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Effectiveness of Financial Sector Reforms in Promoting Domestic Private Investment in Kenya

The Kenyan government has over the last decade been implementing financial sector reforms aimed at promoting private investment. The main focus of the reforms was liberalization of interest rate and exchange rate, privatization of state-owned enterprises, abolition of direct credit controls, and modernization of the Nairobi Stock Exchange to encourage private investment. These reforms were expected to increase credit to the private sector, narrow interest rates spreads and increase private investment levels. However, the response of the reforms has mostly been on the contrary, particularly in increasing investment levels. Growth in private investment as a share of GDP has declined or stagnated. During some periods, investment levels registered negative rates. For example, over the period 1999-2003, private investment growth rate was negative 6.7 per cent of GDP. It is important to understand why private investment has not responded to financial sector reforms, in order to facilitate review of the current financial policy stances, which seem to constrain private investment growth.

The desired outcomes of increased private investments and better allocation of credit to the private sector following implementation of financial sector reforms was not realized largely due to dependence on imported intermediate inputs, low savings and high interest rate spreads, presence of a huge informal sector, and due to inability to exploit the potential of the capital market.

Dependence on imported intermediate inputs and exchange rate effects

The arguments in favour of relaxation of controls were based on the assumption that liberalization of interest rates would allow the free market to determine

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the allocation of credit by triggering positive interest rates, which would in turn trigger increased savings and subsequently increase the supply of financial resources available for investment in the economy. However, the realization of standard outcomes from liberalization of interest rates was limited because of not considering the characteristics typical to Kenya, such as high import content in the production process. The dependence of investors on imported capital goods exposes them to external forces and shocks. Thus, even if there are changes in interest rates triggered by financial sector reforms, positive investment gains arising from interest rate deregulation on aggregate demand is likely to be reversed by the negative effects of the exchange rate variable on the cost of production and its resultant impact on aggregate supply, especially when it involves loss of value of the currency.

Currently, the exchange rate in Kenya is strengthening, a situation that is theoretically expected to depress growth of exports and encourage an increase in imports and ultimately reduce investment. However, according to the findings of the study on which this policy brief is based, a currency that is loosing value may trigger a negative effect on private investment. This implies that the effect on investment from the price of imports when a currency is loosing value may outweigh the benefits of increased competitiveness.

Low savings and high Interest rate spreads

Savings in Kenya are low due to low income levels, high unemployment rates, high dependency ratio resulting from high poverty levels, and poor distribution of financial outlets around the country and especially in the rural areas. Thus, the view of pegging investment on savings as advocated by liberalization theories has limited applicability in Kenya, where almost half of the population lives below the poverty line. Consequently, even when interest rates on deposits increase, the impact on savings is minimal. This is because the resources that would be available for saving in response to high interest deposit rates are diverted to meet the demands of dependants and address household poverty issues.

Moreover, interest rate spreads are still wide. For example, over the period 1995-2003, interest rate spreads were on average 13.5 per cent, which compares unfavourably with other African countries with average interest rate spreads of below 7.5 per cent.

This observation partly explains why the level of private investment as a share of GDP averaged above 5 per cent of GDP over the period 1995-2003 for these countries, while private investment as a share of GDP for Kenya was below 1 per cent over a similar period. This implies that the lending rate of interest is still high and deposit rate still very low. This should also explain why credit to the private sector has not exhibited clear upward trends contrary to the expectations of the outcome of reforms.

Deposit interest rate has a negative effect on private investment. Although the credit to the private sector has a positive effect on private investment, the result is not significant, suggesting that provision of credit to the private sector by banks is not adequate, or that investors rely on credit from the informal sector.

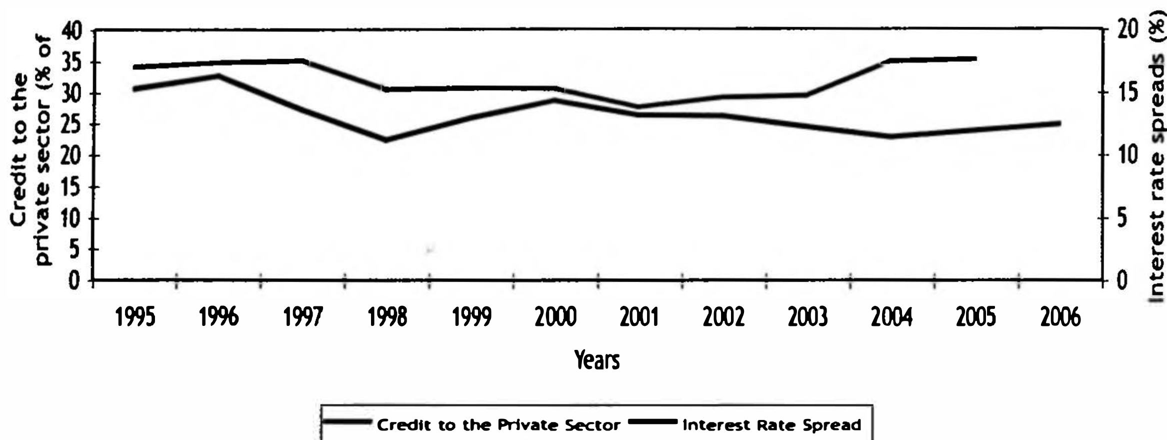
Informal sector

The financial sector in Kenya is dualistic, where the informal sector and the formal sector co-exist. Often, informal modes of financial intermediation prevail in response to government restrictions. Some of the business sector investors, therefore, borrow from unofficial or parallel markets, whose data is unavailable to the government, and its size therefore unknown. Thus, any regulations and prudential guidelines by the Central Bank laws do not have a direct impact since the informal sector is not regulated by any of the laws. For a long time, over 50 per cent of Kenyan investors who are micro, small and medium enterprises have depended on Savings and Credit Co-operative Societies (SACCOs) as the main channel of savings and lending.

Private investment and interest rate spreads, 1995-2003, for selected African countries

	Kenya	Egypt	Botswana	Swaziland
Private investment (share of GDP)	0.51	5.46	7.57	6.39
Interest rate spread	13.48	4.39	5.25	7.40

Source: Computed from the Economic Survey (various)



Source: Computed from the Economic Survey (various)

Consequently, changes in monetary policy actions that are meant to influence the official interest rate have not been effective since the cost of lending and borrowing is unregulated and determined largely outside the official circles. The implication is that the interest rate does not play the expected role in the formal marketing system. Interest rates' effects that operate through the informal market operations are not directly subject to the actions of the Central Bank of Kenya.

The Government has made efforts to reform the informal sector, integrating it into main stream policy making and making provisions facilitative to its growth. Notably, the Micro Finance Act 2006 is a major stride in this direction. However, the capital adequacy requirements for district or divisional community-based micro finance are likely to lock out sections of entrepreneurs. This is because of regional disparities in productivity and expected returns, which are major determining factors in attracting private investment. There is also a possibility of investors, who would otherwise afford to establish a commercial bank, taking advantage of minimum capital adequacy for the national community microfinance due to the differences in adequacy requirements. This implies that the commercial banking sector is likely to thin out over time, which would induce inefficiency and oligopoly structures, especially considering that their capital adequacy requirements have to increase by 300 per cent in three years.

Promoting reforms in the capital market

The capital market in Kenya has developed over time mainly due to privatization of state-owned enterprises through Initial

Public Offerings (IPOs) and investors' demand for alternative forms of funding to the banking sector. Some of the capital market reforms implemented towards promoting and facilitating private investment include:

- Introduction of the Automated Trading System (ATS) in 2006, which has since resulted in high trading volumes with the daily market turnovers exceeding Ksh 1 billion in some days, besides increasing trading efficiency and price discovery, all of which promote increased investment productivity.

- Restrictions on the percentage of ownership for local investors. The percentage was recently revised from 25 per cent to 40 per cent to promote domestic investment.

- Exemption from income tax of all listed bonds with at least a maturity period of three years. This reform was implemented to encourage raising of funds by investors using the bond market.

The capital market has a positive and significant influence on private investment. However, the capital market still has potential to influence private investment in terms of quantity and quality as has been exhibited through over-subscriptions in the IPOs and the excess liquidity within the Kenyan economy. Some of the challenges facing the capital market that constrain private investment include:

- Lack of credit rating agencies in Kenya. Credit rating services in Kenya are provided by an international credit rating agency in South Africa. However, a local credit rating agency is required because it is cheaper and would incorporate the knowledge of unique local characteristics of companies.

- Limitation of financial instruments traded in the exchange to equities and bonds. The futures market is absent, and this constrains private sector agents, particularly traders and farmers, from hedging against risks of fluctuations in the exchange rate and prices through futures contracts.

Policy Proposals

In the recent past, the Government of Kenya has made commendable efforts in enhancing financial sector reform policies by, among other things, laying emphasis on the informal sector and enacting the Micro Finance Act 2006 to cater for small and medium enterprises. However,

there are still other constraints facing private sector investors, which could be addressed through the following policy interventions:

Foster bank competition to reduce lending rates

The absence of adequate bank competition is reflected in the gaps between deposit rates for savers and lending rates for borrowers. To reduce lending rates and, therefore, narrow the interest rates spread and increase credit to the private sector, efforts should be made to cultivate channels for issuance of various debt instruments. Such efforts should be geared towards deepening the bonds market by, among other measures, encouraging establishment of a local credit rating agency through appropriate regulatory framework.

For investors, a credit rating agency increases the range of investment alternatives and provides easy-to-use measures of relative credit risk. A credit rating agency would also promote corporate debt issuance and enhance competition and efficiency in the financial system. This would in turn lower the cost of borrowing, promote credit to the private sector and narrow the interest rate spread. The government should also accelerate privatization of the banks in which it still holds shares to enhance competition and promote corporate governance. Continued partial state ownership of banks interferes with the full achievement of bank efficiency gains from privatization.

Tailor-made minimum capital adequacy

In order to adequately accommodate the needs of the informal sector, the minimum capital adequacy requirements for the operation of a community-based microfinance should be tailored to suit regional disparities in expected returns for investors. The required minimum capital adequacy for micro finance institutions should be maintained for areas that generally attract investment. In marginal areas, the capital adequacy should be revised downwards. This action requires a review of the Micro Finance Act 2006 by the Central Bank of Kenya.

Diversify financial instruments in the capital market

Full exploitation of the capital market potential and enhancement of financial resource mobilization for private sector investment requires introduction of a variety of financial instruments in the

capital market. This will not only provide investors with more risk diversification opportunities but it will also foster competition and innovativeness. Such new products in the market would include: futures and other hedging instruments that are not currently traded in the capital market. Such action requires appropriate legal framework and an enabling environment for the establishment of such markets. The Capital Markets Authority, the Nairobi Stock Exchange and the government are the major actors in the implementation of this action.

Reduce the cost of production

According to the findings of the study on which this brief is based, a depreciating exchange rate depresses private investment. However, theoretically, a currency that is loosing value should enhance competitiveness and improve the trade balance while a strong currency encourages a consumption boom, which in the long run can depress savings and hence investment. The result suggests that the high price of imports resulting from a currency that is loosing value would be one of the factors contributing to depressed investment by increasing the cost of production. Since, most investments in Kenya have a high import content, other measures that reduce the cost of production, such as accelerated expenditure on infrastructure and security, should be enhanced in the medium term. In the long run, pursuing strategies of enhancing the policy of less dependence on imports would be the best option.

Exchange rate band

Analysis of the exchange rate indicates that in the case of Kenya, neither an overvalued exchange rate nor a devalued exchange rate is completely favourable for private investment. This implies that a case for a blend between the controlled and decontrolled exchange rate policy would be one of the preferred options in order to strike a balance between the gains from exporting and importing and hence create a more predictive private investment response to reforms. An exchange rate band—bounded both ends—within which the currency can fluctuate from the assigned value should, therefore, be considered, at-least in the medium-term. Such a policy would not only create predictability and certainty, but it would also allow the investors to approximate the range within which their profits and returns would oscillate and hence facilitate proper planning and decision making.

About KIPPRA Policy Briefs

KIPPRA Policy Briefs are aimed at a wide dissemination of the Institute's policy research findings. The findings are expected to stimulate discussion and also build capacity of public policy makers in Kenya. KIPPRA acknowledges support from the Government of Kenya, the European Union (EU), the African Capacity Building Foundation (ACBF), and all other development partners who have supported the Institute's activities.

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