

**A STUDY TO ESTABLISH FACTORS DETERMINING COST OF FOREIGN  
BORROWING FOR FINANCING INVESTMENT PROGRAMS IN THE PUBLIC  
SECTOR: A CASE IN CENTRAL GOVERNMENT OF KENYA**

**BY**

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**AUGUST, 2011**

## DECLARATION

This research project is my original work and has not been submitted to any other University for examination.

Signature 

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This Research project has been submitted with my approval as the University supervisor.

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**Supervisor**

## **DEDICATION**

This research project is first dedicated to my **loving wife Mercy** and **children, Lynn, Joah** and **Hope** for their moral and emotional support while carrying out the study.

Also to my **parents Eliakim** and **Marren** who have always had good intentions and struggle for me. Thank you very much and God bless you.

Most important may **I** recognize our **Almighty God** and be grateful to Him for His blessings, guidance and protection **I** enjoyed while carrying out this study. **Lord** Thank you very much.

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Last but not least I would like to thank all those who helped me in any way to complete this research project.

May the Almighty God bless you all in abundant.

AdoKL-VIA 1 HJIXc\*

ADB/F	-	African Development Bank/Fund
BOPA	-	Budget Outlook Paper
j)ps	-	Development Partners.
ERS	-	Economic Recovery Strategy for Wealth and Employment Creation
GDP	-	Gross National Audit Office
GOK	-	Government of Kenya
GOVTS	-	Governments
IMF	-	International Monetary Fund
LDCS	-	Loss Developed Countries
MDGS	-	Millennium Development Goals
MTEF	-	Medium Term Expenditure Framework
PRFG	-	Poverty Reduction and Growth Facility
PRSP	-	Poverty Reduction Strategy Paper
SBCS	-	Small Business Credit Scoring
UK	-	United Kingdom
USA	-	United States of America
WB	-	World Bank

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## **ABSTRACT**

The overall objective of Government of the Republic of Kenya's debt management policy is to meet the central government's financing needs at the lowest possible long term borrowing cost with prudent degree of risk. All major development projects targeted by government require huge financing much in excess of what it can raise directly through taxation hence it must look for the excess from outside its normal taxation.

Over the years, Kenya has neither enjoyed a balanced nor a surplus budget. The budgeting process has always been based on a deficit to be filled through borrowings, locally and abroad. It is at this point that the financial system that includes international sources facilitates Government to bridge the deficit (GoK annual public debt management report, 2010).

Economists maintain that social/national wealth increases only if the benefits from specific projects/investments exceed the costs of those projects. Project costs are varied depending on the type and the sector of the project. However all borrowings for investments have one type of cost, the financing cost. It is therefore prudent to borrow for investments only if it is cost effective, that is, when the costs associated with debt financing and likely effects on the economy as a whole is beneficial.

It should be recognized at the outset that the cost of capital is one of the most difficult and disputed topics in the foreign loan theory. Financial experts express conflicting opinions as to the way in which the cost of capital can be measured. It should be noted that it is a concept of vital importance in the financial decision making especially in evaluating investment decisions, designing a firm's debt policy and appraising the performance of the firms' top management, (Pandey.I.M 2004).

This study went ahead to establish factors determining cost of external borrowing for investment financing in Kenya by analyzing data collected from both primary (key participants in investment financing like Debt Officers, Finance Officers, Accountants, Economists among others from both GoK and DPs) and secondary data from various sources.

In summary the study established that factors determining the cost of external borrowing towards investment financing in GoK, can be concluded to be: Legal and policy framework factors;

Interest and transaction cost factors; Donor condition factors; Commitment fee; Economic factors; Political factors, management factors among others.

The study also recommended putting in place proper legislative and policy framework to safeguard against the lenders taking advantage of the loopholes in the financial system, developing capacity building plans to strengthen skills and knowledge of the officers participating in investment financing among others.

# CHAPTER ONE

## INTRODUCTION

This chapter focuses on the background and problem statement of this study as well as the purpose, research objectives, justification and limitation. It also sets the scope and other expected outcomes of the study.

### 1.1 Background to the Study

For effective economic growth, funds (money) must flow from suppliers (savers) to investors (demanders). This occurs through a financial system, a set of financial markets and other institutions used for financial contract and the exchange of assets and risks, (Financial Institutions Management by Saunders et.al.2008). The cost of money (interest rate) prevailing in the economy acts as regulating mechanism that control the flow of these funds from the surplus units (savers) to the deficit units (borrowers). The cost of capital acts as a major link between an organization's investment decision and the wealth of the owners of the organization/firm. Financial management is an area of foreign loan concerned with how institutions (private or public) acquire and utilize funds, how to organize the entity (including Government) in a manner that will attract, raise and service capital for its targeted development/investment plans optimally.

#### **Government foreign loan**

Historically government finance is concerned with how the Government finances its operations under both recurrent and development expenditure plans in line with their strategic plans (programs that create new capital assets for better livelihood). The number and magnitude of development projects determine or influence a pace of nation's growth. Developed countries have necessarily invested heavily in public sector investments eg. Improving education sector by putting up learning institutions, health sector (putting up and equipping hospitals), energy sector (investing in power generation and supply), agricultural sector (offering subsidized inputs, technical manpower support), developing the transport sector among others.

The government has various alternatives of implementing capital/development projects for growth. This can be done directly by its ministries or agencies (parastatals, independent offices, commissions among others). The overall objective of Government debt management policy is to meet the central Government's financing needs at the lowest possible long term

borrowing cost with prudent degree of risk. All major development projects targeted by government require huge financing much in excess of what it can raise directly through taxation hence it must look for the excess from outside its normal taxation. It is at this point that the financial system that includes international sources facilitates Government to bridge the deficit (GoK annual public debt management report, 2010).

The government can raise funds through a deep financial system that involves both domestic financial institutions and markets like capital markets (Nairobi stock exchange, local commercial banks and a galaxy of financial institutions comprising of banks and non banking institutions) and from foreign sources (Government of Kenya, 2010).

Since year 2010, the government of Kenya has increasingly used the domestic capital markets to source for development funds through issuance of bonds of different maturity periods ranging from one year and above. Over the years, the costs and maturity periods for these continue to increase with the latest being the 25 years old Treasury bond (GoK annual public debt management report, 2010). Other long term bonds include 15 years, 18 year infrastructure bonds among others. However for long term borrowing, GOK has been relying on financing provided by the international financing institutions such as World Bank, International Monetary Fund (IMF), African Development Fund/Bank (ADF/B) among others.

Economists maintain that social/national wealth increases only if the benefits from specific projects/investments exceed the costs of those projects. Project costs are varied depending on the type and the sector of the project. However all projects have one type of cost, the financing cost or cost of foreign loan.

In this era of liberalization, fiscal discipline remains a major key to economic growth for many economies world over. In the past, developing countries received huge external aid flows from the donor community aimed at promoting their economic growth and poverty reduction. Although several externally foreign loaned projects and programmes have been initiated, economic growth and poverty reduction rates have been disappointing. Today external resources constitute an integral part of development expenditure in the developing countries, for they are faced with major budgetary constraints and use foreign inflows to cover any deficits within the exchequer (Levy, 1987; Mosley et al., 1987; Devarajan, et al., 1998; Ali et al., 1999).

Unfortunately, with fiscal problems and the change in political focus by the donor community, the foreign aid taps seem to be running dry and the available are accessed at a cost (Feyzioglu et al., 1999)- This has had serious ramifications for the budget process of highly aid-dependent countries.

It is noted that throughout the world, many countries including Kenya face the complex task of trying to redefine the role of the public sector in the pursuit of sustained economic growth and sustainable development. Among the challenges arising from that pursuit is how to introduce efficiency; effectiveness and responsiveness into the way public funds are raised and managed (United Nations, 1996).

Kenya's current development blue print vision 2030, anchored on three main pillars - economic, social and political, is aiming at transforming Kenya into a newly industrializing, middle-income country providing a high quality life to all its citizens by the year 2030. The adoption of the vision by Kenya came after the successful implementation of the Economic Recovery Strategy of Wealth and Employment Creation (ERS) which was in line with the Millennium Development Goals (MDGs) and has seen the country's economy back on the path to rapid growth since 2002, when the GDP grew from a low of 0.6% and rising gradually to 6.1 % in 2006,(Government of Kenya 'Vision 2030',2007).

The proper planning of public expenditure is clearly an important mechanism in the government's overall control of the levels of public sector spending. For example, the Plowden Committee, reporting in 1961, recommended that: 'Regular surveys should be made of public expenditure as a whole , over a period of five to ten years ahead, and in relation to prospective resources, decisions involving substantial future expenditure should be taken in the light of those surveys' (Plowden Report, 1961).

It should be recognized at the outset that the cost of capital is one of the most difficult and disputed topics in the foreign loan theory. Financial experts express conflicting opinions as to the way in which the cost of capital can be measured. It should be noted that it is a concept of vital importance in the financial decision making especially in evaluating investment decisions, designing a firm's debt policy and appraising the performance of the firms' top management, (Pandey.I.M 1999).

In Kenya, the administration of management of public foreign loans is anchored in the Constitution under chapter twelve, the Government Financial Management Act, 2004; the Public Audit Act,2003; the Public Procurement and Disposal Act,2005; Treasury circulars

of management of public funds are the National Assembly, County Assemblies, the Treasury, and the Kenya National Audit Office (KENAO).

The major portion of the Government of Kenya's development projects/programmes are financed by the development partners who give foreign aid in form of grants and loans, based on assumptions of economic rationality. Most of these development partners have often put conditionality that the government must provide counterpart financing in the budget in any given year, either by meeting a certain percentage of cost or providing in kind inputs in the form of staff among others.

The Kenya Government's budgetary process starts with the ministerial expenditure reviews for the previous periods by both the parliament and the concerned stakeholders, taking into account the updates of the macro/fiscal economic frameworks for the ensuing periods in line with the strategic-multiyear, sectoral perspective program focused and the donor commitments. Then under the coordination from both the Ministry of Finance and Ministry of Planning and National Development, Treasury issues Budget Strategy Paper, preceded by the fiscal strategy paper, indicating the sector ceilings for approval by the cabinet, before a detailed budget is prepared by the line ministries, reviewed by the secretariat before tabled to parliament for final approval for implementation, (GoK MTEF Paper, 2005).

Kenya as a country is facing a challenge of balancing between domestic and foreign borrowing and also setting the optimal deficit point in order to minimize the cost of borrowing and budgetary deviations in implementing its investment projects.

## **1.2 Statement of the problem**

The cost of capital (the opportunity cost of capital) serves as a basic financial standard for evaluating the viability of the investment projects especially by using it to discount the expected cash flows. It serves as the minimum required rate of return or cutoff rate for any project to be accepted depending on the riskiness of the future cash flows. In designing the financing policy of any organization, that is the sources of funds, the organization must aim at Minimizing the overall cost of financing, by going for the best options available, (Pandey. I.M, 2004).

The Government's commitment to pursuing its development policy (vision 2030) is based on some assumptions underpinning the fiscal and economic framework. These assumptions



between 20-25% of the GDP, development expenditure growth rate of between 8.5 - 10% of GDP and maintaining both fiscal deficit and inflation of less than 5% each of the GDP. This is consistent with the Kenya Debt Sustainability Needs and ensuring that the country's domestic and foreign debt growth is at a level which allows for the expansion of credit to the private sector commensurate with the need for investments, trade and private sector development (Kenya Government, 2007).

The fiscal deficit has been fluctuating over the years for example it rose from 3.5 percent of GDP in 2007/08 to 6.5 percent of GDP in 2009/10 and 6 percent of GDP in 2010/11. Similarly, government net domestic debt increased slightly over 24 percent of GDP from 17 percent of GDP in 2007/08. It is worth underscoring that without deliberate fiscal and monetary stimulus actions by the Government, the side effects like recession, reduced economic activities, job losses among others are likely to be worse, (GoK, Budget Policy Statement, 2011)

Over the years, Kenya has neither enjoyed a balanced nor a surplus budget. The budgeting process has always been based on a deficit to be filled through borrowings, locally and abroad, besides readjustment of some planned revenue and expenditure programs as necessary to take care of the hidden deviations, (GoK BOPA 2009). The costs associated with debt financing and likely effects on the economy as a whole cannot be underestimated. Most of the externally borrowed funds are concessional, have average grace periods of seven years, with repayment periods ranging between 25-40 years. Attached to these benefits are a lot of stringent conditions from the financiers that have never been taken seriously while sourcing and negotiating for these funds.

A study was conducted by Norwegian Government in 2006 to review the adverse effects of some conditionalities imposed by Bretton Woods institutions on borrowing countries, such as the need to liberalization and privatization before accessing the funds. The study found that there remains a notable absence of "policy space" in many of these countries to implement economic policies contrary to those advocated by the Bank and the Fund despite the institutions' conceptual shift towards "ownership" as a principle guiding their lending operations. Accordingly, the report concluded that "in only 7 of the 40 cases did privatization figure as an important element of the Poverty Reduction and Growth Facility (FRGF)".

It concluded that privatization and trade liberalization continue to feature significantly in loan conditionalities and policy advice from both the Bank and the Fund in spite of rhetoric to contrary and despite the lack of empirical evidence demonstrating the correlation between trade liberalization and poverty reduction.

Sri Lankan Economic Journal, August 2007 on review of Foreign borrowing, 'when costs outweigh benefits' recognized that foreign borrowing has become an intense topic of discussion nowadays in and out of Parliament. This came to the discussion forefront when the government intended to borrow US\$ 500 million from the international money market in 2007, with a lot of political influence rather than being economically driven. Doubts were whether such a magnitude of foreign borrowing would bring in adequate benefits outweighing the costs (not only financial costs but costs associated with consequent bad economic policies). Sri Lanka has managed its foreign debt quite prudently by resorting to borrowing from international agencies at low rates of interest and with long periods of repayment. Many of these loans have been virtually costless. However whether they have been put to the best use and been adequately productive was a different question.

The simple fact is that if the funds are used for investments with a high return and those that produce exportable goods, then the debt burden would be increased only for a brief period of gestation of the investment. Borrowing at commercial rates and short periods of maturity for purposes that don't yield exportable goods could result in the country being caught up in a debt trap. Would the costs of foreign borrowing be justified by the sensible use of the funds so borrowed?

This study therefore was to establish the factors determining cost of external borrowing towards financing the GoK's investment programmes.

### **1.3 Research objectives**

This study was intended to establish key determinants of effective cost of foreign loans borrowed to finance public investment programs, the parameters held before agreeing on the cost of foreign debt in Kenya, the effects of management of external borrowing on the cost of financing, and how the legal and policy framework influences the cost of externally borrowed funds.

#### **1.4 Benefits of the study**

The results of this study are expected to benefit both Government and the general public to gain insight on the factors that affect cost of external borrowing towards investment financing. The study is going to establish the key variables that need to be taken into account by policy makers while negotiating for prices of the loans and other forms of credits. The results of this study will also be used as reference point by scholars wishing to have in-depth understanding on debt financial management criteria in the public sector.

## CHAPTER TWO

### LITERATURE REVIEW

#### introduction

The Literature review will be obtained from Primary and Secondary data collected by the Searcher. The Primary data will be obtained through questionnaires filled by staff of the various Ministries in Kenya. The secondary data is being obtained from relevant magazines, journals, institutional research publications and reports, financial text books, government Publications and projects among others.

#### **An overview of cost of foreign borrowing**

The development theory upon which the issue of foreign borrowing draws its existence dates to the 1930's Marshall Plan and the emergence of the growth models in the late 1940s. Adams Smith and Ricardo advocated for specialization in foreign trade, capital accumulation and **increased** productivity as being the fundamental determinants of growth. Schumpeter (1949) commended the transfer of foreign capital and investment embodying entrepreneurship to the developing countries as the principal means of promoting growth in the developing countries.

The end of the Second World War marked the emergence of the modern growth model, with theories which recognized the need for capital and labor as inputs such as the Cobb-Douglas Production function and Harrod Domar-Model (1947). Research by Rodan (1950) in his theory of the Big push recommended a flow of foreign borrowing of heroic dimension in order to push the Less Developed Countries (LDCs) out of the poverty trap. Reston's take off theory **influenced** public policy especially with regards to foreign aid and its need to boost the economies of LDCs to self sustainable growth. Despite the numerous criticisms the theory attracted, it was very influential in policy formulation during the 1950s. All the above did conclude that the cost of borrowing from outside is far much cheaper than from within the country

The priority of economic thought of foreign aid is somewhat peculiar; the phenomena success Marshall plan in the developed countries would permit their comparable spectacular [Nation in Less Developed Countries (LDCs). This led to belief that foreign borrowing contributed success in LDCs. This underpinning was argued by the Harrod Domar-Model • extended the Keynesian emphasis on borrowing to include its emphasis on physical

capital and the view that shortages of capital largely accounted for the poverty of the developing countries. The role of foreign borrowing followed logically from this analysis.

### 2.3 Relationship Lending and Previous Research

Loan rationing can be reduced by close business relationships between borrowers to help increase availability of loan for applicants. While some previous studies on lending relationships in the USA concluded that improved loan conditions with long term relationships lead to lower interest rates, other studies in Europe conclude the opposite (*Cardone et al 2005*). Because of the different characteristics of financial systems in various countries, for example market based systems of the USA and the UK compared to countries with lending based systems such as Germany, France, Spain and Italy, differences in interest rates charged and guarantees are expected.

Petersen and Rajan (1994), in analyzing the benefits of relationship lending performed a study which measured the duration of lending relationships in the U.S. They examined the effect of relationships between borrowers and lenders on the availability of loan. The study concluded that relationships increase the availability and reduce the price of loan to firms. In another study, Berger and Udell (1995) used the same data to analyze the importance of relationships between borrowers and lenders in the allocation of loan to governments. They also found that the relationship with the lender increases the availability of loan to borrowers.

Table 1. below shows several studies that have been done in various countries namely, U.S., Germany, Italy, U.K., India and Tanzania (East Africa).

**Table 1: Empirical Evidence of Foreign Lending in Various Countries**

Country	Authors	Study Aims.	Study conclusions
USA	Petersen and Rajan (1994)	Measured how firm-lender relationships affect interest rate quoted on the loan applied for.	Relationships increase the availability and reduce the price of loan to firms
	Berger and Udell (1995)	Survey on lender relationship	Relationship with the lender increases the availability of loan to borrowers
	Cole (1998)	NBSSF database on duration effect	The duration of relationship is proportional to loan availability.

<b>Country</b>	<b>Authors</b>	<b>Study Aims.</b>	<b>Study conclusions</b>
ITALY	Angelini Di Salvo and Fern (1998)	Effect of bank-firm relationships on the cost and availability of loan	Longer loan relationships increase the cost of loan pay high interest rates.
UK	Binks and Ennew (1997)	How banks and their 5MB customers could benefit from a closer relationship	Banks and GOVTS's could benefit from closer relationships.
GERIVIANY	Lehmann and Neuberger (2000)	Surveyed banks to find out if social interactions are beneficial to both the borrower and the bank.	Close relationships between banks and firms enhance the availability of loan and reduce the cost of loans.
SPAIN	Cardone, Longarela and Camino (1998)	Analyzed GOVTS's on their financial situations and duration of relationships.	Duration of lending relationships enhances availability of loan.
/	Canovas and Solano (2002)	SABE Database	GOVTS's that work with fewer banks obtain debt at a lower cost.
	Cardone, Cassasola and Samartin (2005)	Survey on effects on number of financial institutions on cost of borrowing	Companies that work with more of banks had more possibility of accessing loan.
INDIA	Ghosh (2004)	Examined relationships between firms and state owned, private and foreign banks	State owned banks have comparative advantage in providing relationships.
TANZANIA EAST AFRICA	Assad and Igogo (2005)	Analyzed the effect of foreign borrowing relationships on GOVTS's on the availability and cost of loan	Availability of foreign loan increases as the firm spends more time in the relationship with the foreign borrowing

Cole (1998) also analyzed the importance of relationships to the availability of loan in the USA. However his study differed from the other U.S. studies as it directly analyzed the effect the relationship had on whether the government was denied or extended loan. This study stressed the availability rather than the cost of loan.

Angelini et al (1998) analyzed the effect of bank-government relationships on the cost and availability of loan from a sample of small Italian firms. Their study however, drew contrasting results from the studies in the U.S. They found that longer loan relationships may increase the cost of loan as companies that maintain longer bank relationships pay high interest rates.

In Germany, Lehmann and Neuberger (2000) found that strong lending relationships between foreign borrowing and GOVTS's play an important role in the lending based financial system of Germany. They stated that close relationships between foreign firms enhance the availability of loan and reduce the cost of loans. They argue that it is the theory of social interactions and not just the theory of intermediation alone that drives availability of loan. Lehmann and Neuberger (2000) also discovered that social interactions are beneficial to both the borrower and the foreign bank. They interviewed managers of financial institutions and found that loan was only issued to firms after 2 years of the lending relationship.

In Spain, Cardone et al (1998) performed a survey on a group of companies by analyzing GOVTS's on their financial situations and duration of relationships. Their study, which had similarity to the study in Italy, concluded that the duration of lending relationships do not enhance availability of loan. Cardone et al (2005) performed a study on whether lending relationships improve loan availability for Spanish GOVTS's. The study looked at lending relationships by examining the effect the relationship on compensation as well as long term loan rationing. Their study concluded that longer relationships increase possibility of more loans.

In the UK Binks, Ennew and Reed monitored the relationship between banks and small governments' between 1988, 1990, 1992 and 1994. They realized that there was concern with bank charges, interest rates and collateral required *{cited in Binks and Ennew 1997}*. This study found out those banks and their GOVTS' customers could benefit from a closer relationship. It was realized that despite changes in procedures by banks to explain the levels of charges, there was still significant lack of transparency in the pricing process *{Binks and Ennew 1997}*.

## **2.4 Theoretical issues in Credit Markets**

Public Institutions have traditionally found problems in accessing funding for their operations due to a 'foreign loan gap' which has been debated over for years since the Macmillan Report (Macmillan 1931). Stiglitz and Weiss (1981) pioneered the theoretical issues in the area of credit markets. They stated that, in a perfect market with information available for both parties, a foreign loan gap would not occur, however markets are characterized by a number of imperfections, which lead to information asymmetry.

Problems that are encountered in providing foreign loan to Public Institutions are due to the existence of asymmetric information. This is because the business owners have more information than the lenders (Burns 2001; Binks and Ennew 1996). Williamson (1975) argued that foreign countries were always more informed than insiders on the market as they had better access to information (cited in Storey 1994). Information asymmetries may result in adverse selection, where the lender is unable to identify governments with the highest expected return relative to risk. This situation could lead to moral hazard (Stiglitz and Weiss 1981). Stiglitz and Weiss (1981) also discovered a problem with credit rationing where lenders exclude potential borrowers from access to credit even when they are prepared to pay higher rates for the funds.

The market imperfection mentioned above thus arises because the interest rate charged to successful borrowers is not the market clearing rate, and this leads to a gap in the market. Jensen and Meckling (1976) introduced the concept of agency where the foreign countries acts as an agent for the bank and the bank has to ensure that the government owner honors the contractual obligations of repaying the loan. However the problem is that the interests of the two parties are not identical and this leads to an appraisal problem with its related costs as the bank is forced to obtain background information for making decisions on whether or not to provide the loans (cited in Storey 1994). Although credit rationing affects Public Institutions in both developed and developing economies, Public Institutions in developing countries are likely to face more severe credit rationing because of lack of strict reporting and auditing requirements (Mullineux and Murinde 2001). Information asymmetry however, can be controlled through traditional banking instruments such as collaterals, covenants, business relationships, ownership, reputation and human capital (Scholtens 1999).



Macroeconomic theories of banking and financial contracting explain that the wide use of collaterals reduce credit rationing. Collaterals can bridge the information gap and reduce risks involved for the bank (Eije et al 2001). Collateral may also accommodate adverse selection and moral hazard as the risk of failure is taken over by the asset owner (the borrower). However Public Institutions are less capital intensive thus suffers from limited collateral. Covenants on the other hand, are used by financial institutions to reduce the credit gap, this gives them more control over borrowers. However Public Institutions do not have proper audited accounts thus makes it difficult to use collateral with them. Lack of business relationships according to Berger and Udell (1998) are a basic cause of information asymmetry, because if the bank does not have close relationships with its borrowers, it will not be able to monitor or influence their activities. Thus if the bank decides to offer other services than just financial services a mutual trust can be developed {Eije et al 2001).

**Table 2: Availability and Access to Loans in 13 African Countries**

	Commercial and Development Banks			NGO Foreign loan		
	Availability		Low	Accessibility		Low
	High	Medium		High	Medium	
Cameroon			x			x
Cote d'Ivoire			x			x
Ethiopia			x			x
Gabon			x			x
Kenya		x			x	x
Mauritius		x			x	n.i.
Morocco			x	x		x
Namibia		n.i			x	n.i.
Nigeria		x			x	x
Senegal			x		x	x
South Africa	x				x	n.i.
Tunisia	x				x	x
Uganda			x		x	x

**Source: ECA (2001)**

### 2.5 Problems in accessing foreign loan by Public Institutions

Problems in accessing foreign loan by Public Institutions in Africa is due to high transaction costs by financial institutions, lack of borrower's credit history and lack of adequate collateral. Other factors are uncertainty of repayment by the borrower, the cost of lending and time factor compared to the profitability of the business opportunity for loan applied, uncertainty of the viability of investment projects, macro economic instability and cultural barriers (Fisher 1995 cited in CIPIA 1999).

A good question for this problem is, have the financial systems been prepared to deal with the access problem? After financial reforms in many developing countries in the 1990s, the financial sector became the fastest growing sector. However a consequence of this was high demand for foreign loan by businesses, which formal financial units failed to satisfy. Small business thus experienced inadequate financial support and when credit was available from the financial sector, the terms under which it was provided, was considered to be difficult for the small businesses to meet (Aryeetey and Fenny 2006). According to Van Eden (2003), factors hindering SME access to foreign loan in South Africa are due to government structures, financial services sector, stringent bank lending criteria, poor quality of business plans, lack of business skills, lack of own capital, lack of collateral, inability to meet loan obligations, high bank costs and discrimination. While in Nigeria the constraints experienced by Public Institutions were access to foreign loan, regulatory and licensing procedures as well as government policies as the major problem (Woldie and Adesua 2005).

According to Peachey and Roe (2004) the main constraints of access in developing economies are due to the absence of basic prerequisites for monetized exchange that is the proximity of the bank to the customers and literacy. While the cost of banking services is another factor, high interest rate is major problem for businesses in Sub-Saharan Africa. Aryeetey and Fenny (2006), state that the problem of high interest rates is caused by lack of competition in African markets. They state that between 1990 and 2004, the difference between lending and deposit rates for many Sub-Saharan African countries was in excess of 12 percentage points and appeared to be widening (Aryeetey 2005).

In 2004, the interest rates in Kenya and Tanzania were at about 13% and that was the lowest. Africa's failure to provide formal foreign loan to small borrowers has meant that the majority continue to seek foreign loans from non-formal sources such as friends, family, relatives, neighbors, traders and other money lenders. The advantage of flexibility speed, transparency of procedures, personal relationships and low transaction costs are the main strengths of informal private foreign loan (Aryeetey and Fenny 2006). However there are disadvantages in informal credit as some lenders charge very high interest rates thus small borrowers tend to borrow only when it is critical to do so, and borrowing is often restricted to small amounts obtained for brief periods.

## **2.6 Improving Access to Foreign loan**

According to Miller and Rojas (2004) the use of small business credit scoring (SBCS) technology is common in developed economies by banks and other lenders to reduce

information asymmetry. This technology is widely used in the US, however in developing economies there is still limited use. They further state that although some large financial institutions in developing countries have implemented SBCS technologies pooled data models have not been adopted. The main problem with this system is that lenders fear to share their data with small business customers which may lead to loss of their information advantage. This technology may not work in the developing world where there is lack of transparency among both lenders and borrowers; furthermore borrowers in developing countries pay high interest rates making it a very profitable market segment. Miller and Rojas (2004) argue that relationship lending may be diminishing in time due to the adoption of SBCS systems. This may be the case in the U.S; however the developing world and even other industrialized countries are yet to have a go on the use of this technology. Furthermore, researchers such as Hauswald and Marquez (2002) and Brevoort and Hannan (2004) in the U.S. have found that it is large internationally active lenders that are employing this technology while local lenders still rely on relationship lending (cited in Miller and Rojas 2004).

Improving business conditions through proper information and adopting clear accounting standards is important in small business lending (Kauffmann 2005). This calls for a proper legal system that is able to settle contract disputes as well as effective bankruptcy procedures. Removing the obstacles to access requires that commercial banks, MFIs, community groups and business development services to work closely together. While Peachey and Roe (2004) argue that pressure for increased transparency on the cost of banking services may improve access to foreign loan. Other forms of improving access to credit have been realized through lending relationships, are discussed above.

### **2.7 Foreign borrowing: when costs outweigh benefits, (by Sri Lankan economic journal, August 2007)**

The journal recognized that foreign borrowing has become an intense topic of discussion nowadays in and out of Parliament. The advisability of foreign loans came to the discussion forefront when the government intended to borrow US\$ 500 million from the international money market in 2007, with a lot of political influence rather than being economically driven. Doubts were whether such a magnitude of foreign borrowing would bring in adequate benefits outweighing the costs (not only financial costs but costs associated with consequent bad economic policies).

The conditions of borrowing such as the interest rate, terms of repayment and the amount of borrowing have an important bearing. The accumulated debt and the debt servicing cost is also an important dimension. Besides this an all important issue is the use of the borrowed funds. Though the purposes for which foreign funds are used are of vital importance it is this aspect that is often neglected. All these issues are of significance in the context of the new endeavour to borrow a large sum of US\$ 500 million on commercial terms.

Sri Lanka has managed its foreign debt quite prudently by resorting to borrow from international agencies at low rates of interest and with long periods of repayment. Many of these loans have been virtually costless. However whether they have been put to the best use and been adequately productive is a different question.

The simple fact is that if the funds are used for investments with a high return and those that produce exportable goods, then the debt burden would be increased only for a brief period of gestation of the investment. Borrowing at commercial rates and short periods of maturity for purposes that don't yield exportable goods could result in the country being caught up in a debt trap. Would the costs of foreign borrowing be justified by the sensible use of the funds so borrowed?

**Professor Raghuram Rajan of the University of Chicago** delivering the Central Bank 57th Anniversary Lecture during then sounded a word of caution when he said that it was better to rely on domestic savings rather than foreign funds for investment. He said that international experience had shown that developing countries that relied on large foreign borrowing had not benefited much. This he adduced to two possible reasons: financial sector underdevelopment and currency overvaluation.

Professor went ahead and said that large scale borrowing could have a negative macroeconomic effect that economists call the "Dutch disease". What it means is that the comfort of foreign funds results in the pursuance of wrong macroeconomic policies. Corrective actions in fiscal policy and money creation are avoided. As a result there is an appreciation of the exchange rate when the fundamental weaknesses require a depreciation of the currency. Consequently this results in a "tax" on exports and subsidization of imports. This in turn contributes to a widening of the balance of payments deficit.

In order to avoid such an eventuality the country will need to devalue the currency which will bring in a further bout of inflation, contributing to another round of Balance of Payments

worsening and distorting real prices. In fact when governments get large sums of foreign exchange, either as loans or windfall gains, they follow the opposite policies than those required. They opt for palliatives for the current woes rather than the correction of fundamental imbalances in the economy.

In fact developing countries should access foreign funds for achieving higher levels of economic growth. However, these funds should be borrowed at lower rates of interest and on long periods of repayment. They should be used for productive purposes and as much as feasible, for the production of tradeable goods. The resort to foreign borrowing can be an important means of supplementing domestic savings and thereby be a means of enhancing investment and economic growth. At early stages of economic growth domestic resources are very inadequate to propel an economy to high levels of economic growth.

### **2.7.1 Operating cost of implementing projects and accrued interest**

Bardhan and Basu (1984) states that loan pushing occurs whenever lenders try to supply more loan to borrowing countries than the later would voluntarily take at the prevailing interest rate. A more formal definition is problematic because once a loan has been made and accepted both sides may be described as favoring it, whatever the prior arguments, bargains and threats. Winkler (1928) and Gwyne (1983) both state that foreign loans have often been used to promote exports, for the borrowing country usually ends up buying goods from the lending country. The government deciding to borrow may have a greater interest in borrowing country. A country may borrow more than there is in its national interest.

The Government also aims to develop policies that are consistent with macro-economic policies. It also aims to foster growth of the domestic market and create a sustainable local interest rate yield curve and monitor and manage other sources of sovereign risk e.g. contingent liabilities, private sector short term debt among others. These efforts by the government are critical because they show linkage between public policies and their impact to the cost of foreign borrowing (Government of Kenya Investment Programme 2003-2007 (Revised Edition March 2004).

## **2.8 Donor conditionalities**

### **2.8.1 Norway study to review IMF-World Bank conditionality, (2006)**

A study was commissioned by the Norwegian Government to review the adverse effects of some of the conditionalities of the Bretton Woods institutions imposed on borrowing countries specifically on implementing privatization and trade liberalization. The study found that there remains a notable absence of "policy space" in many of these countries to implement economic policies contrary to those advocated by the Bank and the Fund despite the institutions' conceptual shift towards "ownership" as a principle guiding their lending operations.

Conditionalities requiring countries to privatize state-owned enterprises were contained in 23 of the 40 programmes studied while an additional 10 programmes detailed privatization plans by the borrowing government but were not explicitly included in the loans as policy conditionalities, the study found. Accordingly, the report concluded that "in only 7 of the 40 cases did privatization not figure as an important element of the Poverty Reduction and Growth Facility (FRGF)".

The review also found that there was also a shift in emphasis in the policy conditionalities relating to privatization with conditionalities increasingly focused on developing regulatory frameworks and institutions to facilitate the process of privatization in developing countries. This shift is particularly noticeable in Bank lending conditions.

It concluded that privatization and trade liberalization continue to feature significantly in loan conditionalities and policy advice from the both the Bank and the Fund in spite of rhetoric to contrary and despite the lack of empirical evidence demonstrating the correlation between trade liberalization and poverty reduction.

The study recommended that there should be a common understanding of what constitutes necessary and sufficient conditionality and to allow flexibility in setting conditions depending on case by case.

The findings from a review of IMF policy and practice also reveal that "the Fund sees the liberalization of trade as a goal in itself and not as a case dependent item on a menu of development policies" for the borrowing country.

The report therefore concluded that the policies of the World Bank and IMF in the area of privatization and trade liberalization continue to be particularly problematic from the perspective of the Norwegian policy on aid as the use of conditionality, especially by the Fund to pursue reform in these areas, may be inconsistent to "the intentions of the Norwegian government". Furthermore, the report notes that while there is "a stronger sense of national ownership" of lending programmes today, this "ownership" is often circumscribed by various factors, not least the question of whether and how the concept of "ownership" is defined and applied.

The study found that "ownership" of economic policies under Bank and Fund programmes are weakened by the limited participatory process of national stakeholders in the design of policies, even though all the countries studied are required to engage in a broad-based participatory Poverty Reduction Strategy Paper (PRSP) process as a pre-requisites of their financing from the Bank and Fund's concessional lending facilities.

"Ownership" is also weakened by the extensive use of foreign consultants in the design of economic policies in developing countries, leading to a lack of local input and constraints on local capacity to develop national plans. This lack of "policy space" is exacerbated by the lack of analysis of policy alternatives presented to the government in question and where there has been divergent voices in national policymaking, Bank and Fund officials have "used these differences strategically to promote their own view".

There is also a concern, highlighted by the report, of the shrinkage of policy space resulting from increased donor coordination. While noting that harmonisation is a positive step forward in aid relations, this may turn out to be "a double-edged sword for borrowing countries". The report's case studies of four countries - Bangladesh, Mozambique, Uganda and Zambia - found that policymakers in developing countries express concern that donors may "gang up" on governments as a result of greater coordination of donor policies on aid, leaving client governments with even less policy space hence the borrowing ending up being very costly than was expected.

### **2.8.2 Disbursement procedures, loan history reviews**

Most of foreign loans that the Government of Kenya borrows from multilateral and bilateral agencies come with accompanying conditionalities. These conditionalities lead to slow and lengthy disbursement procedures. That is why every lender and borrower must undertake a

loan history review of the country. This history ensures that the borrower does not get uncompetitive rates and inflexible loan limits and conditions from the lender. (Budget Strategy Paper, 2010)

As a condition for foreign aid money, many donors apply conditions that tie the recipient countries to purchase products only from the donor/lender country. In a way this might seem fair and 'balanced', because the donor gets something out of the relationship as well, but on the hand, for the poorer country. It means that precious resources are used to buy more expensive options. The recipient country then has less control and decision making on how foreign aid money is spent. It is noted that foreign aid tied with conditions cut the value of aid recipient countries by some 25 - 40 per cent, because it obliges them to purchase uncompetitive priced imports from the richer nations. (Anul Shah, 2010).

Foreign aid has often come with price of its own for the developing nations. He states that aid is often wasted on conditions that the Recipient must use overpriced goods and services from donor/lender countries. Most aid does not actually go to the poorest that would need it most. Aid amounts are dwarfed by rich countries protectionism that denies the market access for poor country products, while the rich nations use aid as a leverage to open poor country market to their products. Large projects or massive grand strategies often fail to help the vulnerable; money can often be embezzled away (Anul Shah, 2010).

Chang and Valesco (1999) suggested that large amount of foreign debt contributed to the poor performance of East Asia firms and that foreign debt may be part responsible for the Asian crisis. While debt is often equated with financial risk, different types of debt give rise to different types of risks, since foreign currency debt by definition requires repayment in a foreign currency, it exposes firms to exchange rate fluctuations.

## **2.9 Commitment charges, service charges and indirect costs**

To manage foreign borrowing and the national vis-a- vis the cost of borrowing the government uses the following strategies which are reduction in the degree of volatility of annual debt service costs and contain government's exposure to risks, external borrowing to be contracted on concessional terms only, timely settlement of debt service to avoid arrears and penalty payments, and establishment of a Primary Dealers System to promote vibrant money and capital markets (Kenya National Debt Strategy Analysis , 2009).

The Medium Term Debt Strategy (2010) states that the Government evaluated the performance of four alternative strategies. These included a strategy envisaging an aggressive switch to



external one-year borrowing, accompanied by an aggressive lengthening of maturities in the domestic market. A priori, this strategy was expected to have very attractive cost and risk characteristics. However, given the potential challenges in achieving the target level of external borrowing (that is, new disbursements), a range of possible contingent strategies were also considered - two envisaging relatively more domestic debt with a continued bias toward medium term debt and with a bias away from medium term borrowing toward shorter- and longer-term debt. It also envisages another strategy where Kenya taps the international capital markets to substitute for any shortfall in official sector borrowing.

According to Sebastian Edwards the associated cost of foreign borrowing include the (a) nominal interest rates; (b) increase in the tax rate; (c) proportion of total borrowing responsive to foreign interest rate; (d) inflation rate; (e) return on savings or nominal marginal cost of foreign borrowing. (Edwards S, 1976)

Sebastian Edwards identifies some of the factors that affect the foreign borrowing as follows: (a) Level of foreign debt portfolio in a given country; (b) Ability to distinguish between good and bad risks; (c) Loan worthiness of a country; (d) Determinants of the spread between the interest rate charged to a particular country and the London Interbank Borrowing Rate (LIBOR); and (e) Probability of default and loan ceiling. (Edwards S, 1976)

## **2.10 Theoretical Literature Review**

The most influential model of the demand to foreign borrowing by the public sector is the permanent income hypothesis (Friedman, 1957) which assumes the presence of perfect capital markets. The model further assumes that economic and political institutions do not matter, even though they determine the structure and costs of human interaction. On the contrary developing countries, especially low-income countries are characterized by institutional rigidities in the capital market that deny the sustainability of the neoclassical assumptions of well functioning markets, perfect competition and mobility of factors of production with institutions playing a critical role in determining the performance of economies, it is perhaps no surprise that loan channels play a critical role as safety nets to cushion the poor against income loss or transitory changes in income as well as counter situations where the state is too weak to implement effective market policies.

Financial markets in developing countries are also characterized by ubiquitous information asymmetry and weak mechanisms to enforce formal contracts forcing them to look for alternatives in the informal sector which act as risk sharing mechanisms (Cox and Fatchamps,

2007) for example, public sector highly likely to receive financial support in form of loans from other governments. In addition, knowledge regarding the cost of capital for investment and its determinants influences investment decisions. Public sector is therefore interested in knowing the price to pay for the form of capital they settle on.

Walrus theory of capital and interests is divided between the stock of capital and income flows arising from the stock. He argued that capital was not used up in the production process but rather provided services and it was the services that entered the production process. The price of capital services is determined by their demand and supply. Capital stock comes under the rule of cost of production pricing which is subject to the law of cost of the production (Walrus, 1874). However, at the same time, Walrus proposed that the price of capital stock is equated to the capitalized net income of capital services, which in turn depends on the price of capital services. In his theory of money Walrus (2006) appeared to support a strong public policy to regulate the money supply in order to ensure the preservation of economic equilibrium. His arguments were motivated by his concern for the wage earners, who are usually the first to suffer in times of economic crisis.

The theory of capital market inflation postulates that the value of long-term security markets is determined by a disequilibrium inflow of funds into those markets. The resulting overcapitalization of companies leads to increased fragility of banking and undermines monetary policy and stable relationships by Keynes in his theory of the speculative in the capital markets as a whole (Jan Toporowski, 2000).

The theory of perfect capital markets developed by Modigliani and Miller (1958) postulates that it is possible for economic agents to spend beyond their income levels. Public sector can therefore borrow to meet their current expenditure against their future incomes. The loan acquired from foreign countries helps in smoothing the consumption behaviour while at the same time promoting investment practices.

The pecking - order hypothesis (Myers, 1977) argued that economic agents finance their needs in hierarchical fashion. They first use internally available funds before settling on debt and equity. This ranking is theoretically examined by the foreign countries costs of the sources of financing, coming from information asymmetries. Credit rationing arises due to the existence of a wedge between what a lender is willing and is able to lend. Stiglitz and Weiss (1981) argue that the wedge results from the exclusive choice of the lender to supply less than what the market demands. Information asymmetry explains the reason why foreign governments practice credit rationing.

Due to adverse selection in credit markets, lenders cannot be able to distinguish between borrowers of various degrees of risks and hence rather than risk their investments they either raise the interest rates or ask for high collateral to cushion themselves against risk of default. This however only attracts large scale borrowers who expect higher returns (Stiglitz and Weiss, 1981). Due to the lenders result to setting interest rates below market clearing but ration their credit to minimize risk of loss. Similar studies on information asymmetry have been carried out by Russell and Jaffee (1976) and Akerlof (1970). Use of non price factors is recommended in credit rationing. Diamond (1984) argued that relationship between financial institutions and firms also determines access. Those organization with close relationships are seen to have more access to credit. Relationships with a single country may reduce risk and hence the cost of credit lie interest rates may be reduced. This is due to reduced incidence of moral hazard and improved knowledge of the firm which ultimately reduces adverse selection.

## **2.11 Conceptual framework**

Key mandate of the Government as per the constitution is to protect the welfare of its citizenry by providing the necessities needed for quality living on a sustainable manner. To achieve this challenging task, they must plan and execute programs that target the maximization of their peoples welfare. Identification and formulation of viable investment programs capable of withstanding the current competitive and dynamic environment is key towards accomplishing the mandate. The constitution of Kenya together with other regulatory framework sets the basis of pursuing the development agenda for the country. Strategic plans like vision 2030, economic medium term plans, millennium development goals among others underpins the way for actualizing this process.

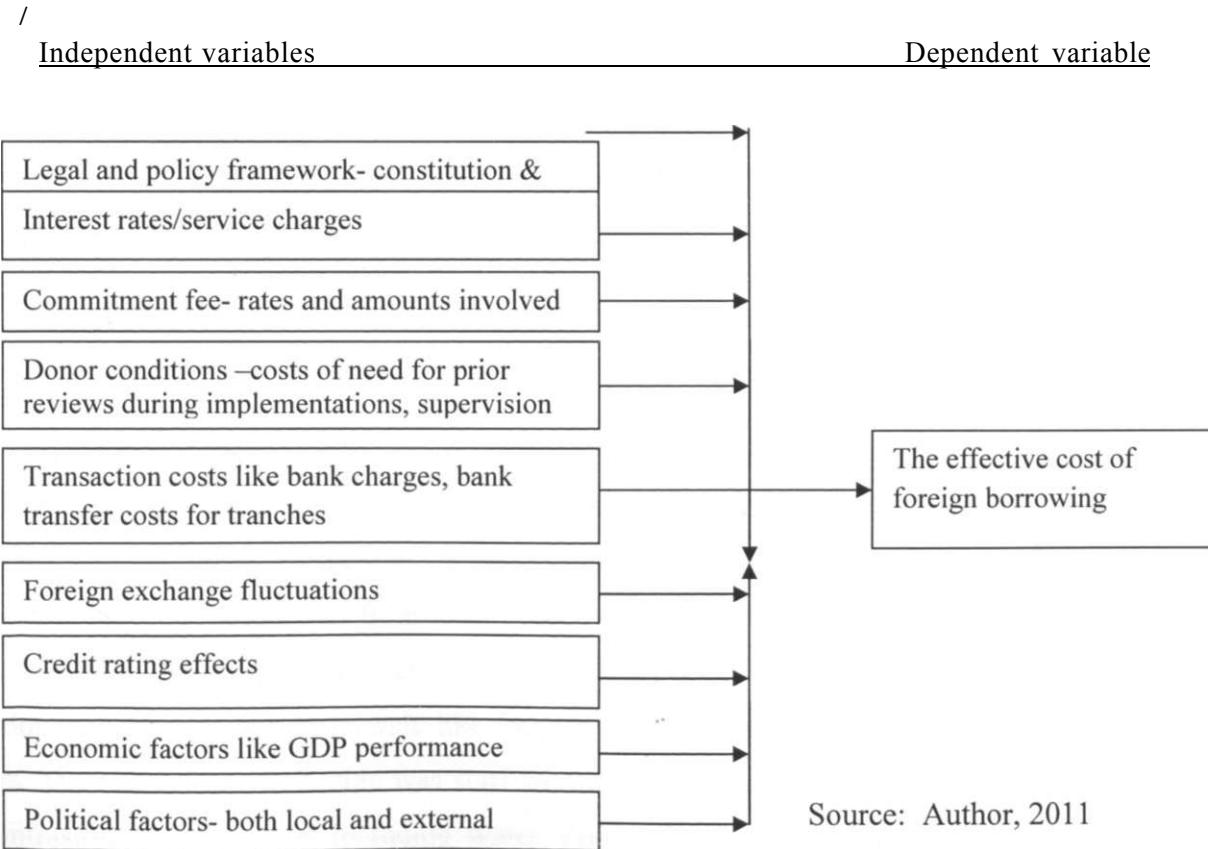
Kenya's main sources of revenue needed to foreign loan its development plans are taxes, borrowings (borrowed both locally and externally), fees, grants among others. Borrowings from outside are normally done for some specific targeted projects. The process is guided by both the domestic and external legal and policy frameworks as prescribed to by the partners involved.

Over the years, Kenya has been borrowing from a number of foreign countries and organizations in order to support its development agenda. During the borrowing process, stakeholders interest has mainly been on the interest rates charged on these borrowings/loans and their repayments. To establish effective cost of these borrowings and their determinants, a number of variables need to be critically analyzed for a more informed decision to be arrived at hence realize value for money.

Whereas it is agreeable that interest charged on any borrowing is the most objective way of assessing how costly or cheap a credit facility is (assuming that the interest element is arrived at after taking into account associated risks and management cost for the credit facility), together with principal repayment (important since it affects the liquidity position of any organization and if not well managed may lead to financial crisis) other factors are also worth critical analysis.

Besides the above, other factors like commitment fee charged on outstanding/undisbursed loan amount held by the financiers, political class dynamic priorities versus implementing the set or on going programs, foreign exchange fluctuations especially when currencies involved are hard (United States Dollars, Euros among others) versus weak (Kenya Shillings), conditions imposed by the development partners on the use of these resources during implementations like the need for prior review and concurrence at any critical stage of implementation, transaction costs ( bank charges, tranche transfer fees, supervision costs, etc), credit rating conditions which influences whether to extend a credit facility or not and if yes at what cost, economic performance as reflected in the country's Gross Domestic Product among others should also be analyze. When all above factors are explored, most effective cost of such borrowing is likely to be ascertained. The diagram below shows factors determining effective cost of foreign borrowing in Kenya:

**Figure 2.1: Conceptual framework**



# CHAPTER THREE

## RESEARCH METHODOLOGY

### 3.1 Introduction

This chapter contains the details about the research design, location of the study, target population, sampling techniques, sample size, instrumentation, validity and reliability. The chapter also includes the method applied in collection of data and the data was analyzed ending up with answers to the- research problem.

### 3.2 Design

The design of the study applied was descriptive research. The design described the past and current situation in foreign cost of borrowing in the public sector. Descriptive research studies are designed to obtain pertinent and precise information relating to current status of phenomena and whenever possible to draw a valid general conclusion from the facts discovered. The researcher selected relevant variables for analysis of their relationship since it was not possible to manipulate the variables in events which already exist (Best and Kahn 1993).

### 3.3 Population and Sample

As Lapin (1987) stated a population is the total collection of elements about which we wish to make some inferences. The collection of all possible observations of a specified characteristic of interest is called population, while a collection of observations representing only a portion of the population is called sample.

The population for this study was all officers participating in and/or facilitating external borrowings for investment financing in Kenya.

#### 3.3.1 Target Population

According to Ngechu (2004), a population is a well defined or set of people, services, elements, events, group of people or households that are being investigated. The target population here was employees from local offices of World Bank (WB), European Investment Bank (EIB), African Development Bank (ADB), International Fund for Agricultural Development (IFAD) and bi-laterals like France (AFD), Japan (JICA), Saudi, China among others. The target from GoK side was staff working with Ministries of Finance and Planning and Infrastructural Ministries including Water, Roads, Energy and Industrialization. These are

about three hundred and fifty (350) in number comprising of Accountants, Finance Managers, Economists, Debt Specialists, External Resource Officers, Project/Programme Managers, and various Desk Officers representing the organizations.

### **3.3.2 Sampling Procedure**

Simple Random Sampling technique, using stratified random sampling, was applied in determining the sample size from each stratum. This technique divided the population into more groups taking into account the geographical location of institution and homogeneity of the data. A random sample was selected in such a way that each member of the population had an equal chance of being included in the sample.

### **3.3.3 Sampling technique**

Simple statistical sampling (the stratified random sampling technique) that relied on mere chance to determine who is selected in the sample and calls for random selection in the inclusion of the cases into the sample was applied.

### **3.3.4 Sample Size**

A sample size of 30% (105 respondents out of the possible 350) from the target population of respondents from GoK and DPs' institutions were selected for interviews. This was considered relevant as it could generate the most representative, accurate and relevant data needed from the study. According to Kothari et al (2004) a sample ratio of 10-20% would be appropriate to obtain the necessary sample size to generate the needed data and reduce the data and sampling errors associated with the study. The choice of this sample size was also influenced by Cooper and Emory's argument that absolute size of a sample is much more important than its size compared with the population.

## **3.4 Data Collection Methods and Techniques**

The researcher used primary data collection as the main method in this study. The method involved the initial collection of data from the source. However, Secondary method was also used sparingly, where the data was sourced from previous researchers and reviewed for the sake of this study. Questioning method of data collection was used in the study. Questionnaire which is a non-verbal means of questioning methods was used in data collection. Both structured and unstructured questions were used as the research instruments. This is because the open-ended give room for supplementary questions and respondents give their opinion without influence.

### **3.4.1 Instrument Validity**

The purpose of pre-testing is to assess the clarity of instrument items that is validity and reliability of each of the items in the instrument as well as the suitability of the language used in the instrument (Mulusa 1988: 154). In validating the instruments, a Pilot study was selected randomly from the strata and tested. The questionnaires were served and collected by the investigator personally and via email. After each respondent had completed the questionnaire, the researcher discussed with the respondent to determine whether the items were correctly worded and therefore no misinterpretation by respondents.

### **3.4.2 Instrument Reliability**

An instrument is reliable when it can measure a variable accurately and consistently and obtain same results under the same conditions over a time as was confirmed in this study during validity test.

## **3.5 Data analysis**

The data was analyzed by the use of SPSS version 17 and excel (spread sheet) where appropriate. Frequencies, percentages and ranking of the identified factors were compiled for the descriptive data. The primary quantitative data generated from the field underwent the following processes before analysis.

### **3.5.1 Editing**

The researcher conducted field editing after data collection. The researcher also conducted central editing after the receipt of all the questionnaire at the conclusion of the data collection process.

### **3.5.2 Coding**

Coding of some responses was done during the questionnaire development phase. However, for the other non-coded responses (for the open ended questions from the field), the researcher did the re-coding in order to ensure that all critical information gathered was analyzed. The data analysis method will be quantitative. The data from the questionnaires will be converted into figures for analysis. The data will be presented in the form of tables and analyzed using quantitative methods. The questionnaires will be set up to work out the frequency distribution with five assertions as follows: Strongly disagree =1, moderately disagree = 2, Agree = 3, moderately agree = 4, and strongly agree = 5. accordingly

## CHAPTER FOUR

### DATA ANALYSIS AND PRESENTATION

This chapter summarizes the findings from the collected data and gives interpretation for the same. The data gathered was analyzed using statistical package for social sciences (SPSS) generating descriptive statistics. Microsoft Excel was used for other quantitative comparative analysis.

#### 4.1 Summary of findings

The total number of respondents was sixty five (65) out of the possible one hundred and five selected. The respondents were from various designation and organization backgrounds as reflected in the tables 3 and 4 and figures 4.1 and 4.2 respectively. These categories of respondents were capable of establishing factors determining the cost of external borrowing for GoK investment financing.

**Table 3: Designation**

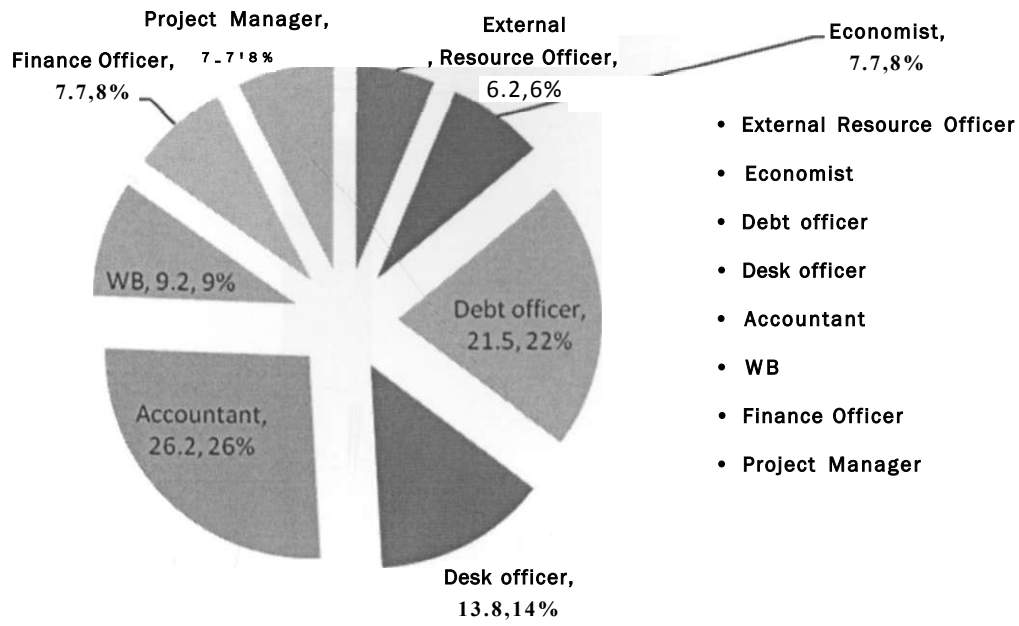
Designation		Frequency	Valid Percent
Valid	External Resource Officer	4	6.2
/	Economist	5	7.7
	Debt officer	14	21.5
	Desk officer	9	13.8
	Accountant	17	26.2
	WB	6	9.2
	Finance Officer	5	7.7
	Project Manager	5	7.7
	Total	65	100.0

**Source: Researcher, 2011**

Table 3 above and figure 4.1 below indicates that 17 respondents were Accountants, 14 were Debt Officers while 9 were Desk Officers. Economists, Finance Officers and Project officers were 5 each while 4 were External Resource Officers. The findings indicate that most of respondents were accountants.



• "igiamiii ui respondents by percentage



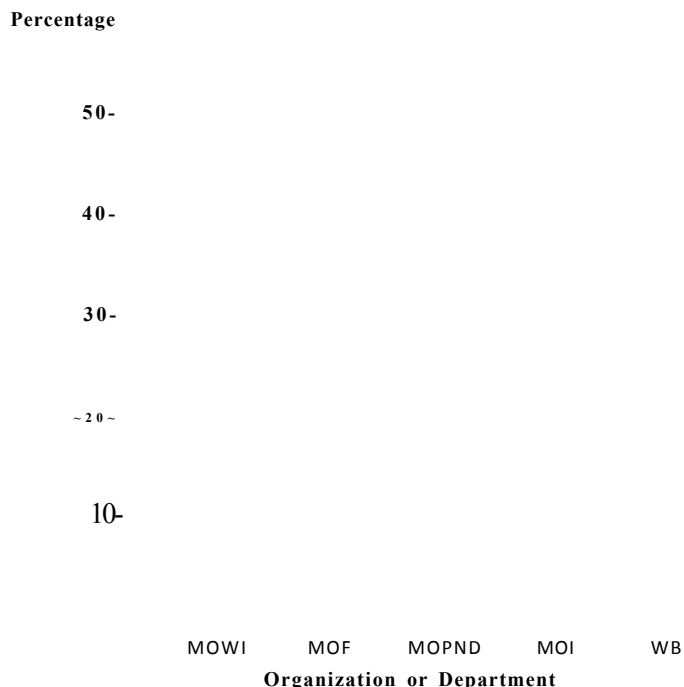
Source: Researcher, 2011

Table 4 Organization/Department

Organization	Frequency	Valid Percent
Valid MOWI	9	13.8
MOF	31	47.7
MOPND	10	15.4
MOI	5	7.7
WB	10	15.4
Total	65	100.0

Source: Researcher 2011

**Fig 4.2 Organization or Department**



**Source: Researcher, 2011**

In summary, the findings indicate that most of the above responses came from Accountants, Debt Officers and the Desk Officers/External Resources Officers (about 67 percent.)

**4.2 Targeted Sectors for Funding**

When responding in regard to sectoral program funding, the study established that 45 percent (from 29 respondents) goes to infrastructure, 15(23.1%) was Agriculture, and health was 6 (9.2%). The study concluded that major funding was for infrastructure and Agricultural development as shown in table 5 and figure 4.3 below.

**Table 5: Sector program funded**

Sector		Frequency	Valid Percent
Valid	Infrastructure	29	44.6
	Agriculture	15	23.1
	Health	6	9.2
	Social	6	9.2
	Administration	9	13.8
	<b>Total</b>	<b>65</b>	<b>100.0</b>

50"

40-

30-

20

10

Infrastructure                      Health                      Administration  
Agriculture                      Social

**Source: Researcher, 2011**

### **4.3 Sources of Financing**

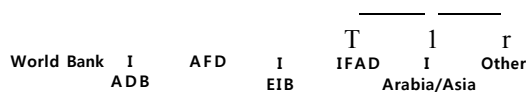
From table 6 and figure 4.4 below, it is indicated that 19 (29.2%) of the respondents stated that Finance was from the World Bank, 11(16.9%) from ADB, while 10 (15.4%) from other financiers. Only 3 (4.6\$ %) stated that the financier was from AFD.

The researcher concluded that majority of the finance came from the World Bank. The study findings also indicate that 80% of the funds come from multi-lateral sources while only 20% are sourced from bi-lateral organizations (see table 7).

Source		Frequency	Valid Percent
Valid	World Bank	19	29.2
	ADB	11	16.9
	AFD	3	4.6
	EIB	8	12.3
	IFAD	8	12.3
	Arabia/Asia	6	9.2
	Other	10	15.4
	<b>Total</b>	<b>65</b>	<b>100.0</b>

**Fig 4.4 Finance Source**

Percent.



**Source: Researcher, 2011**

**Table 7: Type of Financier**

<b>Type</b>		<b>Frequency</b>	<b>Valid Percent</b>
Valid	Multilateral	52	80.0
	Bilateral	13	20.0
	<b>Total</b>	<b>65</b>	<b>100.0</b>

**4.4 Project implementation period, disbursement mode and grace period**

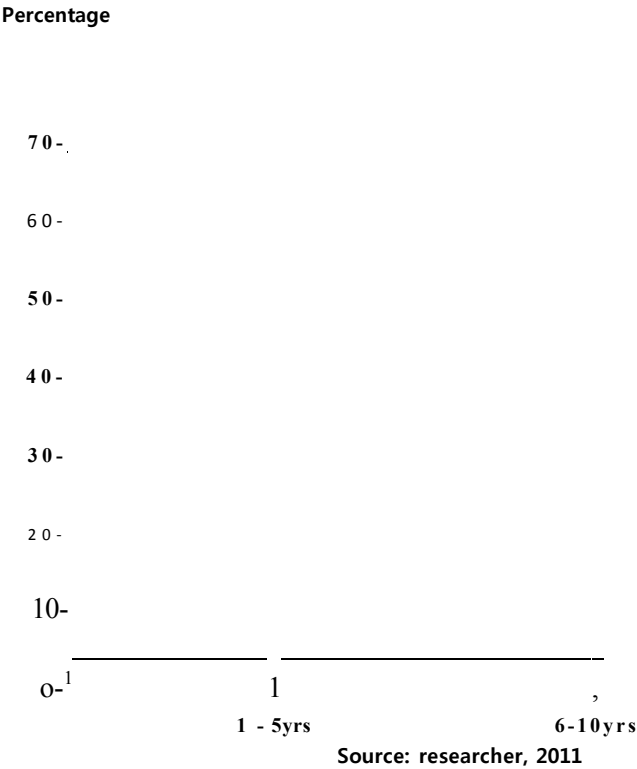
The finding indicates that the implementation period is usually between 3-7 years as was supported by about eighty percent of the responses received on this question. Only 20 percent indicated below two years and above 8 years as average implementation period. It was also established that most of the borrowed funds have a grace period of between 6-10 years before their repayment commences. This is supported by figure 4.5 below.

On which mode of disbursement the financiers are using while releasing funds to the implementing agencies, 66 percent (43 respondents) indicate that both revenue and direct payment modes are used while 34 percent indicated the use of direct payments only. No respondent indicated the use of revenue only as is shown on table 8. The modes were also found to be effective by majority of the respondents and affects cost of borrowing positively.

**Table 8: Disbursement Mode**

<b>Mode</b>		<b>Frequency</b>	<b>Valid Percent</b>
Valid	Direct	22	33.8
	Both	43	66.2
	<b>Total</b>	<b>65</b>	<b>100.0</b>

Fig. 4.5 Grace period



**4.5 Identification of investments for funding**

The respondents were asked to give a brief of how the investments they managed (are managing) were identified for funding. Their general responses were that the identification is done as per GoK and DPs strategic plans and priorities (about 60%) while the rest indicated GoK strategies only. This involved observing GoK and DPs both short and long term investment plan priorities and economic performances in terms of local revenue performance. This is supported by table 9 below.

**Table 9 Identification for Funding**

Factors considered		Frequency	Valid Percent
Valid	Local Revenue Ceiling	4	6.2
	GoK Strategic Plan	24	36.9
	GoK Strategic Plan & DPs	12	18.5
	All	25	38.5
	<b>Total</b>	<b>65</b>	<b>100.0</b>

#### 4.6 Key Objectives and parameters informing Funding

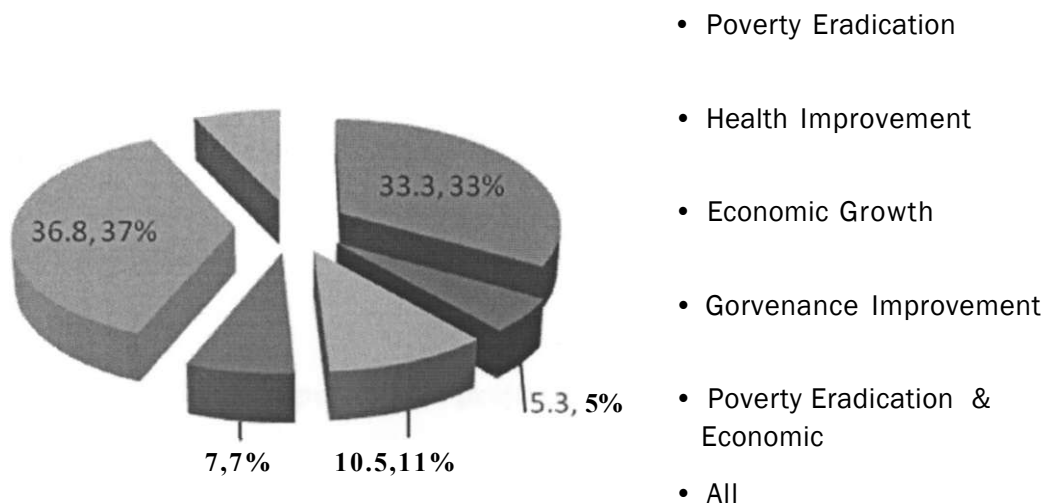
The findings on the objectives of the financed investments were found to be poverty eradication, health improvement, infrastructural development especially in water and communication sectors and to boost overall economic growth.

On parameters informing selection for funding, about 43 (66.2%) responded that this was from both GoK and DPs development policy strategies, with 86 percent of the respondents concurring that the investments are of high priority to the beneficiaries' needs and 22 (33.8%) indicated that it was to support government policy. Table 10 and figure 4.6 below summarize the findings.

**Table 10 Target Group Priority Needs**

Need rating		Frequency	Percent
Valid	Medium	9	13.8
	High	56	86.2
	Total	65	100.0

/ **Figure 4.6: Objectives of investments**

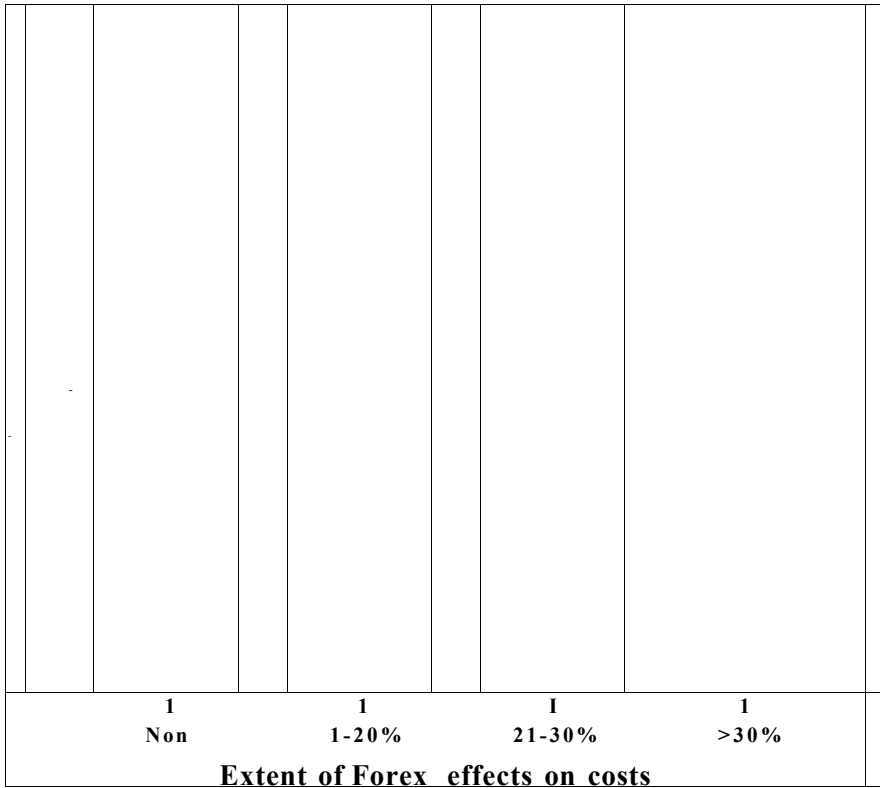


Source: Researcher, 2011

**4.7 Associated Costs of External Borrowing**

While responding to a question regarding the costs associated with external borrowing, majority of the respondents mentioned commitment fee, interest and transaction costs, technical assistance/management costs and donor conditions. Also mentioned was foreign exchange fluctuations as indicated in figure 4.7 below where 31 (41.7%) said that it contributed to 1-20% of the effects, another 15(23.1%) were of the opinion that it did not have any effect, while 13 (20.0%) indicated that it was between 21-30%..

**Fig 4.7 Effects of Forex Flactuation**



**Source: Researcher 2011**

**4.8 Effects of design and preparation of projects**

When asked to comment on the effects of design and preparation of projects, 29(44.6%) cited the high cost of management, while 14(21.5%) talked of slow disbursement and the rest 7(10.8%) talked of both variables. This is mainly when the initial design was not prepared well to suit implementation. Table 11 below reflects the summary of the findings.



**Table 11: Effects of Design and Project Preparation**

<b>Effects</b>	<b>Frequency</b>	<b>Valid Percent</b>
<b>Slow Disbursement</b>	<b>14</b>	<b>28.0</b>
<b>High Cost of Management</b>	<b>29</b>	<b>58.0</b>
<b>All</b>	<b>7</b>	<b>14.0</b>
<b>Total</b>	<b>50</b>	<b>100.0</b>

#### **4.9 Participation in negotiation for funding and its challenges**

As far as participation in negotiation for funding is concerned, 48(73.8%) of the respondents had participated while 17(16.2%) had not. Those who participated identified donor conditionalities, political interest, lack of negotiation skills and weak legislative framework as the main challenges.

However the 70 percent of the responses indicate that the negotiated costs are fair and better for financing. Table 12 summarizes all the findings.

**Table 12 Challenges of Negotiations**

<b>Challenge</b>	<b>Frequency</b>	<b>Valid Percent</b>
Valid Donor Conditions & Political Interests	20	38.5
Negotiation Skills	11	21.2
Legislative Framework	6	11.5
All	15	28.8
Total	52	100.0
<b>Total</b>	<b>65</b>	

#### 4.10: Factors determining cost of borrowing

On factors determining cost of borrowing 85% mentioned cost benefit analysis for the intended investment, grace periods, repayment period and interest rates as the main determinants. Table 13 summarizes findings as indicated below.

**Table 13 Factors determining cost of borrowing**

Factor(s)		Frequency	Valid Percent
Valid	CBA	36	55.4
	Interest Rate	8	12.3
	Grace and repayment Periods	8	12.3
	All	13	20.0
	<b>Total</b>	<b>65</b>	<b>100.0</b>

#### 4.11 Benefits of Foreign over Local Borrowing

The researcher intended to know the benefits of foreign over local borrowing as a justification for the practice. The findings indicate that 24 (36.9%) respondents quoted the low interest rate, long grace and repayment period as one of the benefits, 22 (33.8%) talked of all the variables and 19 (19.2%) alluded to no crowd-out of domestic borrowing. Table 14 below gives summary of the responses.

**Table 14 Advantages of foreign over local financing**

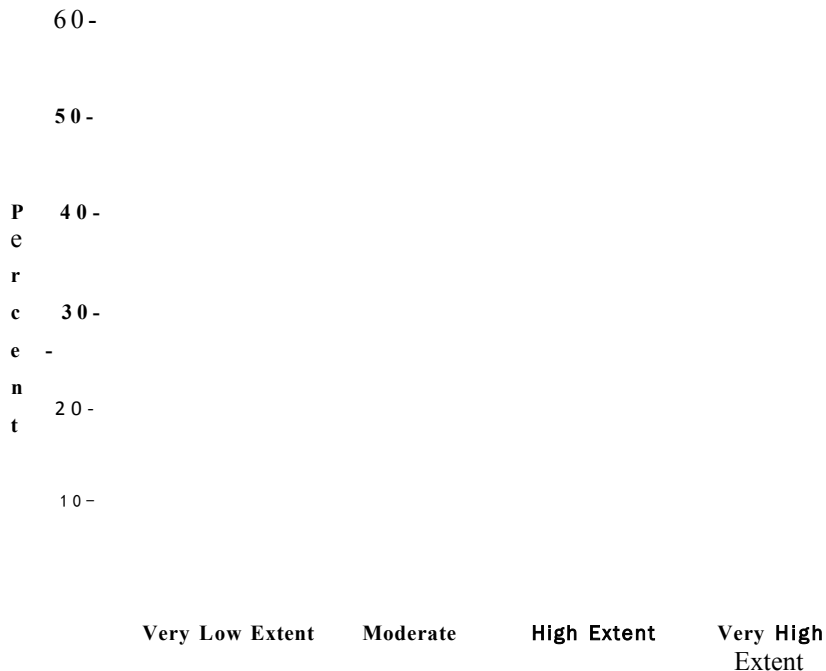
		Frequency	Valid Percent
Valid	Low Interest Rate, Long Grace & Repayment Period	24	36.9
	No Crowd-Out of Domestic Borrowing	19	29.2
	All	22	33.8
	<b>Total</b>	<b>65</b>	<b>100.0</b>

**4.12 The researcher intended to assess the extent to which the following factors affect the cost of external borrowing:**

**4.12.1 Legal Policy Framework**

When asked to comment on the extent to which the legal framework affect the cost of financing, 35 (53.8%) said it does to a high extent, 14(21.5%) to a moderate extent and 5(7.7%) to a very high extent. This indicates that over 70 percent concur that legal policy is a key determinant to foreign investment financing in Kenya. Figure 4.8 below supports this.

**Fig 4.8 Legal Policy Framework**

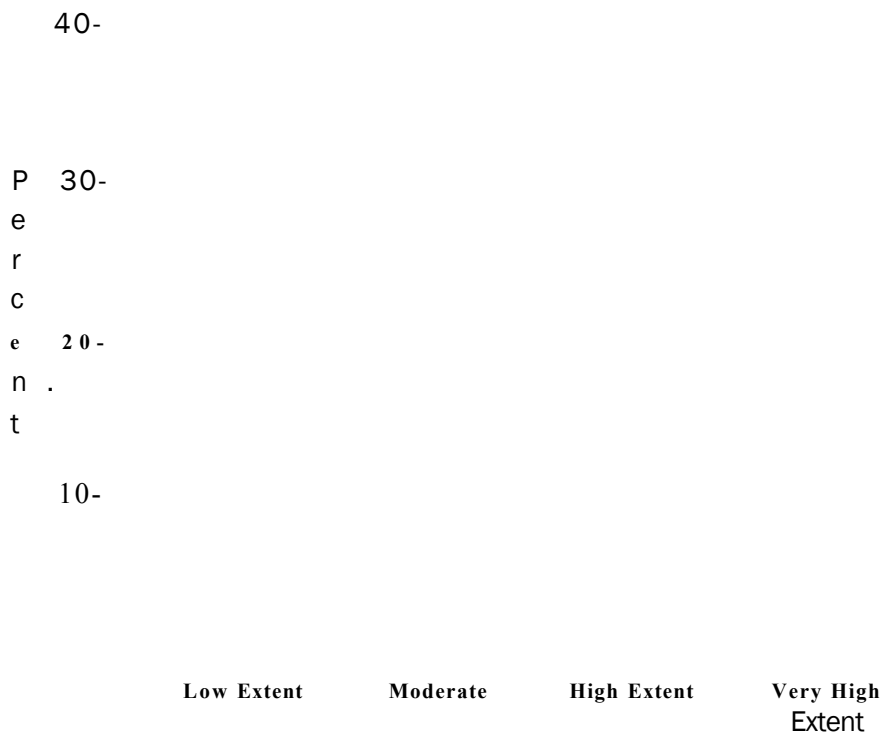


**Source: Researcher, 2011**

**4.12.2 Negotiation Skills**

The study revealed that 25(38.5%) of the respondents indicated that negotiation skills mattered to a very high extent, 22(33.8%) indicated moderate. Another 6 (9.2%) said it mattered to a low extent. In summary 57 percent of the responses indicate that negotiation skills highly affect the cost. See figure 4.9 below.

**Fig 4.9 Negotiation Skills**



Source: Researcher, 2011

**4.12.3 Interest Rates/Service Rates**

On the issue of interest rates/service charges, the respondents indicated that 44(67.7%) it mattered to a very high extent, 14(21.5%) to a moderate extent and the rest, 7(10.8%) to a high extent. This indicates that this is one of most key determinants of cost of financing as 100 percent are in moderate and above as shown in table 15 below.

**Table 15: Interest Rates/Service Rates effects**

		<b>Frequency</b>	<b>Valid Percent</b>
Valid	Moderate	14	21.5
	High Extent	7	10.8
	Very High Extent	44	67.7
	<b>Total</b>	<b>65</b>	<b>100.0</b>

#### 4.12.4 Commitment fee

The factor of commitment fee was rated as follows: 28(43.1%) very high extent, 26(40.0%) moderate and 5 (7.7%) high extent. See the below table 16

**Table 16: Commitment fee**

		Frequency	Valid Percent
Valid	Low Extent	6	9.2
	Moderate	26	40.0
	High Extent	5	7.7
	Very High Extent	28	43.1
	<b>Total</b>	<b>65</b>	<b>100.0</b>

#### 4.12.5 Donor Conditions

Regarding the donor conditions, 30(46.2%) indicated a very high extent, 23(35.4%) high extent and 12 (18.5 percent) moderate. This is a clear indication that conditionalities greatly influence the cost of foreign borrowing as 100 percent of the responses are indicated moderate and above / as shown in figure 4.10

**Fig 4.10 Donor Conditions**

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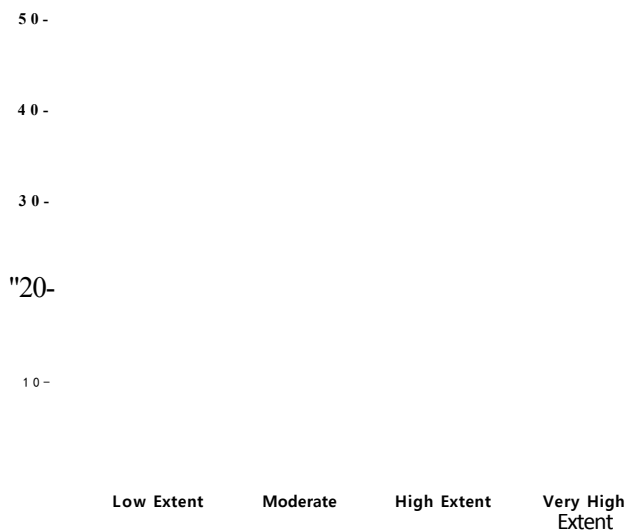
#### 4.12.6 Forex Fluctuations and transaction cost

32 (49.2%) respondents said that forex fluctuation moderately affect the cost, 13 (20 %) to a high extent, 18 (27.7%) to a very high extent and 2(3.1%) to a low extent. This was also concluded to be an important factor in determining cost of the borrowing. Tables 17 and figure 4.11 below supports the findings.

**Table 17: Transaction Costs**

Extent		Frequency	Valid Percent
Valid	Low Extent	18	30.0
	Moderate	22	36.7
	High Extent	11	18.3
	Very High Extent	9	15.0
	Total	60	100.0
Missing	9	5	
<b>Total</b>		<b>65</b>	

**Fig 4.11 Forex Fluctuations**



Source: Resarcher, 2011

#### 4.12.7 Credit Rating Effects

In regards to the effect of credit rating, 25 (38.5%) rated it moderately, 17(26.2%) to a very high extent and 8 (12.3%) to a low extent. At least 85 percent of the responses fall within moderate and above towards the extent of the influence of cost of financing. See table 18 below.

**Table 18: Credit Rates Effects**

<b>Extent</b>		<b>Frequency</b>	<b>Valid Percent</b>
Valid	Low Extent	8	12.7
	Moderate	25	39.7
	High Extent	13	20.6
	Very High Extent	17	27.0
	<b>Total</b>	<b>63</b>	<b>100.0</b>
<b>Total</b>		<b>65</b>	

#### 4.12.8 Economic and political factors

The findings indicate that according to economic factors 26(40.0%) of the respondents affect to a high extent, 25(38.5%) to a moderate extent and 14(21.5%) to a very high extent. Political factors also affect to a very high extent according to 30(46.2%) of respondents, high extent by 15(23.1) and moderate and low extent in equal numbers by the rest of the respondents. Table 19 and figure 4.12 below supports the findings.

**Table 19: Political Factors**

		<b>Frequency</b>	<b>Valid Percent</b>
Valid	Low Extent	10	15.4
	Moderate	10	15.4
	High Extent	15	23.1
	Very High Extent	30	46.2
	<b>Total</b>	<b>65</b>	<b>100.0</b>

**Fig 12: Economic Factors**

**Percentage**

40 -

30 -

20 -

10 -

Moderate

High Extent

Very High Extent

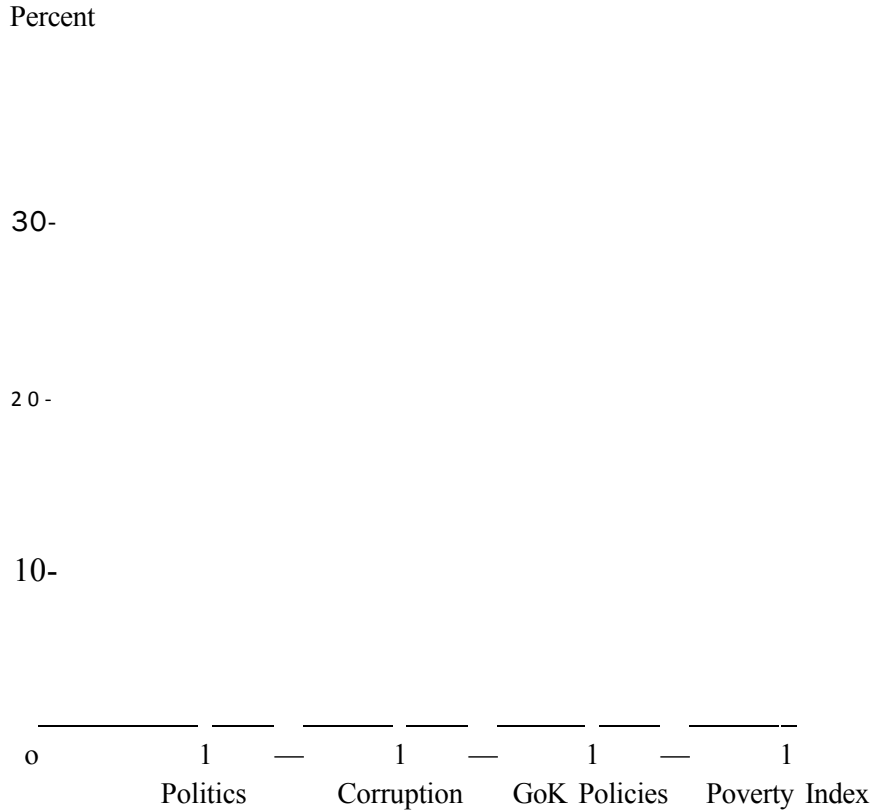
**Source: Researcher, 2011**

#### **4.12.9 Opinion/Observation on Factors determining Cost of Borrowing**

The respondents were given an opportunity to identify any other factor as per their opinion which they think is likely to determine cost of foreign borrowing. The findings indicate that corruption, poverty index, politics, GoK policies were some of the key determinants as shown in the below figure 4.13.



**Fig 4.13 Other factors determining cost**



**Source: Researcher, 2011**

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#### **4.13 Discussion of findings**

When making financing decisions, a proper appraisal of the benefits and costs associated with such decisions are expected to have been done. This is by ensuring that all key factors which are suppose to influence this process are known in advance and taken care of. The main guide to this process is the organization's strategic plans as was highlighted in the background of this study in the first chapter.

The reviews of various literatures did indicate that as much as most governments have their strategic plans and try to pursue them through the most cost effective ways, still other factors like politics, nature of relationships between the lender and borrower need to be closely monitored while sourcing for external financing.

The summarized findings indicate that majority of the respondents (over 70 percent) did concur that besides interest cost which is the most evident determinant of financing cost, donor conditions, foreign exchange fluctuation, technical supervisory costs are among the very

important variables that forms heavy portion of foreign borrowing in Kenya but are rarely quantified and disclosed for effective decision making.

However there was a general consensus that the funds are channeled to priority programmes whose outputs are in the interest of the beneficiaries. The study also found that the explicit interest cost charged on these borrowings is very low and concessional hence attractive over the domestic borrowing.

# CHAPTER FIVE

## SUMMARY, CONCLUSION AND RECOMMENDATIONS

### 5.1 Introduction

The study was done to establish factors determining the cost of foreign borrowing towards investment financing in the Government of the Republic of Kenya. The sample size targeted was 105 respondents, out of which 65 (that is over 60 percent turnout) responded by filling the questionnaires. The data collected was properly coded and analyzed using both statistical package for social sciences and ms excel spread sheet capable of handling descriptive statistics in order to generate relevant frequencies for the variables of interest.

### 5.2 Conclusion

In summary the factors determining the cost of external borrowing towards investment financing in GoK, can be concluded to be: Legal and policy framework factors; Interest and transaction cost factors; Donor condition factors; Commitment fee; Economic factors; Political factors and others.

#### 5.2.1 Legal and policy framework factors;

/

With over eighty five percent indicating that legal and policy framework greatly affect the cost of financing; it is worth concluding that this is a key determinant in setting the cost of external borrowing. This was also supported by the other studies which did indicate that external funds shall only be channeled to certain projects within the agreed sectors between the partners. The theory of lending relationship has also led to conclusion that lending to member states shall only be done as per the laid down legal frameworks and policy guidelines among the partners.

#### 5.2.2 Interest and transaction cost factors;

Interest and transaction costs have come out to be the most key determinant of cost of financing as 100 percent of the responses recorded moderate and above in their rating. The study concluded that the interests charged in foreign borrowed loans are far much cheaper than the local interest costs since most of the loans are concessional in nature.

### **5.2.3 Donor condition factors;**

From the study, it is worth concluding that various financiers from outside the country do impose a lot of their conditions to the borrowers. Such conditions include the requirement to liberalize and nationalize some state owned enterprises before accessing the loans. Other conditions are to do with the sourcing of inputs to be utilized during implementation of the programmes among others. This was confirmed by over 80 percent of the respondents and from analyzed secondary data.

### **5.2.4 Commitment fee;**

Upon signing of the financing agreement between the lender (DP) and the borrower (GoK), the lender starts charging a certain/pre-determined rate of interest periodically, different from the normal interest rate, on the outstanding loan amount held by the lender. Over eighty seven percent of the responses to questions on this did indicate that this has a lot of weight when determining the cost of foreign borrowing. It is therefore worth concluding that this factor is very integral towards setting an effective cost of foreign investment financing in Kenya.

### **5.2.5 Economic factors;**

From the study it is worth concluding that the growth domestic product, cost benefit analysis, government's strategic plan for development matters a lot when it comes to determining the cost of external borrowing for investment. Average inflation rates, expected currency fluctuations, per capita income are among the variables that are used to set the risk rating scale to determine how much and for how long will the loan being issued shall be repaid and at what rate.

### **5.2.6 Political factors;**

The findings of this study did indicate that it is very difficult to assess the cost of foreign investment financing without paying key attention to political interest. This was witnessed in the cases from Sri-Lanka, Norway, European states among others. The conclusion is that political influence matters a lot and can determine borrowing without taking keen interest into economic effects and the viability of the investments to be funded.

### **5.3 Recommendations;**

As has been established from the findings of this study of the factors determining the cost of foreign borrowing for investment financing in Kenya, the following recommendations should be considered in order to realize the value for money from such investment financing:

There should be put in place a proper legal and regulatory framework that are linked to the development/strategic policy framework capable of monitoring and evaluating the inputs, output and outcome of the foreign investment financing. This will ensure that the proceeds (loans) from external sources are channeled to the most economically viable projects capable of servicing the loan associated costs.

There should also be put in place a mechanism of managing the effects of foreign currency exchange fluctuations. This is because most of the financing arrangements go beyond three years exposing the weak currency like Kenya Shilling to serious risks of loosing value. Possibility of hedging arrangements is highly advisable.

Proper analysis and appraisal need to be done on commitment fee, donor conditions and overall management costs in order to determine the true cost of the foreign borrowing for investments since they rarely feature as costs to such financing arrangements yet they bear the largest cost element.

/

There is need to develop a proper capacity building plan to strengthen the bargaining power of GoK Officers participating in negotiations for these funds since it is found to be a big challenge. This will go along way in improving their skills and knowledge hence realizing a value for money while participating in sourcing for funds.

### **5.4 Suggestions for future studies;**

Since the determinants of cost of foreign borrowing for investment financing have been established, it is recommended that a study should now be conducted to help develop a model to help determine effective (true) cost of such financing.

It is also suggested that studies should be conducted to establish the extent of the effects of each of the identified factors on the cost of borrowings. A cost benefit analysis approach would be appropriate while conducting such studies. A study should also be conducted to compare the cost of foreign versus domestic borrowing, bi-lateral versus multi-lateral borrowings among others.

### **5.5 Limitations of the study**

This study was to identify key determinants of foreign financing costs. In order to come up with more representative findings, data was expected to come from all key players in this field like from both bi-lateral and multi-lateral partners. Due to circumstances beyond the researchers control like time constraint, few data was only collected from multi-lateral partners. This may not end up giving a more representative view of all development partners.

Also very few studies have been conducted along this area of study hence it was not possible to get the closely related literatures to review to support this study.

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<http://www.imf.org/external/pubs/ft/irb/archive.htm>.

[http:// www.treasury.go.ke](http://www.treasury.go.ke)



## APPENDICES

### APPENDIX I:

#### SAMPLE QUESTIONNAIRE USED TO COLLECT DATA

#### QUESTIONNAIRE

#### FACTORS DETERMINING COST OF FOREIGN BORROWING IN PUBLIC SECTOR - KENYA.

#### PART I: RESPONDENT'S DETAILS

1. Contact person's name (Optional)
  
2. Title/Designation/Profession
  
3. Organization name and/or Department
  
4. Sector/Programme funded:
  
5. Programme(s)/Project title(s) and **loan** amount (Kshs/USD) under you:
  - a

d.

f.

g-

h.

6. Average Programme/Project implementation period(s)

7. Source of finance - (Name of the lender and nature of the relationship; Bi/Multi lateral etc)

8. Credit/Loan disbursement mode(s): Please tick appropriately

(A) Direct Disbursement mode **(B)** Revenue/Advance mode (C) Both A & B

9. Average Loan Grace period before loan servicing;

10. Project implementing agency(ies)

**PART II: FACTORS DETERMINING EFFECTIVE COST OF FOREIGN BORROWING FOR INVESTMENT FINANCING IN PUBLIC SECTOR - KENYA.**

11. Describe briefly how the programme(s)/project(s) you handle was (were) identified for funding?

/

12. What is (are) the objective(s) of the programme/project?

13. What key parameters informed the selection of this programme/project for funding?

14. Considering the beneficiary target groups' needs, how would you rate the project's objectives in terms of priority?  Low  Medium  High (Tick as is appropriate)
15. According to your opinion, what are the associated costs of these kinds of financing arrangement between GoK and the development partners?
16. To what extent (by what percentage compared to original cost) has the foreign currency fluctuation negatively/positively affected the overall cost of financing the programme?
17. How has the project design and preparation affected the cost of borrowing to support the Project?
18. Have you participated in the negotiations for external borrowing to finance the GoK investment needs?  Yes  No (tick accordingly and if yes respond to no. 19)

19. In your experience what are the challenges affecting effective negotiations for external borrowing for financing

20. In your opinion what do you think should determine the cost of external borrowing for investment financing in GoK?

21. Do you think the negotiated cost associated with the financing is fair? Yes

No  ]

Explain

22. How effective are the modes of disbursing external funds? (Tick where appropriate)

Very effective  ) Fairly Effective (  Effective |  Less Effective  ]

23. According to your opinion, what are the benefits of foreign borrowing compared to local borrowing to finance the GoK investment needs?

24. Considering foreign borrowing in Kenya, indicate the extent to which the following factors affect the cost of financing: **(Tick the appropriate number using the linkert scale below)**

	<b>Very low extent Very high extent</b>	<b>Low extent</b>	<b>Moderate</b>	<b>High extent</b>						
	1	2	3	4	5					
	<b>FACTOR(S):</b>					1	2	3	4	5
1.	Legal and policy framework									
2.	Technical skills of the negotiators									
3.	Interest rates/ service charges									
4.	Commitment fee									
5.	Donor conditionalities									
6.	Transaction costs like bank charges									
7.	Foreign exchange fluctuations									
8.	Credit rating effects									
9.	Economic factors as per GDP									
10.	Political factors									

25. Any other comment or opinion or observation about the factors determining effective cost of foreign borrowing in Kenya?

**Thank you for giving your honest opinion while filling this questionnaire.**

**END**