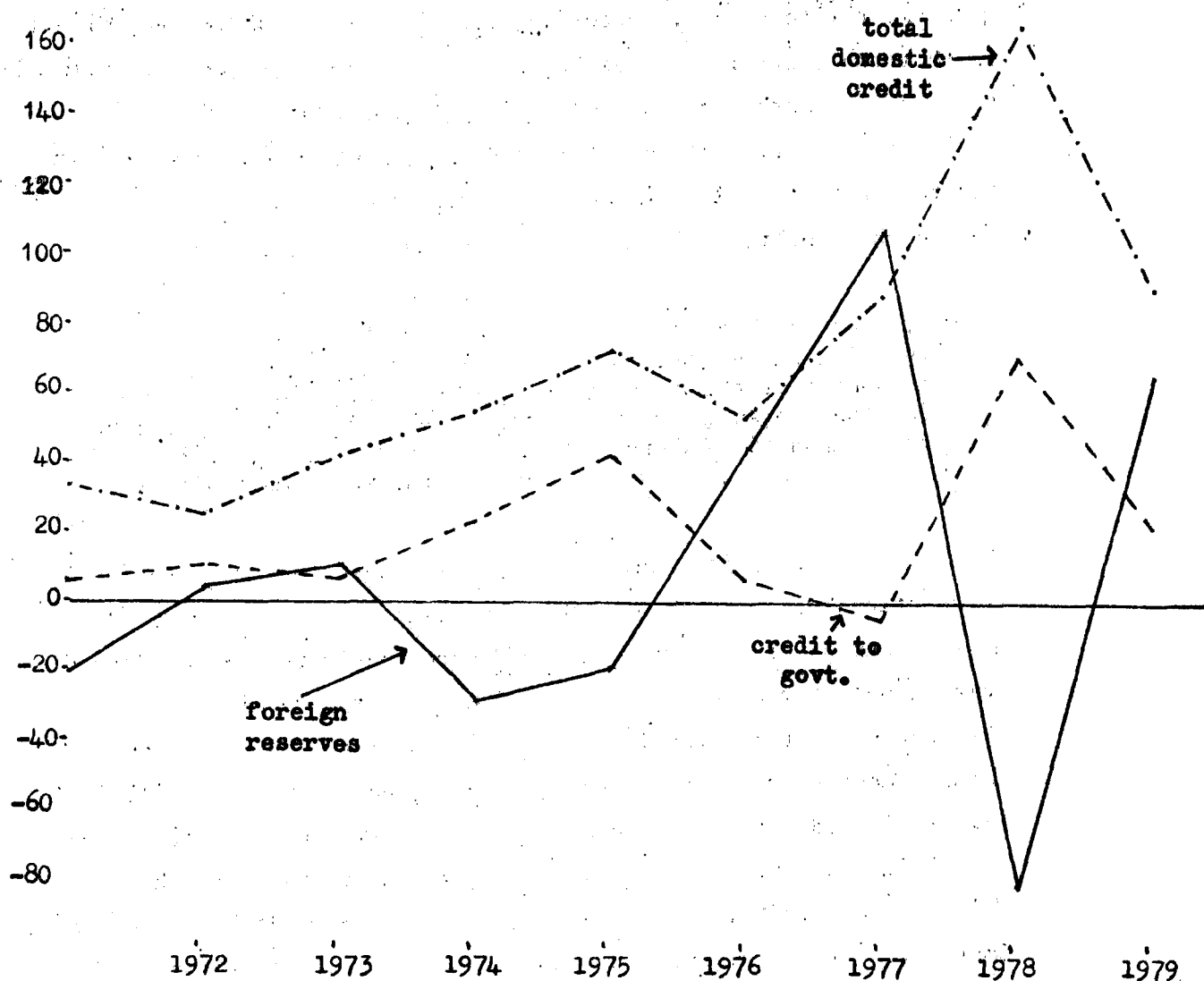
Clearly, D is not an operationally simple concept, although its most important components are all forms of central bank lending to the government (items 1-4). According to G & R (p. 23) "The crucial point" is that the central bank has D "under its deliberate control, primarily through open market operations" which determine its holdings of government paper. Solving their model mathematically, G & R obtain the result that  $\Delta FR$  is inversely related to  $\Delta D$ , which is very similar to the chief policy inference of the Polak model (p. 24):

... the weighted growth rate of reserves is a decreasing function of the weighted growth rate in the domestic component of the high-powered money base, after adjustment for the exogenous growth in the other variables influencing the transactions demand for money: real income, prices and interest rates, and for changes in the money multiplier.

Testing the model with Kenyan data, they obtain the predicted negative correlation between  $\Delta FR$  and  $\Delta D$ , significant at the 99% level despite a small number of observations (reference to Figure 10-3 also provides some support for a monetarist position, with the foreign assets of the banking system ('foreign reserves') inversely related to both total domestic credit and credit to government in most years). G & R find their model to be quite successful in tracking the actual behaviour of foreign exchange reserves and contrast their results with those of Maitha et al (1978). These they criticise as leaving "the overwhelming impression" that payments imbalances "are the result of very many forces beyond the control of policy makers" (p. 14), against G & R's conclusion that "Kenya's balance of payments has been determined primarily by the deliberate monetary policy actions of the Central Bank of Kenya" (p. 29).

Given the prime facie evidence presented earlier of powerful exogenous forces operating on balance of payments outcomes from 1974 onwards, a conclusion which "attributes most payments imbalances to influences fully under the control of government" (G & R, p. 14) is radical to the point of straining credulity. It is worth devoting some space to a critical evaluation of this, not least because of the apparent influence of monetarist explanations on the policy recommendations of the IMF.

**Figure 10-3. Year-to-year changes in monetary aggregates (KE mn)**



First, note how G&R (and also King) use 'changes in reserves' and 'changes in balance of payments' as synonymous. Comparison of line 7 with the other entries of Table 10-2 (page 10) reveals immediately that changes in reserves are an undependable indicator of changes on current account, with long- and short-term capital movements in some years dampening (1974, 1975, 1978) and in others magnifying (1976 and 1979) the impact of the current account on monetary account. If we accept the definition of a balance of payments equilibrium presented in chapter 2 (page 16), it is clear that it is inadequate for policy purposes to take changes in reserves as the sole (or even the chief) measure of the health of the payments situation, not least because the later 1970s saw a worryingly rapid increase in Kenya's external debt. It is better to study a range of indicators and there must be doubts about the policy

value of any analysis which takes a single-indicator view.

Second, it is evident from close examination of the results that G & R's analysis predicts best for 1968-72 and 1977-78, breaking down rather badly in 1973 and 1976 (see G & R, Fig 7). Had there been enough observations to confine the test to the period of major disequilibria, beginning 1974, it is not at all clear that it would have yielded statistically acceptable results. Their analysis, and also the predicted relationships in Figure 10-3, tend to break down in 1975, with a smaller volume of imports and a larger stock of reserves than would be predicted. Maitha et al (p. 10) explain the small volume of imports in terms of lagged price-elasticity responses to higher relative import prices, the income effects of the depressed state of the domestic economy, a once-for-all inventory adjustment and the effects of tightened import licence allocations.

This leads to a third line of criticism, that the rather exclusively monetarist interpretations placed by King and G & R on their results ignores the 'real' forces featured in their own models. It has for example, been argued that the Polak model is an amalgam of monetary and Keynesian theory; and in the model employed by G & R real income must be expected to have a strong influence on the demand for money, so that the performance of the export and import-substituting sectors will have an impact on how the economy reacts to a given monetary impulse. Insistence on a purely monetarist interpretation leads G & R apparently to dismiss the relevance of variables other than D in a way which is difficult to defend. For example, writing of the pre-1974 period Maitha et al (1978, p. 14) had drawn attention to an underlying tendency for the payments position to worsen because export volumes had been growing more slowly than the remainder of the economy. G & R criticised this, arguing that the payments position in this period "simply was due to excess growth in the money base" (p. 20). Does this mean that they regard export performance, and the structure of incentives underlying it, to be irrelevant? Surely not. Interestingly, although the exchange rate does not feature in G & R's model and their emphasis on the potency of D seems to leave no room for an active exchange rate policy, one of the authors was a well-known advocate of a devaluation in the late 1970s, which suggests that his views were not as purely monetarist as might be thought.<sup>16</sup>

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16. Herbert G. Grubel, 'Why the Kenyan shilling should be devalued'. Sunday Nation, Nairobi, 11 February 1979.

There are, in fact, difficulties about the policy inferences drawn by G & R. We have already shown (p. 16) that, in accounting terms, their variable D is complex and includes items ('uncleared effects' 'revaluation account', 'other' assets and liabilities, etc) which probably could not be easily manipulated for the purposes of short-run economic management. It is true that central bank credit to the government is the most important ingredient of D and this does appear to be a magnitude that could be manipulated. Bolnick (1975A) has argued, however, that the magnitude of deficit financing is determined by the Treasury and is not under the control of the monetary authority. Of course, this leaves open the possibility that the Treasury, working with the central bank, could vary its own deficit financing as a way of managing the balance of payments, but we show later that there are formidable difficulties in the way of doing this (Table 10-6). In any case, G & R reject Bolnick's view. They suggest (p. 23) that, even though deficit financing may be beyond its direct control, the central bank could regulate its holdings of government paper "primarily through open market operations..." To this one must ask, what open market? To the extent that there exists in Nairobi any non-bank market for government paper<sup>it</sup> is extremely slender. An active policy of market intervention by the central bank (which has never yet been attempted), buying and selling large values of securities so as to maintain a desired level of D, would be liable to have wildly destabilising effects on interest rates and would probably be quite unfeasible.

But while the monetarist interpretations are open to criticism they nevertheless do contribute importantly to an understanding of Kenya's payments problems. The models are right to stress the constraints imposed by the balance of payments in an economy like Kenya's on the speed of credit expansion. They are right too in drawing particular attention to credit to the government (deficit financing) for this normally takes forms which maintain or augment the high-powered money base and hence the banks' ability simultaneously to lend to the private sector.

King has successfully demonstrated the influence of credit expansion on the reserve crisis of 1971 and there were later years in the 1970s when the monetary factor was strongly in evidence. This was most obviously the case in the commodity boom period of 1976-77. In terms of economic management, there was an overwhelming case for preventing <sup>some</sup> of the windfall gains created by the extraordinarily high world coffee and tea prices from accruing to the farmers. These were purely fortuitous profits, in no sense a return on past investments, and they were large in relation to total domestic demand. Alone among the major coffee producing countries, Kenya did not tax coffee revenues, either directly or through a marketing board arrangement (Davis, 1980, Table 4). The obvious response, therefore, was to introduce a tax to cream off much of the windfall, putting the proceeds into a stabilisation fund which could be used to support the farmers in leaner times (but not using the proceeds to finance an equivalent increase in government spending!). The central bank proposed such a measure and IMF staff also urged the desirability of action along these lines but the government effectively vetoed this and decided that the gains should go to the farmers. The word 'effectively' is used here because the government did introduce a nominal export tax in the 1977 budget but this was (a) too late and (b) designed to leave most of the gains in the hands of the farmers and raised only derisory revenues.<sup>17</sup> It was, in fact, a personal decision of the late President Kenyatta that virtually all proceeds should be passed on to the farmers; Finance Minister Kibaki was faced with important party elections at the time and was content to go along with that decision.

This decision led directly to the unsustainable upsurge in imports of 1977-78 revealed in Table 10-2 and fathered the payments crisis of 1978. While it is true that the government did not increase its own bank borrowing in this period, it actually took measures to stimulate the expansion of bank credit to the private sector in 1977, instead of raising banks' reserve ratios to minimise the impact of the swollen incomes of the coffee and tea farmers on aggregate demand. Thus,

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17. In the 1977/78 and 1978/79 fiscal years revenue from this tax amounted to just K£10.8 million, against export proceeds from these crops in 1977-78 of K£464.2 million. It is only fair to add, though, that governments in other coffee producing countries also failed to resist the temptation of windfall gains. While they typically creamed off far more of the gains through formal or informal export taxation they also typically used it to finance a burst of government spending - see Davis, 1980 and also Struckmeyer, 1977.



between end-1976 and end-1978, while the foreign assets of the banking system went up by nearly half, total domestic credit was also allowed to rise by 67%. Lacking experience in such matters and caught off-balance by the speed and size of the world price rises, the government during this period neglected the basic tenets of economic management and compounded the difficulties emanating from the world economy.

Monetarist writers are correct to draw attention to the importance of such factors. But they overstate their case and present their conclusions as if acceptance of the importance of monetary variables renders all other considerations irrelevant, other than as temporary disturbances. To obtain a rounded view of the determinants of Kenya's payments situation it is also necessary to draw attention to some features of her economic structure.

(c) The influence of structure

While we have chosen to concentrate largely on the period of most acute difficulties, beginning 1974, even before then there were signs of a gradual deterioration. The World Bank (1975) drew attention to these and made projections showing a large and probably unsustainable financing gap for the second half of the 1970s. Underlying this trend was the indifferent performance of the export sector. While the total value of exports tended to rise more rapidly for Kenya than for ldc's as a whole, this was entirely due to favourable prices and the volume of exports scarcely grew at all (Ibrahim, 1980). The official index of export volumes stood in 1979 at 115 with 1970 = 100, which implies an annual growth of 1.5% and may be compared with the 4.6% growth rate of GDP over the same period. The export sector hence contributed a diminishing share of total GDP during the 1970s.

Similarly little success was achieved with the long-standing government policy of export diversification. Since the oil refinery came on stream in the mid-1960s there has been no major addition to the country's exports and Ikiara (1981, Table 14) has shown that an index of export concentration has shown no sign of declining since Independence and may have been rising.

We should also pay attention to the performance of the agricultural and industrial sectors as they also have a potent influence on the longer-term payments situation. In fact, the ability of agriculture to participate rather fully in overall growth during the first decade or so of Independence meant that Kenya, unlike several of her neighbours, had little normal need to import staple foodstuffs and, indeed, was usually a net exporter (Maitha et al, 1978, p. 3). Since 1974, however, agriculture has been growing only slowly and food imports have assumed increasing importance. To a considerable extent (especially in 1974-75 and 1979-80), this deterioration was caused by adverse weather and it is thus difficult to say whether the slowing-down of this period reflects a secular trend.

The industrialisation that has occurred since Independence has also influenced the payments situation. It has reduced Kenya's dependence on imported consumer goods (Hazlewood, 1979, pp. 71-76) although many of these import-substituting industries are themselves heavily reliant upon imported inputs and capital equipment - a reliance that may even be growing over time (Ikiara, 1981, Table 7). While a significant part of total exports is of manufactures and a good deal of industrial output is exported, the statistics on this are dominated, perhaps distorted, by sales of an oil refinery which processes imported crude and generates only modest local value-added. If petroleum products are excluded, a little under 8% of total manufacturing output was exported in 1979.<sup>18</sup> To some extent, this small proportion was caused by the collapse of the East African Community in 1977 and Tanzania's closure of her frontier with Kenya, but analysts have pointed to the dangers of inefficiency created by the often generous provision of protection from competing imports and have expressed doubts, therefore, about the international competitive potential of the country's manufacturing industries (Hopcraft, 1972). Underlying these aspects of productive performance, of course, is a structure of incentives. The sluggish export performance suggests that the relative rigidity of the exchange rate has not been sufficiently compensated by export subsidies. Agricultural performance has been affected by the generally adverse trend in the domestic terms of trade between the agricultural and non-agricultural sectors and by the large-scale outflow of investible resources from the former to the latter (Sharpley, 1981). Industrial efficiency has been particularly affected by the excesses and arbitrariness of the system of protection (Wescott, 1981).

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18. Computed from Kenya, Economic Survey, 1980 and Statistical Abstract, 1979.

But while it is clear that the structural factors just summarised cannot fail to influence the balance of payments they have probably played a minor role in the wild swings that have occurred since 1974. Structure helps us understand the underlying trend but not the fluctuations, which have been dominated by the exogenous and monetary factors already surveyed.

### III - EXPLAINING DOMESTIC DISEQUILIBRIA

As was shown in Part I, there was a destabilisation of domestic activity from about 1973 so we turn now to examine the causes of this. While concentrating largely on the inflation of this period, we commence with a summary examination of the sources of fluctuations in the growth of GDP.

#### Fluctuations in the growth of GDP

Under this heading, the greatest interest centres on the slump of 1974-75 (when the growth rate fell to about 2½% p.a., implying a decline in per capita income) and the rather remarkable recovery of 1976-78 (when growth rate averaged nearly 7% p.a.). There was another downturn in 1979 but this appears to have been largely the result of the impact of adverse weather on agricultural production, with non-agricultural GDP expanding by 5.3%, and is of less interest for present purposes. These events have already been analysed by Maitha et al (1978, pp. 31-34), with the present writer as one of the authors, and it may therefore suffice to summarise their main conclusions, modified in the light of more recent information. They suggest that:

- (a) The 1974-75 slump was partly the time-lagged effect of greatly increased import surpluses, which absorbed a large amount of domestic demand.

b/...

- (b) This was reinforced by the monetary effects of the deterioration in the balance of payments, with an expansion in domestic credit being substantially offset by losses in the foreign assets of the banking system, resulting in an expansion of money supply well below the expansion of current-price monetary GDP in both these years.
- (c) These depressants originating in the world economy coincided with drought conditions at home. This seriously held back the expansion of agriculture, independently of the slump in the remainder of the economy.
- (d) The recovery of 1976-78 was also much affected by trends on the world economy, in particular the boom in world coffee and tea prices. As we have already seen, the export boom much improved the balance of payments on current account, although a very large deficit reappeared in 1978. The improvements of 1976-77 reduced the deflationary drag exerted by the former import surpluses and, with domestic credit still expanding, was associated with a rapid monetary expansion which, despite its negative effects, did release the economy from any monetary constraint that may have existed.
- (e) These sources of recovery were reinforced in 1976-77 by renewed agricultural expansion, largely in response to better rainfall.

The fluctuations of these years are thus seen as resulting from a combination of the income and monetary effects of external world forces, combined with domestic credit policies and the random effects of changing weather conditions.

The sources of inflation: (a) imported inflation

As was shown in Figure 10-1, consumer prices, after a long period of relative stability, moved abruptly into double-figure inflation during 1973 and remained there for virtually all the remainder of the decade. While not denying the presence of domestic factors, the government has consistently emphasised rising import prices as the chief cause of inflation, so we may begin by examining the likely impact of this factor. Here again we build upon the methodology employed in Maitha et al (1978, p. 37).

In seeking to establish the impact of import prices on the lower-income consumer price index the key fact is that this index has a small import content. Use of the inverted matrix of an input-output table for Kenya in 1971 yields the result that the weight of direct and indirect imports in this index is only 0.14. Multiplying the official index of import prices by this coefficient gives an approximate estimate of the contribution of rising import prices to general inflation, summarised in Table 10-3. Not surprisingly, 1974-75 emerges as the period in which imports had the strongest effect, although even then they accounted for only a little over a quarter of the total. In several years of rather rapid inflation (1976-78) the influence of rising import prices was only minor, implying that we must look to other factors as our chief explanatory variables.

It could reasonably be objected that calculations of this kind greatly underestimate the influence of imports by neglecting the dynamic forces at work. If there were a strong propagation mechanism, for example trade unions and other pressure groups powerful enough to protect their members from the effects of higher import prices by securing larger incomes in compensation, the initial impulse from the outside world would be magnified and could lead to a self-sustaining inflation. There is little evidence of any such process in Kenya at this time, however. Partly as an anti-inflationary device and partly to create new employment, the government embarked upon a policy of wage restraint which was so effective that the real value of average wage-earnings was cut by 8% in 1973-75, the period in which import prices were rising most rapidly (Killick, 1981E, Fig. 1).

Even in 1979 real earnings were still nearly 7% below the 1973 level. If there was a propagation mechanism at work in Kenya it certainly was not operating through the labour market.

Table 10-3: Contribution of Import Prices to Consumer Price Inflation in Kenya, 1973-79

	Increase in CPI (%) <sup>a</sup>	Increase in import prices, lagged (%) <sup>b</sup>	col.(2) multiplied by .14	col.(3) as % of col.(1)
	(1)	(2)	(3)	(4)
1973	10.2	15.7	2.2	22
1974	18.4	34.3	4.8	26
1975	19.3	36.6	5.1	27
1976	13.0	15.9	2.2	17
1977	16.7	11.8	1.7	10
1978	15.7	6.7	0.9	6
1979	7.9	10.8	1.5	19

Sources: Kenya, Economic Surveys and Statistical Abstracts

Notes: (a) Changes in Nairobi lower-income consumer price index, calculated from averages of quarterly data.  
(b) Lagged by approximately six months by taking the mean value of the import price index in the current and previous years.

The obvious alternative is to explore the behaviour of monetary variables. Indeed, a thorough-going monetarist would deny the legitimacy of the exercise illustrated in Table 10-3 on the grounds that higher import prices would be compensated by falls in other prices if the supply of money were restricted to a sufficient extent. Even if we reject this on the grounds that prices are sticky downwards and that so restrictive a policy was neither feasible nor desirable, it is still worth investigating whether the large residual of inflation not directly explained by import prices was caused by excessive monetary expansion at home.

The sources of inflation: (b) monetary factors

First, there is the question of how a monetary explanation of the inflation might be reconciled with the monetarist interpretations of the balance of payments discussed earlier. According to the monetary theory of the balance of payments, excess money balances result in additional imports rather than higher domestic prices. An increase in domestic credit (or in the high-powered money base) is expected to lead to corresponding reductions in foreign reserves, leaving total money supply at approximately its trend value. This is the rationale for concentrating on domestic credit, rather than total money supply, as the key policy variable for the management of the balance of payments. In practice, however, imported goods are only imperfect substitutes for locally-produced goods and services, so that unwanted money balances are likely to operate jointly on the volume of imports and domestic prices. Moreover, while the Kenyan experience has shown a clear inverse relationship between changes in reserves and domestic credit (or the domestic component of the money base), this has not been of a one-for-one nature. In all years in which foreign assets diminished, domestic credit rose by a considerably larger amount and in some of the years in which foreign assets increased, domestic credit increased too, leading to large increases in money supply. It is therefore appropriate to investigate the behaviour of the money supply in our attempts to explain the inflation of those years.

Table 10-4 summarises data on the growth of GDP and money supply during the period under investigation. In addition to the direct influence of import prices, we hypothesise that the rate of inflation will be inversely related to the real growth of the economy<sup>19</sup> and positively related to the growth of money supply (which is lagged six months in Table 10-4). We thus expect inflation to be greatest when the expansion of money supply much exceeds the real growth of GDP. Column 5 of the table shows there to have been particularly large excess increases in money supply in 1973, 1976 and 1977, with substantial excesses also in 1974 and 1978. 1973 was the year in which inflation first emerged as a problem, which this evidence suggests was initiated by a combination of excess money creation (Table 10-4) and the

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19. There is much evidence from other countries for such an inverse relation, as shown in chapter 2, page .

influence of rising import prices (Table 10-3).<sup>20</sup> The influence of import prices was also apparent in 1974 but the further rapid expansion in money supply was probably the major source of the continuing inflation. In 1975, however, the increase in money supply was much more moderate but proportionately less demand was absorbed by imports and this plus the impact of import prices prevented inflation from falling. The years 1976-78 are those in which the monetary expansion was at its peak and they were also years of further rapid price rises. However, in 1977-78 a substantial part of the inflationary potential of the excess money creation was absorbed by the balance of payments, as was seen earlier, with Table 10-2 recording massive increases in the import bill in both years. A moderation in monetary expansion during 1979 was accompanied by slowing inflation despite a reduced import bill.

Table 10-4: Increases in GDP, Consumer Prices and Money Supply  
in Kenya - 1973-79

	(% increase over previous year)				
	constant price GDP (1)	current price GDP (2)	consumer price index (3)	money supply, col.4 minus lagged <sup>a</sup> (4)	col.1 (5)
1973	6.5	16.0	10.2	25.5	19.0
1974	4.8	20.4	18.4	16.2	11.4
1975	1.2	11.6	19.3	6.4	5.2
1976	5.7	23.1	13.0	22.3	16.7
1977	9.0	28.4	16.7	47.4	38.4
1978	6.9	9.0	15.7	19.0	12.1
1979	3.1	10.4	7.9	11.1	8.0

Sources: Kenya, Economic Surveys and Statistical Abstracts: Central Bank of Kenya, Economic and Financial Review.

Note: (a) Lagged by six months, e.g. 1973 entry refers to increase between June 1972 and June 1973

20. The 10.2% inflation recorded for 1973 in Table 10-4, which is based on comparisons of averaged quarterly data disguises the accelerations which occurred during that year. On a December-to-December basis, the inflation rate was 16.0%.



We saw earlier that G & R's monetary analysis of the balance of payments placed heavy emphasis on domestic sources of monetary expansion, especially credit to the government, so we should enquire into the sources of the monetary growth recorded in Table 10-4. In fact, during the three years of the most rapid money creation (1973, 1976 and 1977) the foreign assets of the banking system increased, so the balance of payments added an important monetary impulse of its own. This was particularly the case, of course, during the coffee/tea boom. But this does not mean that domestic credit was blameless. From 1974 onwards there were major increases in domestic credit. There was a case for credit expansion in 1974-75 to offset the deflationary influences then in operation, and in September 1974 an IMF report expressed concern that credit policies had become too restrictive. During 1976-77, however, there was no attempt to cut back on credit in a counter-cyclical manner to offset the monetary effects of the commodity boom. In 1978 a monetary contraction emanating from reductions in international reserves was swamped by a very large rise in domestic credit.

As can be seen from Table 10-5, two-thirds of the total increase in domestic credit went to the private sector and only a little over a quarter of it was borrowed by the central government. Only in the 1974/75 and 1978/79 fiscal years were there large amounts of deficit financing. On the other hand, the statistics in Table 10-5 do tend to understate the importance of government borrowing because, unlike that of the private sector, much of it took forms which added to the reserve assets of the banking system and thus had a potential money-multiplier effect. This was most obviously so with borrowings from the central bank but the indications are that well over half of borrowings from the commercial banks took the form of sales to them of Treasury Bills which are included among the banks' liquid assets when calculating their reserve ratios.<sup>21</sup> Even so, it would clearly be easy to exaggerate the contribution of deficit financing to the monetary expansion of these years.

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21. The ratio of liquid assets to liabilities is the operative control ratio in Kenya's banking system, not the cash ratio, and Treasury Bills are the chief domestic liquid asset. The 1980 Annual Report of the Central Bank of Kenya (Table 7, p. 18) indicates a net increase in liquid claims on government by the commercial banks of KSh42.5 mm in the 1973/74 to 1979/80 period, which may (approximately) be compared with the entry of KSh64.43 mm in Table 10-5.

Table 10-5: Composition of Increases in Domestic Bank Credit  
in Kenya, 1973-79

(K£ million)

Borrowers	Amount of credit as at:		Increase over
	end-1973	end-1979	period
1. Central government (net) of which:	23.90	156.13	132.23
(a) from central bank	(-4.80)	(63.00)	(67.80)
(b) from commercial banks	(28.70)	(93.13)	(64.43)
2. Other public sector <sup>a</sup>	18.77	46.92	28.15
3. Private sector <sup>a</sup>	150.23	488.72	338.49
4. TOTALS	192.90	691.77	498.87

Source: Central Bank of Kenya, Annual Report, 1980.

Note: (a) The system of classification employed by the central bank in fact includes some public sector borrowing in the statistics for the private sector.

The sources of inflation: (c) structural factors

For the sake of completeness, a word should be said about the influence of the productive structure on the inflationary process. The chief influence of this has, in fact, already been discussed under the heading of imported inflation. Had it been less open and less reliant upon imported energy it is no doubt true that the economy would have been less vulnerable to the effects of world inflation. On the other hand, it was shown in chapter 2 that there is nothing intrinsically inflationary about trade dependence and this is supported by the absence of significant inflation in Kenya prior to 1973.

More generally, it can be said of the productive structure that during the 1960s and into the 1970s it demonstrated an impressive ability to combine rapid and sustained economic growth with price stability. Leaving aside the element of imported inflation, it would be implausible to hold that the sudden emergence of an inflationary problem in 1973 could be explained by the nature of the productive structure, for that changes only slowly. The relatively good agricultural performance of the first decade after Independence was a major factor in the stability of the earlier years. Even since 1974, when agriculture has grown more slowly, food prices have not set the inflationary pace for more than brief periods; with December 1972 = 100, the food price component of the Nairobi lower-income consumer price index stood at 264 in June 1980, against 269 for all items taken together.

#### Conclusions on domestic disequilibria

As in the earlier analysis of the balance of payments, the foregoing implicitly rejects the idea that Kenya's domestic disequilibria can be satisfactorily explained by any single cause. The income and monetary effects of the outside world and trends in domestic credit creation have emerged as important explanatory variables, as was also the case with the balance of payments. The vagaries of the weather and other more temporary factors also played their part from time to time. To those who are tempted, as the government is, to blame most of the problems on the outside world, we have shown that government deficit financing and large increases in credit to the private sector were almost certainly of greater importance in the inflation of 1973-78. But to those who might take a strict monetarist line and argue that the influence of imported inflation, as well as the more domestic factors, could have been neutralised by a more effective monetary policy, we would reply that fiscal and monetary policies so severely deflationary as to offset completely the effect of rising import prices would have imposed economic costs larger than the costs of the inflation itself. It is thus unlikely that such a policy would have been politically feasible. Partly for reasons to be provided shortly, there would also have been formidable technical difficulties in the way of effective monetary action. Nevertheless, policies certainly could have been improved. The mishandling of the 1976-77 commodity boom, in particular, revealed serious weaknesses in the management of both the balance of payments and inflation.

#### IV - THE POSSIBILITIES OF SHORT-TERM ECONOMIC MANAGEMENT

##### Government attitudes to stabilisation

The criticism of the last sentence may be misplaced, however, in its implicit assumption that stabilisation was among the government's prime objectives. In fact, if we attend to actions rather than public statements it is not at all clear that the government gave much priority to short-term economic management during the 1970s. One could interpret the post-1973 period as revealing a failure to come to terms with the new policy challenges posed by the emergence of financial constraints.

It is useful in this context to draw a distinction between fiscal and monetary policies which are conservative in their general thrust and policies of active economic management. King (1979, pp. 60-62) has shown, for example, that the Finance Minister during 1962-69, James Gichuru, pursued conservative policies designed to reduce the government's dependence on outside budgetary support, which involved tight restraints on the spending ministries and substantial increases in taxation, but that the corollary of these policies was that "aggregate fiscal policy could not be and was not used for short term stabilisation measures" (p. 62). In 1969 Gichuru gave way as Finance Minister to Mwai Kibaki, who has held the post ever since (also becoming Vice-President in 1979). Kibaki proved more expansionist and King (pp. 65-67) is critical of the 1971 budget as causing the foreign exchange crisis of that year by opting for expansion when reserves were already falling, prices had begun to rise, domestic credit was already expanding fast and there was little Keynesian-type excess capacity in the economy. The adverse consequences of this led to more cautious budgets in 1972-74, giving greater emphasis to control over government expenditure. During this period the Treasury widened the tax base and, despite the increasing difficulty of controlling the spending ministries (resulting in substantial over-runs against budget estimates), it made only modest use of borrowing from the banking system.

The first half of 1975 saw a potentially important landmark in the history of economic management with the publication of Sessional Paper No. 4 of 1975: On Economic Prospects and Policies. This was issued in response to the worsened world economic climate that had emerged with the oil crisis and attempted to state how the government intended to adjust. It could be described as the first serious public attempt to reconcile the objectives of long-run development and short-term stability, and contained explicit recognition of the desirability of using fiscal policy as an instrument of stabilisation. Unfortunately, in this as in other respects, the implementation of the admirable policies set out in that document left much to be desired.<sup>22</sup> The budget of 1975, announced a few months after the issuance of the sessional paper was sensible but by the 1976/77 fiscal year the beneficial effects of the coffee/tea boom were already large and the Treasury chose to exceed the credit ceilings agreed with the IMF, forfeiting access to the extended facility credit that had been negotiated in the previous year, in favour of a more expansionary budget. The result was a record budget deficit on current account, although other forms of borrowing limited the government's recourse to the banking system.

If the 1976 budget gave forewarning that the government was not serious in its statements about the use of fiscal policy for stabilisation the next one proved the point to the hilt. When it was obviously only a matter of time before world coffee and tea prices fell back to more normal levels, when the turnaround in the balance of payments was already leading to large increases in the domestic money supply and when the economy was already awash with the spending power resulting from the export boom (which the government refused to tax), the 1977 budget opted for large increases in government spending and a record amount of deficit financing.<sup>23</sup> The 1978 and 1979 budgets

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22. See Killick 1981D for a brief general evaluation of the implementation of the sessional paper; also Killick, 1980, pp. 41-42.

23. In a newspaper article at the time of the budget the present writer criticised it as ill-advised, based on a mis-reading of the economic situation and adding fuel to an already over-heated situation, cf. Tony Killick, 'Kenya's budget: expansion or inflation', Sunday Nation, Nairobi, 19 June 1977. In the event, an unforeseen upsurge in tax revenues resulted in a much improved budgetary out-turn, but what is most relevant for present purposes is that in its fiscal planning the government should favour what they intended as an expansionary budget in circumstances where short-run management clearly indicated the desirability of moderation.

were more moderate but both could be - and were - criticised for accurately identifying the re-emergence of a balance of payments problem without proposing any solutions.<sup>24</sup> The new development plan issued in 1979 was criticised on the same grounds.<sup>25</sup>

In short, if the government was ever serious about the importance of stabilisation it abandoned this priority as soon as the commodity boom allowed it off the hook. In the first half of 1980 a new sessional paper was issued (Kenya, 1980) for purposes exactly analogous to the 1975 paper. Like its predecessor, it included a strong assertion of the need for effective stabilisation, for measures to adjust the domestic economy in the face of a payments constraint, and other sensible things. Moreover, the 1980 budget made a good beginning with implementing those policies, including a rationalisation of industrial protection and a strengthening of the export subsidy scheme.<sup>26</sup> But it remains an open question whether the commitment to stabilisation will prove more enduring in the 1980s than it did in the 1970s.

Effective stabilisation would necessitate a far more active monetary policy than has hitherto been pursued. We have seen already how the authorities failed to manipulate domestic credit to safeguard the balance of payments and avoid inflationary money creation. Despite routine public statements about the importance of using fiscal and monetary measures for economic management, there is little such tradition within the Treasury and the central bank.<sup>27</sup> The central bank has consistently adhered to an objective of 'maintaining the integrity of the Kenya shilling', which it has interpreted primarily as entailing a stable exchange rate but not, curiously, as entailing the manipulation of credit as a safeguard against domestic inflation. Particularly in response to prodding by the World Bank, there is a statement in the 1980 sessional paper about the desirability of using interest rates more actively as an instrument of stabilisation but this remains a proposal to which the leadership of the central bank remains resolutely opposed and it is not at all clear that changes in the rate structure will be more than marginal.

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24. On these budgets see articles by Killick in the Sunday Nation, Nairobi, 18 June 1978 and 17 June 1979.

25. Killick, 1981B, strongly criticises the plan for the weakness of its balance of payments policies, especially its silence on exchange rate policy and its failure to offer adequate incentives for improved export performance.

26. See Rupley and Funucane, 1980, for a detailed examination of the 1980 budget.

27. Brough and Curtin, 1981, are highly critical of the ineffectiveness of monetary policy, in an essay that generally takes a positive view of government policies.

Effective stabilisation would arguably also require more flexibility on the use of the exchange rate as a policy instrument. During the years under review there was only one devaluation - by 14½% in October 1975 - undertaken in collaboration with the Ugandan and Tanzanian governments (the three currencies were at that time fixed at par with each other as part of the East African Community arrangements) at the prompting of the IMF.<sup>28</sup> Thereafter, by word and deed, the government set its face against the overt use of the exchange rate, although it tacitly admitted the existence of over-valuation by fiscal measures - an import duty surcharge, an export subsidy, etc - which have the effects of partial devaluations. The logic of the strategy set forth in the 1980 Sessional Paper pointed to a devaluation and while in 1979-80 the government explicitly declined to employ this policy instrument, there was a surprise, although small (5%), devaluation in February 1981.

It is important to keep these policy weaknesses in perspective, however. For example, while there has been a case for currency depreciation, the official rate of exchange has not been allowed to move hugely out of line with a notional 'equilibrium' rate, as has occurred in other ldfs. Similarly, while the budget has not been used effectively as an instrument of short-run management in other respects the fiscal record has been good.<sup>29</sup> While there has been a massive increase in state spending since Independence, current revenues have generally kept pace and in almost all years (including the most recent) have financed 75-80% of total spending. Budgetary reliance on external grants and loans is much below the immediate post-independence situation and in recent years has generally fluctuated around 10% of total spending (although this went up to an average of 15% in the 1978/79-1979/80 fiscal years). As already shown, large-scale financing of deficits by bank borrowing has been confined to a few years (mainly the mid-1970s and 1978/79). International comparisons of tax effort among ldfs show Kenya with an above-average and improving record,<sup>30</sup> and another comparison shows the overall budgetary deficit to have been better in recent years than the African average.<sup>31</sup> Kenya could not be accused of the fiscal irresponsibility which has marked some other countries.

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28. See Maitha et al, 1978, pp. 50-51, for a discussion of this.

29. See Brough and Curtin, 1981, for a general review. Also Killick 1981E, Table 3 and text.

30. Tait et al, 1979, compute international tax comparison indices for 47 ldfs for 1969-71 and 1972-76. By this comparison Kenya ranked 18th and 11th for the two periods respectively. Chelliah et al, 1975, also rank Kenya with above-average tax effort indices in 1966-71.

31. Data in IMF Survey, 18 August, 1980, p. 254, show an average overall deficit for 1974-77 equal to 19% of expenditures for Kenya, against 21% for Africa as a whole.

Similarly, while we have criticised the weak implementation of the 1975 sessional paper, it would be wrong to leave the impression that nothing has been done to adjust the economy to the post-1973 economic realities. There have been useful improvements in the structure of price incentives, taxation, government spending and industrial protection. The government has proved itself more willing than some to increase its taxation of petroleum products, and the indications are that its policies are resulting in some diminution of the economy's dependence on oil-based energy sources.

The main criticism, therefore, is not that the government has acted irresponsibly but rather that the fiscal and monetary authorities have failed to adapt to the need for more effective short-run economic management necessitated by the financial constraints which first emerged in the earlier 1970s and re-emerged a few years later. The stabilisation of an economy such as Kenya's is bound to be most difficult, however, so we turn next to examine some of the technical difficulties which the authorities would encounter in attempting this task.

#### Problems of stabilisation

The earlier analyses of the causes of the inflationary and balance of payments disequilibria placed considerable stress on the influence of unpredictable changes in world prices, as well as the more secondary influence of weather conditions, with the strength of external factors particularly large on the balance of payments in 1974-77. Were these exogenous forces to remain as unruly in the future as they were then, it must be doubted whether stabilisation would be an attainable objective, although the relative stability of an extended period prior to 1973-74 indicates that exogenous disturbances are not inevitably unmanageable. Nevertheless, to maintain equilibrium in such an economy must be a demanding task necessitating the use of powerful policy instruments with which to counter the exogenous forces. How potent are the conventional fiscal and monetary instruments of economic management in Kenya?



As a first approach we can enquire into the extent to which fiscal variables are sufficiently predictable to be capable of short-run manipulation. A study was undertaken of the seven budgets of 1973/74 to 1979/80, comparing actual outcomes with the values that were predicted in the budgets, with the results summarised in Table 10-6. Column (1) provides a measure of the extent to which actual outcomes differed from the budgeted amounts and columns (2) and (3) together reveal the direction of bias in the budgets.

Table 10-6: Variability and Bias in Kenyan Budgets, 1973/74-1979/80

	coefficient of variation <sup>a</sup>	direction of bias: <sup>b</sup>	
		over- estimate	under- estimate
	(1)	(2)	(3)
1. Current revenue	14.3	1	6
2. Recurrent expenditure	10.7	0	7
3. Current account surplus	126.5	5	2
4. Capital expenditures	42.2	5	2
5. Receipts of external grants and loans	20.5	6	1
6. Remaining deficit for domestic financing	266.9	2	5
7. Deficit for financing by bank borrowing	106.6	4	3

Sources: Central Bank of Kenya, Annual Reports; Kenya, Economic Surveys.

Notes: (a) In percentages of original budget estimates.

(b) Number of observations.

Take variability first. All the items show significant and, as is not surprising, the residual items (entries 3, 6 and 7) very large average deviations of actual from budgeted values. Strong systematic biases are also revealed. On current account both revenue and expenditure is generally under-estimated, but the difference is largest with expenditures, so that there is a persistent tendency to over-estimate the current account surplus (line 3). External aid almost always falls short of budgeted amounts,

but the potential for non-bank domestic borrowing is generally underestimated, as can be inferred from a comparison of lines 6 and 7. Interestingly, there is no particular bias in the estimates of bank borrowing, although the proportionate extent of deviation from budgeted values is very large.

Particular interest attaches to this last fact, for bank borrowing by the government is generally regarded as the chief fiscal variable to be manipulated for short-term management, and is the main ingredient of the domestic component (D) of the high-powered money base (H) featured in the G & R model (see page 16). But since it is a residual, meeting whatever deficit (or absorbing whatever surplus) happens to result when all the other entries in the budget have been completed, can it rightly be treated as a policy instrument at all? As one Kenyan adviser complained, it is a "residual of a residual", ie, that part of item 6 which is left over after the Treasury has made its decisions about non-bank borrowing. Since the total deficit to be filled by domestic borrowing has a coefficient of variation of 267% and bank borrowing of 107%, it is not at all clear that manipulation of deficit financing is a practical way of trying to maintain the macro balance of the economy.

To this it can reasonably be retorted, on the other hand, that it should be possible to improve the accuracy of budget forecasting, as the IMF staff has urged. A reduction in the eccentricity of the tax on company profits, which yields almost all its revenue in the fourth quarter of the fiscal year, would ease the task of prediction and reduce the present large degree of seasonality in government revenues. Imperfect information inevitably means that there will be some - possibly quite large - deviations from budget forecasts but the biases revealed in Table 10-6 are presumably capable of elimination or reduction because other African governments have managed to avoid the severe sources of unpredictability which characterise Kenya. It should be possible for the Treasury to adjust for the tendency to under-estimate revenues and current spending; and to correct for the over-estimation of current savings, capital spending and aid receipts. Were this achieved,

it would undoubtedly bring greater predictability to items 6 and 7 of the table. Whether there would be sufficient improvement for deficit financing to become a practical instrument of stabilisation policy must nevertheless remain in question, although this has been the chief item upon which the IMF has focussed in stand-by negotiations.

There are further difficulties, concerning the transmission mechanism between deficit financing on the one hand and the performance indicators it is intended to influence, on the other: the GDP growth rate, the balance of payments and the price level. For one thing, variations in government indebtedness to the banks may be offset by contra-variations in credit to the private sector, as tended to happen in 1974, 1975 and 1978. It is thus necessary to look at the total credit scene. There is also the question of the magnitude of the impact and of time lags. King (1979, p. 100) expresses doubts about the practicability of a workable contra-cyclical stabilisation policy (a) because his financial flows model indicated that "budgetary policy has a relatively small effect upon economic activity at the best of times" and (b) because of "the eighteen-months delay between the Kenyan authorities' decision to borrow in 1970 and the impact of this decision on the economy."

When we turn from fiscal to more purely monetary factors, there are further technical complications, of a type already examined generally in Chapter 3. As was noted earlier (p. 14), the Polak-type model utilised by King treats the propensity to import ( $m$ ) and the income-velocity of circulation ( $k$ ) as constants. The G & R model analogously required stable relationships between the money supply, on the one hand, and time (as a proxy for income?) and high-powered money at the other, as well as stable elasticities of demand for money with respect to prices and interest rates. Polak also makes the assumption that imports are the only leakage out of the circular flow of income, thus disregarding saving and taxation. Are these assumptions realistic for Kenya? As regards the leakages, we can note that gross domestic saving averaged 20% of GDP in 1977-79, while taxation was equal to 21% of GDP, which must call into question the validity of this aspect of the Polak model, at least in the simple version treated here.

Calculations of the coefficient of variation of  $m$  and  $k$  yield the following results (as % of the mean values for each period):

	<u><math>m</math></u>	<u><math>k</math></u>
1968-71	8.3	4.7
1972-79	12.6	9.6

The estimate for  $k$  can be compared with a similar calculation by Park (1970, Table 1, col.  $V_3$ ) for 14 ldc's which had an average coefficient of variation of 7.1% in 1953-68. On the basis of his estimates Park was pessimistic about the practicability of monetary models for short-term forecasting and management, yet the Kenyan figure for the 1970s is larger still. The variability of  $m$  is even greater, of course.<sup>32</sup> It is true that the above calculations are for the average propensity and velocity, whereas King merely assumes constant marginal values, but it is surely the case that the variability revealed above is also inconsistent with assumptions of constant marginal values.

This leaves us to examine the stability of the money-multiplier,  $b$ . This was investigated by Bolnick (1975A) for 1967-73 who concluded that:

- (1) Variations in the 'money multiplier' on a quarter-to-quarter basis have been relatively large, implying instability of the behavioural parameters affecting the money stock.
- (2) The major source of variation in the money multiplier has been commercial bank liquidity behaviour. Our analysis suggests that the liquid asset ratio is neither fully predictable nor fully controllable...

Bolnick's analysis thus casts doubt on the feasibility of effective monetary policy but G & R (1979, p. 27) obtain less negative results. Utilising annual (as against quarterly) data they derive a money supply function which provides a good statistical explanation, with the high-powered money base and a time trend as the independent variables ( $R^2 = 0.98$ ). They think their result is consistent with Bolnick's because, by using annual data, they abstract from intra-year variations and "it is well known that in most countries the money multiplier is much more unstable in the short than in the long run. But relevant for policy is the long-run stability observed in our data." This latter point is questionable, however. In the context of economic management

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32. The variability of both parameters is much smaller for the 1968-71 period, which may explain why King obtained reasonable predictions from his model.

(and negotiations with the IMF!) it is most important to be able to predict for the short-run.

We must conclude this section, therefore, on a note of scepticism concerning the feasibility of effective stabilisation. Against the potentially large exogenous destabilising forces are arrayed a set of fiscal and monetary instruments of dubious reliability. It is unclear:

- whether the government could be in a position to manipulate the volume of its deficit financing for stabilisation purposes in more than a very approximate manner;
- how much impact deficit financing will have on total domestic credit and/or money supply;
- whether the key parameters are sufficiently well behaved to permit the short-run forecasting accuracy needed for stabilisation policy;
- whether the time lags are short and predictable enough to allow the manipulation of instrument variables to achieve desired, short-run macroeconomic results.

Having thus laid an analytical foundation we turn finally to examine the role of the International Monetary Fund in the quest for stabilisation in Kenya.

## V - RELATIONS WITH THE INTERNATIONAL MONETARY FUND

A number of considerations make a study of Kenya's relations with the IMF of more than normal interest. First, being wholly dependent on imported supplies Kenya has been one of the countries most seriously affected by the large relative rise in crude oil prices and by the oscillations in world economic conditions associated with that. Second, even though the economic philosophy of the government is closer to that of the Fund than is true of many ldc's, being essentially pragmatic, conservative and market-oriented, Kenya-IMF relations have had a troubled recent history and it is thus particularly interesting to enquire into

the reasons for this. Third, while we have seen that Kenya has had major payments difficulties since 1974, it is not a country which has allowed economic conditions to deteriorate dramatically before a last-ditch recourse to the Fund, as demonstrated by its good credit rating and its ability to borrow from the Euro-dollar market. In general, the government has been fairly prompt in commencing negotiations and might therefore expect to have received more favourable policy conditions than the late-appliers. Finally, Kenya has been the subject of a degree of collaboration between the IMF and the World Bank, and was the first country to reach an agreement under the Fund's extended facility (EFF) which came into operation in 1975.

Financial flows between Kenya and the Fund are summarised in Table 10-7. As can be observed, credits were used under the 1974 and 1975 oil facilities; and substantial use was made of the compensatory financing facility in 1976 and 1979. There were also credits from the higher-conditionality facilities recorded in lines 2-4 of the table in 1975 and 1979-80 and it is on these that we focus below. Line 9 reveals significant net inflows from the Fund in 1974-76 and 1979-80, with a relatively large net return flow in 1977. Lines 13-15 record the balance of certain other receipts as at mid-1980, not included in the remainder of the table.

What follows will concentrate on the higher-conditionality credits of 1975-76 and 1979-80, most notably the EFF credit of SDR67.2 million (equivalent at that time to K£29 million) intended to be drawn down during 1975-78, and two-year upper-tranche stand-by credits negotiated successively in 1979 and 1980. These were of SDR122.45 million and SDR241.5 million (K£59 and K£117 millions) respectively, which latter amount was equivalent to approximately 350% of Kenya's IMF quota. We choose this focus because these are the credits which raise the issues of economic management and Fund conditionality which are the prime concern of this book.

#### The 1975 extended facility agreement

The EFF was established in September 1974 to give medium-term assistance to countries in 'special circumstances of balance of payments difficulty'

Table 10-7 Financial Flows between Kenya and the IMF, 1974-80<sup>a</sup>  
(K£ million)

	1974	1975	1976	1977	1978	1979	1980
Gross inflows:							
1. Reserve tranche	5.4	-	-	-	3.2	-	-
2. Credit tranches	-	5.8 <sup>b</sup>	-	-	-	8.4	8.2 <sup>d</sup>
3. Supplementary facility	-	-	-	-	-	-	20.8 <sup>d</sup>
4. Extended facility	-	3.7 <sup>c</sup>	-	-	-	-	-
5. Oil facility	14.0	13.9	1.5	-	-	-	-
6. Compensatory facility	-	-	11.6	-	-	33.3	-
7. TOTAL GROSS INFLOWS	19.4	23.4	13.1	-	3.2	41.7	29.0
8. REPAYMENTS (repurchases)	-	-5.8 <sup>b</sup>	-5.1	-18.1	-1.2	-14.8	-3.4
9. NET INFLOW	19.4	17.6	8.0	-18.1	2.0	26.9	25.6
10. Use of Fund credit (outstanding balance at year-end)	14	33	41	23	25	52	94
11. Quota (year-end)	21	23	23	23	33	33	64
12. Credit as % of quota	67%	144%	177%	100%	75%	157%	147%
<u>Other receipts as at mid-1980</u>							
13. SDR allocations	14.5						
14. Profits from gold sales	2.8						
15. Loans from Trust Fund (gross)	22.6						

Sources: IMF, Annual Reports and International Financial Statistics.

- Notes:
- (a) Converted from SDRs at the year-end exchange rate. There were no transactions of the types recorded in lines 1-6 prior to 1974.
  - (b) A net credit tranche drawing of K£5.8 million was both effected and paid back during 1975.
  - (c) During this year an Extended Fund credit totalling K£29 million was agreed, intended to be drawn during 1975-78.
  - (d) During 1980 a two-year stand-by credit was agreed for total amounts of K£27.6 of ordinary credit tranche drawings and K£89.1 from the supplementary facility.

whose solution would require a longer period than that for which normal credit tranche facilities are available.<sup>33</sup> Requests for EFF credits may be approved 'in support of comprehensive programmes that include policies ... required to correct structural imbalances ...' Credits may be drawn over a 3-year period. They were originally repayable over a maximum of 8 years, since extended to 10 years.

Kenya's request for assistance was the first to be received and approved (in July 1975) under this scheme and was thus regarded as of particular interest. The credit was approved on the grounds that the economy was 'suffering serious payments imbalances relating to structural maladjustments in production and trade and where price and cost distortions have been widespread'. The request was in support of a three-year programme covering the 1975/76 to 1977/78 fiscal years, spelled out in the sessional paper on economic prospects and policies referred to earlier (Kenya, 1975). According to Bhatia and Rothman (1975, p. 40 - hereafter B & R):

The program reflects, in part, extensive discussions by the Kenyan Government with staff members of the Fund and of the World Bank who have made coordinated policy recommendations to the Government.

The credit was to become available in six half-yearly instalments, with the bulk of the money becoming available during 1976 and 1977, subject to six-monthly reviews of progress. It was repayable over a maximum of eight years. Performance criteria were established, satisfaction of which would govern the government's continued access to the credit. The total value of the credit of SDR 67.2 million was then equivalent to 140% of Kenya's IMF quota. At approximately the same time, the World Bank approved a programme loan for \$30 million (KSh11 million). The Fund essay describing the agreement (B & R) includes an account of the longer-term factors contributing to the payments difficulties but rather remarkably fails to mention the payments impact of higher oil prices and the other external factors analysed above. It also contains a fairly detailed statement of the programme set out in the sessional paper, as well as shorter-term measures such as the control of credit.

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33. This and the following paragraph are based upon Bhatia and Rothman, 1975, which provides a useful account of Kenya's EFF credit.



Examination of the evidence and interviews with some of those involved in the negotiations somewhat modifies the public presentation just summarised, however, and yields insights into the EFF. First, the Fund did not provide a major input into the substance of the 1975 sessional paper, nor did it attempt to do so. The World Bank made the running on the paper, initiating the idea that the government should prepare a programme in support of its application for a Bank loan. The Bank particularly pushed for the inclusion of measures that would limit the (previously very rapid) growth of spending on education, increase the share of government spending on agriculture, and introduce a more active use of interest rates (although in the event the paper was notably non-committal on this latter point). IMF-Bank coordination did not go much beyond fairly routine exchanges of information and views to ensure consistency, although the Bank's decision to approve the programme loan was influenced by the government's willingness also to comply with the additional conditions accompanying the EFF credit. Although this was an EFF credit no doubt necessitating the existence of some medium-term programme, the Fund staff were content to play a largely passive role in the formulation of the policies for structural adjustment in the sessional paper, although they did press for a tariff reform. Negotiations for the EFF credit centred on the strictly traditional Fund concerns with credit ceilings and other short-term factors bearing upon demand management. As explained in chapter 5, letters of intent from member governments to the Fund identify the variables regarded by the Fund to be of the greatest importance, for these are written in as 'performance criteria', satisfaction of which governs continuing access to the credit. The performance criteria written into Kenya's 1975 agreement related only to government borrowing from the banking system and the net domestic assets of the central bank,<sup>34</sup> both of which were restricted to specified ceilings. Most of the detailed negotiations were about the rival merits of government and Fund forecasts for the 1975/76 budget and the resulting requirements for deficit financing.

These facts raise interesting issues. The EFF, remember, was designed for countries experiencing longer-term payments problems requiring, inter alia, measures 'to correct structural imbalances'.

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34. Ceilings on the net domestic assets of the central bank are another form of credit restriction, limiting the lending power of the bank. In conjunction with ceilings on government borrowings, the effect is to limit the amount of credit to the private sector.

The Kenyan credit was explicitly approved on the grounds that the imbalances were related to 'structural maladjustments'. But when it came to the crunch of detailed negotiations it was as if the government was negotiating a normal one-year upper-tranche stand-by: demand management primarily through credit restrictions, with the usual provisions concerning performance criteria, six monthly reviews, and so forth. The Fund was requiring policies of short-run demand management to deal with problems which the Fund itself identified as longer-term structural maladjustments. As shown earlier, they were also problems substantially created by external forces entirely beyond the control of the Kenyan authorities.

Although it seems that the Fund took little active interest in the contents of the sessional paper, had it done so and if the EFF credit would not have been agreed in the absence of some such medium-term policy commitments, it follows that any such conditions were additional to the Fund's conventional short-term monetary conditions. Careful reading of the Board decision setting up the EFF confirms this because,

a member making a request for an extended arrangement must, in addition to presenting a program 'setting forth the objectives and policies for the whole medium-term period...' present 'a detailed statement of the policies and measures for the first twelve months... of the program' (B & R, p. 41, our italics).

This new form of support provided by the EFF, while undoubtedly valuable, thus provided an occasion for increasing the scope of Fund conditionality and by retaining the conventional demand management programmes for which the Fund is well known it places an exceedingly ambiguous gloss on the extent to which the Fund's policies were adapted to take account of structural or supply-side considerations, or of externally-caused disequilibria.

Whether the actual credit ceilings written into the agreement were reasonable is a question taken up shortly but we should also ask about the adequacy of the EFF credit in relation to the size of Kenya's payments imbalances of that time. Relevant data are summarised on Table 10-8,

from which it appears that the value of the credit was substantial in relation to past and expected future payments deficits, especially when viewed as part of a package which also included the World Bank loan, possibly increased aid from bilateral sources (which did, in fact, increase - see Maitha et al, 1978, p. 45) and any additional private inflows which might result from agreement with the Fund. In the event the EFF targets and the value of the credit itself were quickly rendered obsolete by the coffee/tea boom but what is important for present purposes is the size of the assistance in relation to the payments deficits experienced in the immediate past and anticipated at that time for the immediate future. Even taken by itself, the EFF credit would in 1976 have been equal to about half the actual previous year's deficit on basic balance, about a quarter of the government's estimate of the financing gap and nearly all of the targeted deficit on the overall balance.

Table 10-8 Financing Gaps and Kenya's EFF Credit, 1974-76

(K£ million)

	sums available from EFF <sup>c</sup>	actual deficit on basic balance	expected financing gap <sup>a</sup>	EFF target <sup>b</sup>
	(1)	(2)	(3)	(4)
1974	-	41	35	-
1975	3.7	27	50	37
1976	13.0	n/app.	60	17

Sources: Kenya, 1975, p. 4 and other official sources

Notes: (a) Expected gap after 'normal' inflows of aid and other capital.  
(b) Targeted deficit on overall balance.  
(c) A further amount of K£15.7 was scheduled to become available during 1977.

As things turned out, coffee export prices began a fairly rapid rise in the second half of 1975, standing at the end of the year 69% above the June level, although it was not until April 1977 that the price peaked and it was not until 1977 that tea export prices were strongly influenced.<sup>35</sup> The favourable movement in the commodity terms of trade (see Figure 10-2) took pressure off the government and probably explains why it quickly borrowed from the banks in excess of the ceiling agreed with the Fund, forfeiting continued access to the credit. This failure by the government to observe the terms of the agreement was not allowed to stand in the way of reaching new understandings at the time of the 1976 budget but by then much of the rationale for the loan had disappeared and the ceilings were again breached. This first experiment in the use of the EFF thus rather fizzled out. Only the initial instalment of K£3.7 million was drawn and the actual impact of the demand management package associated with it was negligible, although that was scarcely the fault of the IMF.

#### The 1979-80 stand-bys

As was shown in Part I, major improvements occurred on the balance of payments in 1976-77 followed by a drastic deterioration in 1978. Towards the end of that year, the government applied for a stand-by loan within the first credit tranche, to which, of course, it had nearly automatic access. This credit of K£8.4 million was drawn down in the first half of 1979, as recorded in Table 10.7. The government anticipated financing needs additional to this sum and thus initiated a number of further moves. First, it approached commercial banks and agreed a Eurodollar loan of \$200 million (K£74 million). This was arranged prior to the budget in June 1979, although it was not signed until July, and a substantial part of it was almost immediately utilised. No policy strings were attached but the commercial terms (1½% above the libor rate, repayable over 7 years) were expensive.

This loan gave the government an assurance that it would not be forced into a devaluation during the politically sensitive period of a presidential election and the settling-in of the President's new Cabinet.

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35. Monthly data on Kenya's export prices are reported in the publications of the Central Bank of Kenya.

The loan thus gave the government a stronger position vis a vis the IMF but notwithstanding this the government began negotiations for a two-year upper-tranche stand-by credit of SDR122.5 million (K£59.2 million) and agreement was finalised in August 1979, i.e., only a month later. Finally, negotiations were also commenced with the World Bank for another programme loan, totalling \$70 million (K£28 million),<sup>36</sup> agreement on which was finalised in December 1979. We are particularly concerned here, of course, with the stand-by, especially because it was negotiated after the Fund had reviewed its guidelines on conditionality in March 1979 (see Chapter 5). Since this review was heralded as ushering in some relaxation in the stringency of the Fund's policy conditions, it is instructive to enquire whether as a result the conditions put to the Kenyan government showed signs of a greater liberality.

It would be difficult to assert that they did. In fact, they were arguably tougher than in 1975. The programme presented by the government for the two-year period of the loan included provisions for improvements in tax revenues; real reductions in government recurrent and development spending in 1979/80; a 15% expansion in bank credit to the private sector; a study of the potential value of interest rate adjustments as a policy instrument (again!); a policy of wage restraint which would reduce real wages; and careful control over new additions to the external public debt. As always, however, what was of greatest importance were the items included as performance criteria. These were (a) ceilings on the net domestic assets of the central bank; (b) ceilings on net government borrowing from the banking system; (c) an "understanding" with the Fund on exchange rate policy, to be reached by the end of 1979; and (d) another "understanding" by the same date on the early elimination of an advance import deposit scheme which had been introduced at the end of 1978 and had proved highly effective as a means of achieving a once-for-all reduction in the volume of imports.

The import deposit scheme was, in fact, relaxed in November 1979 (which contributed to the larger volume of imports experienced in 1980),

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36. Of this sum \$55 million was to come from the World Bank's IDA window, to be supplemented by a \$15 million EEC Special Action Credit.

and no difficulties were experienced with the agreed ceilings on the domestic assets of the central bank. An IMF report recommending a devaluation was quietly pigeonholed and the official exchange rate remained unchanged. However, the ceilings on bank credit to government proved entirely unworkable. These were greatly exceeded during July-December 1979 and, although the government was able to reduce its indebtedness to the banks in the final three months, it was only at the very end of the fiscal year that the amount came within the agreed ceiling and the government seemingly became eligible to draw upon the credit. In retrospect officials both of the Kenyan government and the IMF now recognise that this ceiling was excessively restrictive.

When in mid-1980 its bank borrowing eventually fell within the ceiling and the government sought to draw upon the credit it was astonished to be told that it was ineligible on technical grounds. The letter of intent had contained the standard undertaking not to introduce multiple currency arrangements. In his 1980 budget, however, the Minister of Finance announced certain changes intended to make the long-standing export subsidy scheme more effective. The rate of subsidy was doubled and, to speed up payments of the subsidies, its administration was to be transferred from the Customs Department to the Central Bank. The Fund was notified of the intention to make these changes and offered no objection. After they had been announced in the budget, however, the Fund's lawyers ruled that this administrative transfer (which in the event was never implemented) converted the scheme into a multiple currency arrangement and that the government thus stood in breach of its undertaking. This left a hapless Fund mission to break the news to annoyed Kenyan officials, although the blow was softened by making the new stand-by negotiated in 1980 larger in compensation. Strong views are still held about what was regarded as the malign influence of remote lawyers whose inflexibility revealed scant sensitivity to local problems but those opinions on this issue prevailed in Washington over the objections of the Fund mission.

The end result of these events was that the credit negotiated in 1979 was never utilised, even though there is no question that the country was faced with major payments difficulties, monetary expansion was fairly moderate and bank credit to government by the end of the fiscal year was actually lower than at the beginning. Instead of trying to revive the 1979 agreement it was decided to make a fresh start.

A new two-year, upper-tranche stand-by worth SDR 241.5 million (K£117 million) was negotiated and received approval by the IMF in October 1980, of which K£31 million had been drawn by the end of the year.

It was believed that the ceilings negotiated for bank borrowing by the government were less draconian both in amount and in form than those of 1979. More generally, the Fund mission displayed flexibility during negotiations, departing substantially from their initial brief in response to the case presented by Kenyan representatives. In fact, Kenyan officials suspected that the IMF mission chief was under instructions to reach an agreement at any reasonable cost: the 1980 Fund-World Bank annual meeting was imminent and it was desired to minimise allegations of Fund harshness and rigidity on policy conditions. Whether or not this is the case, members of the Executive Board in Washington expressed disquiet about what was regarded as the laxity of the policy conditions in the agreement, although it was eventually approved. But while for the purposes of public presentation the Fund press release implied that the credit was in support of a medium-term programme of structural adjustment,<sup>37</sup> in fact the focus of the negotiations was again almost exclusively on short-run credit ceilings and the underlying fiscal projections. At the time of writing (February 1981) it is too early to comment on progress under this agreement, and the feasibility of its performance criteria, but the payments situation continues to be grave.

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37. The relevant part of the press release read as follows (IMF Survey, 27 October 1980, p. 339):

The Government has formulated a set of medium-term policies designed to strengthen the balance of payments and establish a high rate of growth of output and employment. These policies address the restructuring of the economy, with greater emphasis on agricultural growth and a reorientation of the manufacturing sector away from import substitution and toward exports. This medium-term strategy will be complemented by short-term demand management policies designed to contain inflationary pressures and the external deficit while the reallocation of resources in the economy is taking place. The Government also intends to take firm action to restrain the consumption of petroleum-based energy by making optimal use of imported fuels and by accelerating the development of alternative energy sources.

What can be said is that the 1979 and (especially) 1980 credits were quite large in relation to the country's payments magnitudes. The 1979 agreement would have provided Kf59 million over two years and the 1980 agreement was for Kf117, also over two years. These sums may be compared with the deficits recorded in columns (2) and (3) of Table 10-1 (page 8) and with the government's expectation of an overall financing gap of Kf139 million in the twelve months beginning July 1980. Although the increase in Kenya's quota was modest as between 1975 and the times of the 1979 and 1980 negotiations (see Table 10-7, line 11) and indeed diminished in real terms (when deflated by an index of the country's import prices), policy changes allowed the IMF to grant larger credits relative to quotas, so that the amount of assistance agreed in 1979 and 1980 was substantial relative to the likely size of the payments deficits. The assistance was short-term, however, being repayable over a maximum of five years.

#### Evaluation of the credit ceilings

We have seen that bank credit to the government was a key performance criterion in all the higher-conditionality credits negotiated.<sup>38</sup> Evaluation of the policy conditions attached to these credits therefore involves forming a judgement about whether the credit ceilings were reasonable. Evidence on this issue is summarised in Table 10-9 for each of the fiscal years for which higher-conditionality agreements were negotiated (although the figures are not yet available for 1980/81). These statistics are based on June-to-June comparisons (the fiscal year runs from July to June) and thus ignore the additional ceilings for intermediate dates within the year.

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38. The ceilings on the net domestic assets of the central bank never created any difficulties and this item was dropped as a performance criterion in 1980, when total domestic credit was added.



**Table 10-9. Targeted and Actual Bank Credit to  
Kenyan Government, Selected Years<sup>a</sup>**

	1975/76 (1)	1976/77 (2)	1979/80 (3)	1980/81 (4)
1. Amount of additional credit during year <sup>b</sup> (Kfmm)				
(a) ceiling	17.5	30.8	45.0	
(b) actual	26.6	9.5	(-3) <sup>d</sup>	
<u>Ceiling as percentage of:</u>				
2. Amount of government credit at year-beginning <sup>c</sup>	32	38	31	
3. Money supply at year-beginning <sup>c</sup>	5.8	8.3	6.2	
4. Domestic credit at year-beginning <sup>c</sup>	6.3	9.7	7.2	
5. Total budgeted government spending	4.9	8.0	6.2	
6. Monetary GDP <sup>e</sup>	1.9	3.1	2.7	

Source: Own computations.

- Notes:
- (a) The years selected are those for which upper-tranche or EFF credits were negotiated. The figures do not agree with published data because of differences in the definition of credit to government.
  - (b) On a June-to-June comparison. Ceilings were also agreed for various dates within the fiscal year, which are not shown above.
  - (c) 'Year-beginning' refers to the balance as at end-June 1975, 1976, 1979 and 1980 respectively.
  - (d) Provisional.
  - (e) As a percentage of monetary GDP at factor cost and in current prices, in the last calendar year before commencement of the fiscal year in question.

On the basis of the evidence in Table 10-9 it would be impossible to characterise the ceilings as very restrictive. They generally envisage total government borrowing increasing annually by about a third (line 2) which, when compounded, is a very rapid rate of increase. Lines 3 and 4 record the amount of the ceilings as percentages of money supply and total domestic credit but this understates the monetary expansion that would result because much state borrowing from the banking system takes forms that increase the high-powered money base, thus permitting a secondary round of credit expansion to other borrowers. Bolnick (1975A, Table 1) found a money multiplier with an average value of 2.3 so the figures in lines 3 and 4 might be roughly doubled to obtain a better grasp of the degree of expansion implicit in the deficit financing ceiling. (In fact, the letters of intent also contained explicit or implicit targets for the expansion of total domestic credit, which were 19% for 1975/76, 21% for 1976/77 and 19% for 1979/80.)

In the light of information then available and reasonable forecasts of the immediate future, there was a case for some monetary expansion in mid-1975, to offset the deflationary forces then emanating from the outside world, even though the government had set itself the objective of reducing inflation to "no more than half of the increase in import prices" (Kenya, 1975, p. 7) and the emergence of the coffee boom in the second half of 1975 soon changed the situation. But any case for expansion had disappeared by the time of the 1976 budget (see page 34 above) and the ceiling for that year could be criticised as too high for the purposes of economic management. 1979 was perhaps an intermediate case but given the underlying weakness of the balance of payments situation it would be difficult to argue that a ceiling permitting a 31% increase in government bank borrowing (and a 19% increase in total credit) was excessively restrictive. The fact is, of course, that in two of the three years actual deficit financing was well below the agreed ceiling (but see page 50 on the 1979/80 situation), which increases the difficulty of viewing the ceilings as too low.

The matter no doubt looked different to Treasury officials, concerned more with the fiscal situation and how to balance the accounts. Line 5 of the table shows that the ceilings were equivalent to 5% to 8% of total budgeted government spending, which is relatively modest.

The Treasury was being buffeted by competing pressures - from the IMF to limit the deficit, from the party not to raise taxes and from the spending ministries to increase their budget allocations. The ceilings were also modest in relation to GDP (line 6). It was through the monetary system rather than because of its direct impact on aggregate spending that the deficit financing would have its main impact on the economy. But, to repeat, it is difficult to think that the monetary impact would be deflationary.

#### Matters arising

We have analysed three higher-conditionality agreements between the Kenyan government and the IMF. Of these, the first two quickly broke down, with the third being too recent to judge whether it will prove workable. Generally, the relationship has not worked smoothly. It was the Kenyan government (and the improving payments position) which was responsible for the breakdown of the 1975 agreement, although the government may have been less inclined to go its own way had it not perceived the Fund terms as onerous. In 1979/80, however, intra-year credit ceilings proved unworkably tight so that the government was unable to use this credit. The Fund then declared Kenya ineligible in mid-1980 on a legal technicality but immediately followed with another stand-by that was more generous both in value and policy conditions.

These difficulties must be seen in the context of an economy which has rarely been grossly mismanaged - no hyper-inflation, no hugely over-valued currency - with a conservative, pragmatic and generally market-oriented government. Senior officials<sup>39</sup> in the Treasury and central bank are by no means heedless of the importance of economic stability, nor are they hostile to the basic role of the IMF. The principle of conditionality is not contested by them and they see the Fund staff as potentially useful allies in restraining the spending ambitions of ministers and their departments. The Fund's influence is seen as strengthening the hands of the Treasury and bank in their efforts to impose financial discipline. It is all the more significant, therefore,

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39. The Kenyan government's negotiations with the IMF are almost entirely conducted by senior officials and advisers. Finance Minister Kibaki rarely involves himself to any great extent and is usually content to act on the advice he receives. The terms of the agreements with the Fund have not engaged the Cabinet or the President to any great extent, and in the later years of the Kenyatta era the Cabinet met only infrequently.

that the same officials dislike the way in which the Fund plays its role. They contemplate an application for IMF assistance with reluctance and regard negotiations with it as unnecessarily taxing.

One reason for this is that they view the Fund as being far too concerned with the short-term. We have shown earlier that, in addition to short-run monetary factors, Kenya's payments difficulties stem from basic structural weaknesses and from the effects of rising oil and other import prices. In truth, the high real oil prices are unlikely to be reversed and Kenya must adjust to them. But such adjustment cannot reasonably be expected quickly and in the interim there will remain large financing needs. One of the most interesting results to emerge from our research has been the relative IMF disinterest in medium-term restructuring, even in the context of the EFF, with negotiations and performance criteria being largely confined to conventional, short-term concerns. When Kenyan negotiators urge the need to take a longer-term view and to go beyond the scope of demand management the response from Fund mission is to the effect that they are personally sympathetic but that Washington is less so and is looking for a conventional financial programme. On the evidence of the Kenyan case, the EFF makes few concessions to the case for structural adjustment when it comes to detailed policy conditions. To the extent that 'structural' measures are included they are additional to the usual Fund ceilings. This not only opens the Fund to the criticism that the limitation of aggregate demand is far from being a sufficient condition for adjustment to structural disequilibria but also leaves it appearing always to demand quick, perhaps severe, action when a gradual approach might impose smaller costs.

It is not clear the Kenya has received an easier deal than other member governments because it has gone to the Fund at relatively early stages of its crises. It was also difficult to perceive much softening in conditionality as a result of the guidelines review of March 1979. The general scope of the conditions in August 1979 was no less extensive than in 1975 (and included a clause that appeared to foreshadow a devaluation). The Fund ceilings on government borrowing at various dates within the 1979/80 fiscal year were regarded in Kenya as harsh and, in the event, proved unworkable. On the other hand, the Fund's willingness to accept the 1980 agreement despite continuing government refusal to devalue may be significant. And we should bear in mind the conclusion drawn from Table 10-9 that, on a June-to-June basis, the ceilings on government credit were not generally deflationary.

But even though they were not excessively restrictive, the ceilings are open to the criticism of being highly imperfect and insufficient instruments of macroeconomic management. Recall:

- that monetary forces were shown earlier to be only partly responsible for the payments difficulties and inflation;
- that the relevant parameters are not sufficiently stable and the time lags not sufficiently understood for the outcome of any given credit restriction to be predicted with reasonable confidence;
- that the uncertainties surrounding budget planning are too large for the deficit financing residual to be readily manipulated as an instrument of management.<sup>40</sup>

Deficit financing is relevant, of course, and it would surely be feasible to improve the accuracy of budget forecasting in Kenya. But the amounts of deficit financing and private credit are weak reeds upon which to place so much of the burden of macroeconomic management.

Not the least of the practical drawbacks of a focus on deficit financing ceilings is the attention bias it causes in negotiations between the government and Fund missions. Much time and effort is spent arguing about the merits of rival forecasts of government spending and revenue; how best to define credit to government and other concepts;<sup>41</sup>

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40. The 1975 EFF agreement provides a revealing illustration of the uncertainties and the resulting difficulties of treating government bank borrowing as a variable to be consciously manipulated as a policy instrument. This set a ceiling on bank lending to the government in the July 1976/June 1977 fiscal year of K£30.75 million. In a draft communication to the Fund of 11 May 1977 (i.e. only about 7 weeks before the end of the fiscal year) the government wrote that it now expected government borrowing to exceed the ceiling by the end of the year and to amount to K£42.5 million: "It appears that the budgetary situation has become more intractable than we had anticipated." In the end, however, there was a large reduction in government indebtedness in the last weeks of the year and the net increase in government borrowing was only K£9.5 million. A year later a Fund staff evaluation wrote of "growing uncertainties surrounding budgetary prospects which have led the authorities to produce varying estimates of likely budget deficits and, correspondingly, their requirements of bank financing."

41. There was, for example, much concern in 1976-77 within the Fund and the Treasury about precisely what item should be included in calculations of net credit to the government from the banking system, and there appears to have been considerable confusion about the application of this.

and other minutiae of far from central importance to the macro problems of the economy. The arguments tend to be about numbers and are thus a distraction from a serious debate of the nature of the problems and how best to solve them - a feature that government officials find particularly irksome.

That it has a doctrinaire tendency to focus narrowly on a small number of monetary variables is, of course, a common complaint by Idcs against the Fund and yet when working outside the framework of a stand-by negotiation Fund economic reports reveal a broader approach, depending on the interests and personality of the mission chief. We have already cited the 1974 report which urged a relaxation of credit policies; this report also urged the government to begin to give thought to the medium-term adjustment problem. Other IMF reports over the years have concerned themselves with the desirability of tariff reforms, of agricultural policies, of energy conservation and so forth. But these are mere staff reports and have little impact in Nairobi or Washington.

We have earlier noted other ways in which Fund doctrines have had unfortunante effects. This was most notably the case with the 1980 use of the multiple currency clause (see pp. 50-1). When the evidence is fully available, it is likely to show that Fund insistence on the phasing out of the import deposit scheme (for all its defects) was premature and contributed to the payments crisis of 1980. A less legalistic approach, more sensitive to local circumstances, would probably have achieved better results for Kenya without significantly undermining the Fund's own objectives.

How might the relationship be made more fruitful? A less standardised approach to stabilisation programmes, willing to focus less on the restraint of aggregate demand (although that may often be essential), more on non-monetary variables and to take a longer-term view, would take matters some distance. So would an abandonment of the belief that credit targetry is useful, in favour of a more qualitative approach. Negotiations may well prove more fruitful if they concentrate more on seeking a consensus about the nature of the problems confronted and the most appropriate policy responses, to be implemented over a medium-term period.

The matter would be made easier yet if the Fund were to adopt greater flexibility in the interpretation of its Articles and conventions, a greater willingness to concede that there are circumstances when a temporary increase in exchange controls may not only be useful for balance of payments management but actually serve the longer-term objective of liberalisation.

It is not only the IMF which needs to change, however. The Kenyan government has yet to demonstrate a steady adherence to the objective of economic stability and does not yet seem to have fully come to terms with the implications for economic policy of the harsher world environment which appeared after 1973. It is important here not to confuse the conservatism and responsibility which has generally characterised the government's policies with the active pursuit of policies for short-run economic management. It has not yet set in place the data base and reporting procedures necessary for monitoring short-run economic trends,<sup>42</sup> there is need for further studies of key macroeconomic relationships leading to the development of a short-term forecasting and policy-oriented econometric model, and the rather poor record of fiscal forecasting revealed in Table 10-6 could and should be improved. Although we have drawn attention to the limitations of monetary policy, we would add that monetary policy has been weak in Kenya, partly because the central bank has interpreted its role in ways which have been incompatible with the increasingly urgent need for effective short-term economic management.

The role of a lender of last resort is inevitably unpopular. There is a residual degree of conflict of interest and perception between the IMF and its member governments which is probably irremovable. But there is scope for reducing the friction and improving the relationship so as to reconcile the objectives of the Fund and its members.

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42. See Murugu, 1978, for a survey of short-run economic indicators in Kenya and suggestions for improvement.

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