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Financial Mobilization and Macroeconomic Stability in Kenya

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Abstract

In this paper we provide a brief review of Kenya's monetary policy, drawing on the repressionist hypothesis advanced by McKinnon and Shaw in the 1970s. We find that for Kenya at least, the repressionist hypothesis offers less of an explanation of Kenya's monetary policies than does the problem of financial transparency. Given Kenya's abundance of natural resources, creating a sustainable path for economic growth must begin first and foremost with greater financial accountability and transparency. In so doing, Kenya can achieve rates of economic growth that can assure rising levels of per capita income.

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1. Introduction

Looking back at the past three decades (1970-1990), monetary management in developing countries went through a revolution in following the repressionist hypothesis advanced by McKinnon (1973) and Shaw (1973). This held that a repressed financial system may lead to the retardation of economic growth and development. Following this notion, a good number of developing countries, particularly in Asia and Latin America, started liberalizing their financial systems to allow for full operation of market forces. By the mid-1990s the wave of liberalization had reached the shores of Africa and had engulfed most of them, including Kenya.

The repressionist hypothesis was based on the argument that negative real interest rates have adverse effects on savings leading to a decline in economic progress. Furthermore, the controlled nature of such repressive regimes characterized by interest rate ceilings, credit rationing, and liquidity requirements do not promote the proper allocation of resources in the economy. The standard approach for correcting such distortions, as suggested by McKinnon and Shaw, would be to liberalize the financial system. This would involve the removal of direct controls on interest rates, elimination of credit ceilings and liquidity requirements and, finally, pursuit of price stabilization through appropriate macroeconomic and structural policies. The primary objective in such a liberalization process is to improve economic growth through increased competitive efficiency in financial markets, which indirectly will benefit non-financial sectors of the economy.

Some of the countries, which had adapted this approach, have raised skepticism about the repressionist hypothesis. Countries such as Argentina, Chile, Uruguay, and Indonesia have been cited among the failures. Few of the developing countries, such as Taiwan and Korea, have pronounced success with their financial liberalization programs. Some of the reasons given for those which have failed include (a) chronically unstable macroeconomic conditions; (b) improper speed and sequencing of financial reforms; and (c) high financial deficits.

2. The Institutional Context in Kenya

We examine the implications of the financial liberalization and management in Kenya from the 1970s to the 1990s. The main hypothesis to be investigated is that given the underdeveloped nature of the financial and market systems, full liberalization adjustment would present a problem with macroeconomic management.

Of all the larger economies of Africa (except South Africa), Kenya still remains one of the best prospects to emulate the Asian countries' performance. There is little doubt in our mind that at this critical juncture, this is the challenge most relevant to Kenya.

The key challenge facing Kenya is to create jobs for all who want to work. This is a formidable challenge because unemployment in the formal sector is currently very high, estimated at about 20%. Moreover, with a predominantly young population, about 500,000 Kenyans or 5% of the labor force are entering the job market every year. Economic growth of 7-8Y, per year would be necessary over the next ten years if unemployment is to be reduced to 5% by the year 2005 or so. This would be difficult, but certainly not impossible.

Kenya has had repeatedly unsuccessful trials with direct controls of interest rates and other instruments in its monetary policy programs. We believe that there are, indeed, some strategic lessons that Kenya could learn from East Asian experience. That is not to say that there is any simple formula or any single model for emulation. The East Asian success includes countries with significantly different initial endowment of natural resources, human capital, and foreign aid; it includes countries that have attempted more and less intervention policies at different times; and it covers diverse institutional arrangements. The ideologue will find enough reasons to substantiate any particular formula for success. We would certainly not support the mechanical application of an East Asian policy approach (prescription) to the economic circumstances in Kenya. Nevertheless, there are no fundamental reasons why Kenya could not do so.

A close study suggests a number of important themes that provided an escape for East Asian countries to sustained economic growth. The first is the importance of efforts to maintain a social harmony. Each country in this area had achieved, in its own way, a social compact, which ensured a shared vision and substantial support for a hard-driving, pragmatically-defined development agenda. Why was this possible? There has been several critical ingredients: (1) a set of government policies which led to reduction in inequality and to wide distribution of national benefit of growth; (2) a determination to ensure that those who benefit most from opportunities to accumulate wealth do so as a result of activities which are broadly beneficial to society as a whole; and (3) a civil service which is relatively incorruptible, reform-minded, and goal-minded. There is enough evidence to justify our claim. During the period 1968 to 1993, East Asian per capita incomes grew fourfold, absolute poverty declined by 2/3, and access to education and health services increased dramatically. How does Kenya fit/measure as far as the Asian situation is concerned?

Kenya, in general, lacks in most of these ingredients. Kenya experiences problems in social cohesiveness (harmony), a high inequality and unbalanced distribution of the national benefits of growth, accumulation of wealth continues to be for the privileged and rarely benefit the society at large. The civil service is highly corrupt and non-reform-minded. Access to education below university level has dramatically increased. Three quarters of those who qualify to go join universities cannot do so because of lack of facilities and financial resources. Health services in public hospitals and clinics have drastically declined because of poor management. It is important, at this point, to note that this unfavorable situation has, for the past four years, led to disinvestments by some foreign companies.

The second main theme is the critical importance of the efforts to stimulate high domestic savings, which are the major source of financing for investment. In the case of East Asian economies, great emphasis was placed on fiscal discipline and on building a strong, effectively supervised financial sector able to mobilize private savings and allocate them to efficient investment.

Kenya took a different approach to private investment, which undermined the role of foreign investment by promoting government investment for achieving sustained economic growth. This approach weakened the financial sector in mobilizing domestic savings and improving the availability of venture capital and other forms of long-term finance. The government was not determined to keep tight controls on public expenditure by maintaining strict priorities on expenditure and financial discipline. This could have been done by strengthening the stock market and the issuance of shares by public enterprises through privatization, which would have given impetus to mobilization of domestic savings. This approach was further short-sighted in that the government did not see the need to consider other strategies to further promote domestic resource mobilization.

The third common thread is that policies that actively seek to encourage markets and private enterprise are a *sine qua non* for economic development. The truth of the matter is that a government that is actively pro-market is distinctly different from the typical polar choice presented in classroom economics, of laissez faire government or strongly intervention, market substituting government. What does this mean in concrete terms? First and foremost, it means that a government that is committed to the maintenance of macroeconomic discipline to sustain low and predictable inflation over the long-term. It also calls for a continuous effort to ensure that government restrict itself to activities that it has the capacity to implement and which the private sector clearly cannot carry out. It means that unnecessary regulations of private sector is avoided. And, most importantly, if means that the guiding principle of policy towards the private sector should be to promote competition, both internally and with the outside world.

While some import protection was maintained in East Asia over the 1960s and 1970s, it was moderate and it did not result in overprotected activities since ultimate success was defined in terms of export performance. Attempts at activist industrial policy, the attempt to "pick winners," were tried by various governments of the region but abandoned in cases where it became apparent that this path to development was costly and inconsistent with maintaining macroeconomic stability and with advancing the export and productivity growth, which are both essential to sustained increases in production and income.

The fourth theme that emerges from East Asia experience is that great attention was paid by government to providing infrastructure. A critical lesson has been the single-minded attention paid to ensuring that services are adapted to need and are as efficient as possible--goals which must take precedence over concerns over private or public ownership, excessive direct job creation or containing the pricing of services through direct intervention.

Finally, a theme familiar to Kenya: the importance of investment in human resources (human capital). East Asian economies have given high priority to investment in education and facilitated by declining population growth rates, such investment has grown rapidly in per capita terms. In contrast to other regions, such as sub-Saharan Africa, public expenditure in these countries has been focused on primary and secondary education, leaving tertiary education largely to the private sector. Limited public expenditure on university education has been focused on science and technology. As a result, the broad base and technical bias of human capital in the East Asian countries has been noteworthy.

2. Structural Adjustment in the Financial Sector

Let me now turn to Kenya, which is the focus of this study. With those East Asian lessons in mind, what does Kenya need to do? As I indicated earlier, the potential for foreign investment in Kenya is great. Historically, as you all know, Kenya has welcomed international enterprises, boldly doing so even as other countries in the region were espousing a much more autarkic, centrally controlled approach to trade and investment. The underlying spirit of enterprise has always been strong. Even during the

Africanization drive following independence in 1963, government remained sensitive to the country's need to retain and attract non-African investment and expertise. The Foreign Investment Act of 1964 alleged investors concerns regarding nationalization and repatriation of profits. Kenya's commitment to a system that favored markets and encouraged foreign investment was also reiterated in the 1965 “Sessional Paper on African Socialism and its Application to Planning”. These initial steps laid the basis for what is now a long tradition of openness to private investment.

Despite the legacy, there is a perception today that the government must woo skeptical foreign and domestic investors. The skepticism reflects, we believe, a concern that Kenya's deteriorating economic growth performance over the past two decades stems from some serious underlying problems in economic management. Until mid-1993, there were severe repeated failures in efforts to maintain macroeconomic stability. Domestic saving had been weakened by the public sector by the public sector dissaving and by erosion of confidence in the financial sector. An inefficient, favored, parastatal sector; strong intervention by the government in markets; and unnecessary regulation discouraged productive private initiative and absorbed increasing amounts of scarce investible resources. The quality of basic infrastructure had deteriorated steadily as a result of weak public expenditure management. The combined impact of the rapid population growth and inefficient resource allocation have undermined the exceptional achievements of Kenya in developing its human resources.

It is no secret that these policy failures and perceptions of increasing corruption have contributed to the erosion of investor confidence in Kenya. Between 1979 and 1993 the aggregate investment rate declined from 23% of GDP to 15% of GDP over the same period. The underlying trend of real economic growth has fallen from the 5% annual rate achieved over 1984 to 1991 to about 1% over the past four years, well below the population growth rate of 3.1%. There is now a real hope that Kenya has began the long, hard climb back to reclaiming its status as a leading example of economic stability in East Africa.

Starting from the mid-1970s, and as a part of the International Monetary Fund and World Bank supported structural adjustment program, Kenya began a process of liberalizing its financial system. Specifically, an International Financial Sector Adjustment Program (IFSAP) was initiated and a number of institutional and policy reforms were carried out, which culminated in the liberalization of infrastructure adjustment at the end of 1992. Under this liberalization system, interest rates were deregulated, responsibilities for the production and delivery of goods and services from the public to private sector through the reduction and rationalization of operations of public enterprises, price controls and import licensing were removed, progressive decontrol of foreign exchange management, and introduction of retention accounts for export earnings for monetary policy management.

Financial sector discipline is now being strictly enforced to ensure accountability for past lapses are being taken. The process of reestablishing the credibility of the key institutions responsible for economic management are strictly being enforced. We believe that there is a growing recognition in the government that far-reaching changes to economic management and radical structural reform are essential if Kenya's evident potential for rapid economic growth and poverty reduction is to be achieved. Nowhere has infrastructural adjustment been more impressive than in the changes to the trade and exchange regime which were undertaken at the end of 1994, where import licensing was substantially dismantled and where the market was set free to determine prices of commodities and availability of foreign exchange. Price controls were entirely eliminated except in fuel. Civil service reforms were implemented to create a streamlined and motivated service whose hallmarks are integrity and efficiency. In addition, early retirement has implemented with increased benefits for those who wished to take advantage in private business.

A full appreciation of these increases has been overshadowed by the past mismanagement in the financial sector and by lingering debate over political and human rights issues. These changes constitute important initial steps towards creating a strong basic framework for efficient private investment and towards revitalizing the economy. There is now a possible prospect, we believe, that Kenya is at the beginning of a new era of expanding economic opportunity. We are particularly impressed by 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 few years.

Doubtedly, encouraged as we have been by the government's concern and efforts over the past few months, we are quite aware of how much remains to be done. The government must have a vision of what is and how it can promote the country's economic growth and financial stability. It must fully commit itself to upholding of the democratic ideals as a vehicle for the development of the Kenyan Society, both socially, politically, and economically.

There is a need for Kenya to develop by at least 8% a year if adequate employment opportunities are to be created for the half million young people who enter the labor force each year. The pattern for human capital must be targeted to skill-oriented education than purely academic field. This is necessary for reduction of unemployment among the school leavers, particularly at 0-level. Educational loans and grants must be provided to the poor, but not to all, in order to mobilize the labor force for the next decade. Non-boarding university institutions must be established to enable those who are unable to pay for boarding to pursue higher education.

The main challenge to the Kenyan government now is to stay the course and build a growing consensus of all partners in Kenya's economic development around the direction that has been set. We do not, in any way, underestimate the difficulties of the policy challenges that Kenya faces, but I believe we are all inspired by the start that has been made and by the sure knowledge that the potential is there. If strong reform and wise economic management can continue, the opportunities for adversement and investors will be great and the ultimate goal of real improvements in the well-being of ordinary Kenyans can come in to sight. But this can only be forthcoming if corruption, particularly within the government structure, becomes transparent and reduced to a minimal.

4. Conclusion

In conclusion, the analysis of this paper clearly suggests that the repressionist hypothesis formulated by McKinnon and Shaw (1973) appears to have a pronounced negative effect in Kenya. Our analysis confirms that the failure of Kenya's economic mobilization and adjustment was, in greater part, due to lack of transparence in government and rigid social system since Kenya is well endowed with natural resources.

The inapplicability of the repressionist notion leading to drastic decline in Kenya's economic growth and weakening of the financial management has recently forced the government to undertake serious liberalization and infrastructure adjustments in order to give some impetus to economic development and financial stability. There is some evidence that these measures have stimulated a positive change in both economic growth, financial management, and the well-being of the society as a whole.