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The Financial Framework of Business Opportunities in Kenya

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Abstract

It is well known that an efficient financial sector is essential to sustainable economic growth and development. In this paper we review the financial institutional framework in Kenya, with particular emphasis on the role of fiscal incentives to mobilize private sector investment. We find that restructuring in the Kenyan economy represents an important step in achieving greater economic efficiency and higher rates of growth.

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1. Background

Long before the Keynesian revolution of the 1930's money was regarded as neutral as it was seen to have no effect on real variables such as output, investment, savings, interest rates and so on. The national economy was dichotomized into real sector and monetary or financial sector. The two sectors were independent and, therefore, financial sector had no effect on real sector or the vice versa.

This view persisted until studies carried out by Tobin (1965), Johnson (1967), Patinkin (1968) and Sidravski (1961) showed that money was not neutral as far as the real variables are concerned[1]. These studies concluded that money had influence on real variables. However, this view also presented a problem as to what the direction of the change is and also whether the effect of money is negative or positive.

Tobin concluded that introduction of money led to greater income and capital formation in non-financial/monetary sector. On the other hand, Johnson, and Sidravski differed with Tobin and concluded that money had an opposite/negative effect on the said variables. In any case, there exists a problem in the way money was introduced by these scholars in their theories. Tobin's model introduced money as a free gift from nature. Johnson, and Patinkin introduced money as a factor of production or output in the production function. Thus, their results did not show a positive correlation. In addition to this, they defined money in the narrow sense. That is to say, as a medium of exchange. They neglected the wider definition which includes all types of financial assets, currency, demand, savings and deposits. For instance, shares, capital accounts, primary securities and life insurance, among others. These, in essence, constitute financial instruments held by financial intermediaries.

The existence of financial intermediaries contribute to savings ratio by providing a convenient form of savings. It is less risk to hold savings in monetary form than real form. This paper addresses the major issues in financial management and international diversification of private investment in Kenya.

2. The Framework of Financial Institutions in Kenya

The financing of economic development has posed serious problems in Kenya for the past three decades. The peculiar problem of finance is fundamentally the question of using the fiscal system to capture resources for the purposes of economic growth. Hence, promotion of economic development requires the raising of revenue through mobilization

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[1] *Journal of Economic Reflections,* Vol. II, No. 1, 1980.

of investment resources to an optimal point for the achievement of economic transformation and create a conducive environment to private sector investment.

At the present, Kenya has six hundred (600) manufacturing organizations. Most of these are operated by private individuals. When we speak about the private sector it is important to recognize that private investment is already broadly based and deeply established in Kenya. Local and foreign investment ranges through agriculture, horticulture, light and heavy manufacturing, services, including tourism, finance, transport and shipping, excluding the vital informal sector known as Jua Kali, which makes its own very important contributions to employment and economic growth. Most of these sectors have their organizations to represent their interests and maintain dialogue with government on experience and issues of concern to them.

When we talk about economic mobilization we refer to a complex economic growth process which is discontinuous and necessarily unbalanced. It is associated with and also generated by profound changes in the productive, social, political and demographic structures of the country. It encompasses both quantitative aspects as it not only refers to an increase in net national product, but also the process of improving the standards and well-being of the population. This can only be achieved through increase in industrialization relative to reliance on agriculture alone.

Financial management/development, unlike economic development, does not consist of a pure and simple growth of the total float of financial assets. It is an evolutionary process that implies a transformation of a qualitative nature connected with the adoption of innovation in technology which is considered to be the driving force behind financial mobility and stability.

3. Government Economic Policy Objectives

These objectives are designed to create an environment which will both attract and provide protection for foreign investment. They include:

a. Minimizing government participation in economic activities (investment).
b. Identification of private sector as the engine of economic growth.
c. Determination of price levels by market forces of supply and demand.
d. Provision of security and order for private investment.
e. Allowing partnership between government and private investors.

4. Kenya's Financial Institutions

Kenya's financial system is fairly developed and diversified. At the apex of Kenya's financial sector is the Central Bank of Kenya, which is the central authority in the country. This institution was established by the Act of Parliament in 1966. It supervises the operation of the commercial banks to ensure that they carry out their business prudently. The commercial banks' operational policy is to be transparent, accountable, consultative and decisive. At the present, we have thirtythree commercial banks. Between 1973 and 1992 commercial banks' liquid assets grew by 5% per year (from kshs 1048 million in 1973 to kshs 22,565 million by the end of 1992). During the same period, the private financial institutions' assets grew by 3% per year (from kshs 1,008.28 million to hit at kshs 53,517.58 million at the end of 1993)[2]. Other financial institutions include Barclay's Bank, Standard Chartered Bank, Grandly's Bank, Bank of Baroda, Citi Bank, Pan-Am Bank, National Bank of Kenya, Cooperative~Bank, Post Bank and many more.

In addition to the above, we also have non-banking institutions. This sector has about 54 non-banking institutions with a network of 89 branches (1988). The system also includes 32 building societies, 52 insurance companies, 207 hire purchase companies, 10 development finance institutions, private pension plans and over 900 savings and credit cooperative societies[3].

5. The Pre-1992 Institutional Framework in Kenya

Historically, the government of Kenya has always advocated and welcomed foreign investment, boldly doing so even as other countries in the region were espousing a much more autarkic, centrally controlled approach to international trade and investment. Kenya's underlying spirit of enterprise has always been strong. Starting with the Africanization drive following independence in 1963, the government remained sensitive to the country's need to retain and attract nonnational investment and expertise. The Foreign Investment Act of 1964 alleged investors concerns regarding nationalization and repatriation of profits[4]. The government's commitment to a system that favored open markets and encouraged international investment was also reiterated in the "1965 Sessional Paper on African Socialism and Its Application to Planning." These initial

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[2] Central Bank of Kenya: Its Evolution, Responsibilities and Organizations, 1973-1993.

[3] R.Brenneisen. (May 6, 1994). "Private Sector Assessment of the Current Investment Climate in Kenya." Paper read at the International Conference in Kenya.

[4] Kofi, A. Osei. (December 3-8, 1994). "Analysis of Factors Affecting the Development of an Emerging Capital Markets: A Case of the Ghana Stock Exchange." A research proposal presented at the EARC Workshop in Nairobi, Kenya.

measures laid the basis for what is now a long tradition of openness to private investment, both domestic and foreign.

However, despite this legacy, there has been a perception that the government has been wooing skeptical foreign and domestic investors. This skepticism reflects, we believe, a concern that Kenya's deteriorating economic growth performance over the past ten years or so stems from some serious underlying problems in economic management arising from government "rent-seeking." Until mid-1992 there were repeated failures in efforts to maintain macroeconomic stability, domestic savings had been weakened by public sector dissaving or swinddling of funds intended for developing economic infrastructure and by erosion of confidence in the financial sector. There existed an inefficient parastal sector; a strong intervention by the government in markets operations; and unnecessary regulations driven by rent-seeking activities which discouraged productive private initiatives and absorbed increasing amounts of scarce investible resources. As a result of a weak public expenditure management, the quality of basic infrastructure had steadily deteriorated. The combined impact of rapid population growth and inefficient resource allocation had undermined the pronounced achievements of Kenya in developing its human resources.

Obviously, these policy failures and the perception of increasing "rent-seeking" activities have contributed enormously to the erosion of investor confidence in Kenya for the past one and a half decades. Between 1978 and 1992 the aggregate investment rate declined from 24% of Gross Domestic Product to 16% of GDP. Real private investment, which is the best realistic barometer of business confidence, shrank to less than half its 1978 share of gross domestic product over the same period. The underlying trend of real economic growth fell from the 5% annual rate attained over 1985 to 1990 to approximately 1% over the past four years, well below the population growth rate (3.O%).

Before 1992, Kenya's economic and financial management systems were characterized by the following features:

a. A rigid system of Import Administration. Each import of a value over U.S. $500 required the approval of the government and importers were required to lodge their applications with the Ministry of Commerce which, together with the treasury and Central Bank, processed them.

b. Applications to remit dividends, school fees (abroad), medical fees and others were to be lodged with the Central Bank**.** Approvals took as long as two years to be approved except for those who made accommodation for "rent-seeking."

c. The value of the shilling against other world currencies was determined administratively.

d. Equally, the monetary authorities fixed interest rates and other bank charges

These measures (procedures) were extremely cumbersome, causing businessmen to spend hours chasing their import applications. They were L, also frustrated. These controls consequently encouraged "rent-seeking" which became a source of wealth for government administrators in all spheres of economic life. These experiences had negative effects on economic growth and financial stability. The economy collapsed, inflation rose drastically and basic necessities of life became increasingly scarce due to high prices of basic commodities. Thus, the government was forced to charter a more responsible course in mobilizing its economic management, making the control of inflation and encouragement of foreign investment its immediate objectives.

6. Structural Adjustment Initiatives in Kenya, 1992-1993

During the financial year 1992/93, Kenya embarked on a long, hard climb back to capturing its status as a leading example of economic stability in East Africa. It was the only country in Africa under a multi-party democracy, which was completely controlled by the party in power (KANU). However, early in 1993 the government unearthed a series of extraordinary financial scandals that had serious macroeconomic consequences. This forced government to begin to charter a more responsible course in its financial sector discipline by strictly reinforcing and ensuring that future accountability. The process of reestablishing the credibility of the key institutions responsible for economic management had began and at the right moment.

Beyond these efforts to reverse earlier declining trends, the government has began to recognize the view that far-reaching changes to economic management and radical structural reforms are essential if Kenya's evident potential for rapid economic growth, financial stability and poverty reduction is to be achieved. Nowhere has structural adjustment reform been more impressive than in the changes to the trade and foreign exchange regime in mid-1993 where import licensing has been substantially dismantled and where the market now determines the price and availability of foreign exchange.

In order to create an enabling environment for the local and foreign investors, import controls have been lifted, exchange controls have been relaxed or removed, with all foreign exchange and other foreign requirements of the private sector delegated to commercial banks; foreigners have been allowed to pay their hotel bills, airline tickets, airport taxes and so on in Kenya; freeing of remittance of the majority of payments, including dividends, profits, school fees, blocked funds and expatriate earnings; removal of restrictions on domestic borrowing by foreign-controlled companies; freeing of the shilling exchange rate, leaving it to be determined by market forces of supply and demand; freeing of interest rates to also be determined by the market forces; allowing exporters to retain 100% of their export earnings; permitting residents to borrow from abroad with no limit on the amount to finance investment in Kenya; and, finally, promotion of an active foreign exchange market system. These financial management adjustment reforms now in place allow the investors a wider availability of both local and foreign sources of finance.

In addition to the above , the government has began a civil service reform aimed at creating a streamlined and motivated service whose hallmarks are integrity and efficiency. Bold steps have been undertaken towards the full liberalization of maize marketing and incentives for early retirement are being provided for those who want to retire early. However, a full appreciation of these measures has been overshadowed by the past mismanagement in the financial sector, "rent-seeking" and by lingering debate over political and human rights issues. Nonetheless, they constitute important initial steps towards creating a strong basic framework for efficient private and towards revitalizing the national economy. There is now a hope in the future, we believe, that Kenya is at the beginning of a new era of economic expansion and opportunities.

7. Remaining Challenges

The adoption by the government in November 1994 of a Policy Framework Paper that charts a bold course of far-reaching policy reforms over the next three years was an impressive step to take. Let us look at the most challenging measures that need to be implemented in order to allow the economy to "take-off."

Kenya's economic growth needs to grow by at least 7% per annum if adequate employment opportunities are to be created for the half million young persons who enter the labor force every year. The challenge for the Kenyan government is to halt the course and build growing consensus of all partners in Kenya's economic development around the direction that has now been set.

We do not underestimate the difficulties of the policy challenges that are characterized by unacceptable high levels of inflation, interest rates and depressed economic conditions. The unwarranted Exchange Control Act, which needs to be repealed or suspended allowing a full convertibility of the Kenya shilling. It is our belief that if strong reform and wise economic management can proceed, the opportunities for both local and foreign investors and the ultimate target of real improvements in financial management and external investment will undoubtedly give impetus to Kenyan economic growth and improve the well-being of the society.

7.1 Opportunities for Investors/Businessmen

All economic and financial systems of any country are founded on the factors coherent in each given country. Kenya, as a country, must have some of these endowments in order to attract both local and foreign investors and to ensure that such investments yield high returns while, at the same time, contributing to the improvement of the welfare of its society. At the end of November 1994 Kenya had 150 public enterprises available for privatization. By the beginning of 1995, 56 of these public-operated businesses had already privatized leaving 94 public enterprises available to private investors.

Kenya possesses adequate natural resources, an environment conducive to private investment, a well-established transport system, human resources, sufficient technological knowledge, electrification system and manufacturing sector. In addition to these, the anti-corruption squad, which has been set up and the Investment Promotion Center, which has been established, is now operating as an effective one-step office for licensing and approval of financial transfers, thus, ensuring the investors of a smooth flow of communication and protection from rent-seekers.

What opportunities does Kenya offer to foreign investors? There are numerous opportunities which are available to potential investors. For simplicity, these are categorized into six groups as follows:

Table 1
Sectoral Composition of Priority Investment Sectors

Transport	Farming	Service Industries	Processing Industries	Power Schemes	Manufacturing
Road	Ranching	Hospitals	Agriculture	Thermal	Cement prod.
Railway	Horticulture	Hotels	Coffee	Geothermal	Textile prod.
Airport	Vegetables	Insurances	Tea	Solar	Vehicle assem.
Shipping	Irrigational Schemes	Banking	Vegetable		Chemicals
		Real Estate	Meat		Fertilizers
	Rice	Telecommuni-cations	Milk		Sanitary wear
	Wheat		Food		Paper products
		Gas			
		Steam			
		Water			
		Loaning Agencies			
		Clearing and Forwarding			
		Catering			
		Education			

In addition to the opportunities listed above, there are other areas for business investment, such as in retailing, restaurants, pharmacy, printing, legal services and so on. Once these opportunities have been undertaken by private investors, the government will continue to ensure that the incentives offered to investors are appropriate and competitive.

8. Conclusions

Mobilizing Kenya's financial resources represents an ongoing challenge. The current economic policy that has emerged to tackle the bottlenecks inhibiting the growth process of the country is the liberalization of financial management and investment and a requisite shift in investment from human to physical capital. Thus, the liberalization of the financial management and market structure has intensified competition and the business community which have to adjust themselves and take advantage of the new opportunities for their future gains.

The establishment of the National Investment Committee in February 1994 made Kenya a natural focus for increased foreign investment. Another factor which is important in locating investment facilities is that Kenya has numerous large and well-established industrial centers such as Nairobi, Mombosa, Nakuru, Kisumu, Thika, Eldoret, Machakos and Kitale to name just a few.

Finally, the financial and investment adjustments implemented in mid-1993 provide financial security and freedom of remittance of most of the payments, including profits, dividends and domestic borrowing by foreign investors. All these measures are favorable for foreign investors and give them the best opportunity for considering Kenya as one of the best alternatives for their investments. We strongly believe that their decisions to invest in Kenya will be undoubtedly financially beneficial to them in the long-run.

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