MANAGEMENT OF FOREIGN EXCHANGE RESERVES THROUGH QUANTITATIVE CONTROLS: THE KENYAN EXPERIENCE

BY

A. T. DLAMINI

A MANAGEMENT PROJECT PAPER

SUBMITTED IN PARTIAL FULFILMENT

OF THE REQUIREMENTS FOR THE

AWARD OF THE DEGREE OF

MASTER OF BUSINESS AND ADMINISTRATION

OF THE UNIVERSITY OF NAIROBI

NOVEMBER, 1987

This project paper is my original work and has not been presented for a degree award in any other University.

A. T. DLAMINI

This project paper has been submitted for examination with our approval as University Supervisors.

1. FMMwega

DR. F. M. MWEGA
Chief Supervisor
Lecturer, Department of Economics

2.

J. M. ANGIMA
Supervisor
Lecturer, Department of Accounting

ACKNOWLEDGEMENTS

I wish to thank all those who helped in one way or another in this study. Special thanks go to the Central Bank of Kenya and the Ministries of Finance; Planning and National Development; and Commerce for allowing me access to their records and providing explanations of some issues in foreign exchange operations. Without their assistance, this project would not have been completed.

I also wish to extend my profound gratitude to my supervisors, Dr. F. M. Mwega and Mr. J. M. Angima for their valuable advice, guidance and encouragement. I am also grateful to the Commonwealth Secretariat for sponsoring the study. While I am greatly indebted to my supervisors and the institutions mentioned above, I am the only one responsible for the views expressed in this paper. They should not be interpreted to reflect the views of supervisors, the institutions mentioned above or the University of Nairobi.

TABLE OF CONTENTS Page

LIST OF TABLES

A B S T R A C T

Most non-oil developing countries have in recent times experienced foreign exchange reserve shortages and deficits in their current accounts implying that they import more than they export. One of the major reasons for foreign exchange problems in these countries is the unfavourable international trade position in which they find themselves in. They are engaged in a trade pattern which is characterised by exports which are dominated by products like coffee, tea, sisal, pyrethrum and horticulture which are characterised by high price elasticities of demand in the world market and unstable prices.

On the other hand, most of these non-oil developing countries are unable to produce efficiently many of the goods and services required to promote their economic development. This means that these countries have to look beyond their borders for items necessary to develop their economies to levels at which they can produce these goods and services. These imports must be paid for. Many non-oil developing countries have found it difficult to finance imports due to the problem of inadequate foreign exchange reserves. In the face of overwhelming balance of payments problems, these countries have resorted to enormous external debt on severe terms, thus raising their debt servicing burdens to almost unmanageable proportions. Faced by this situation, some of these countries have found it necessary to introduce foreign exchange control regimes in an attempt to conserve foreign exchange.

This paper attempts to analyse the quantitative foreign exchange control system as a tool of managing foreign exchange reserves in Kenya. The study critically examines the administrative framework within which the quantitative control

system operates. The import liberalization process in the country is also examined.

Data for the study was obtained from the Central Bank of Kenya and the Ministries of Finance; Economic Planning and National Development; and Commerce. The collection of data was personally done by the researcher. The data collected included import licence approvals, foreign exchange releases by Central Bank of Kenya, classification of import items by schedules, global allocation of foreign exchange by schedules and the value of actual imports as provided by Customs Office. The data was in the form of computer print-outs.

The findings indicated that:-

(a) During the course of the implementation of the quantitative restrictions on imports, policy makers recognised that some problems were generated by the system. Some of the adverse effects of the system were that it encouraged slack management and inefficiency which reduced the ability of local firms to export. This made the country's exports less competitive in world markets both because of high prices and poor quality. In response to these problems, the government introduced the policy of liberalization in 1980. The restrictive import licensing was gradually to be replaced with tariffs.

(b) At least more than 65% of the restricted import items have been liberalized or shifted to the priority schedules. However, the rate at which these items have been liberalized has been slower than planned.

(c) There is no transparent criteria of approving or rejecting an import application. The system is open to abuse and corrupt practices.

(d) The annual foreign exchange allotment system has not been implemented as planned.

(e) There is lack of co-ordination between the institutions involved in processing import licences.

Due to limited time that was available to the author, the study does not analyse the aggregate demand for foreign exchange which would have assisted in assessing the adequancy of the current tariff and sale tax rates.

There is no doubt that substantial progress has been made towards the liberalization of the import administration. However, it is recommended that the import licensing system be made as transparent as possible to reduce opportunities for bribery and corruption and to facilitate administration.Clear guidelines would also minimise the divergence in the decisions made by the institutions involved in processing import licence applications.

CHAPTER 1

INTRODUCTION

1.1 Background of the Study

The problem of inadequate foreign exchange reserves to finance the import of goods and services needed for economic development is familiar to most less developed countries. This is particularly acute with non-oil developing countries.[1] These countries experience foreign exchange reserve shortages and deficits in their current accounts, meaning that they import more than they export. In most cases the outflow of foreign exchange is greater than the inflow.

A major reason for the foreign exchange problems in non-oil developing countries is the unfavourable international trade position in which they find themselves. These countries find themselves in a trade pattern which is characterised by exports dominated by agricultural and primary products like coffee, tea, sisal, pyrethrum and horticulture. This reliance on such commodities causes some problems. One of the problems is the high price elasticities of demand they experience in the world market[2]. This results in unstable prices and unstable export earnings.

---

1. Khan, Mohsin S., and Knight, Malcolm, Determinants of current account balances of non-oil developing countries in the 1970's: An empirical analysis <u>IMF Staff Papers</u> Vol.30, No.4, December 1983, p.819

2. Vinnae, Volker, Exchange control systems in less developed countries . I.D.S. Working Paper No.49, University of Nairobi, p.3

With the increase in oil prices, the non-oil developing countries oil import bill rose substantially. At the same time the increase in the price of oil led to increases in the price of other essential imports.[3]

Another problem which non-oil developing countries experience is the tendency for import prices to increase faster than export prices. In Kenya, for instance, average import prices rose by 61 per cent in 1974 while the export prices rose by 30 per cent.[4] This type of phenomenon, in which import prices rise faster than export prices is called an adverse swing in the terms of trade. In practical terms, it means that a country must export a greater share of its domestic products to purchase the same volume of imports. If domestic production is not rising fast enough to provide for this higher real cost of imports, the volume of goods left over for domestic consumption by the people will fall.

1.2. The Balance of Payments: Definition and the accounting frame-work[5].

Definition

The balance of payments is defined by the International Monetary Fund (IMF) as a record of:

---

3. Budget speech for fiscal year 1980/81 of the Republic of Kenya, P.4
4. Budget speech for fiscal year 1975/76 of the Republic of Kenya, P.1
5. For a more complete account of the materials in this section, see Financial Policy workshops: The case of Kenya.

(i) transaction in goods, services and income such as exports, imports, tourism transaction and interest payments between the economy in question and the rest of the world.

(ii) changes of ownership and other changes in foreign assets and liabilities (including capital transactions such as loans, and allocation of Special Drawing Rights (SDR) by the IMF) and

(iii) gifts, and other accounting entries required to complete the balance of payments record.

The accounting framework

The various transactions which enter the balance of payments are assembled according to an established framework[6]. The purpose of the framework is to group transactions which have common features, so that sub-totals relevant for economic analysis can be compiled. The main elements of the framework are:

(a) The Merchandise Account (the trade accou

This account covers imports and exports of moveable goods.

(b) Invisible Account

This account covers transactions in services (such as tourism, freight, insurance, port services), interest and dividends, and certain

---

IMF Institute, International Monetary Fund, Washingto D.C. 1981, P.97-127 . An even more detailed account of much of the material is contained in IMF Balance of Payments Manual , Washington D.C., 1977, 4th ed.

6. An established frame work is contained in IME,ibid However, in its Staff Papers Vol.1, No.2, Septembe

types of labour income , unrequited transfers (gifts) such as official grants (aid), and remittances from workers engaged abroad. Migrants' transfers may also be included in the invisibles account, although they are sometimes shown separately.

(c) Capital Account

The capital account covers transactions in financial assets and liabilities. These transactions include direct investment, e.g the 49 per cent shareholding of the U.S.A based General Motors Corporation in General Motors (Kenya) Limited is an example of inward direct investment. The capital account also includes portfolio investment, long-term loans and other equity transactions.

(d) Foreign Reserves

This account comprises those (net) liquid foreign exchange assets held by the Central Bank (and in some countries by Commercial Banks). They include transactions with the IMF, e.g. SDRs and drawings on IMF resources (itself a negative item since reserve liabilities increase when drawings occur, offset of course by a rise in liquid foreign exchange assets). Such other assets as bank balances and investments which are available to finance payment in balances are included in foreign reserves.

Sub-Totals for economic analysis

The accounts of the Balance of payments can be compiled into sub-totals of interest for economic analysis. Various combinations of the accounts can be constructed depending on the purpose at hand. The sub-totals most frequently used are outlined below.

1986, The Central Bank of Kenya has given an example of Balance of payments framework , p. 3 - 6 .

(a) Balance of trade (Merchandise Balance)

The Balance of Trade is simply the difference between the value of exports and imports of goods. This sub-total excludes receipts and payments for services so that the balance of trade is not by itself particularly useful.

(b) Current account

The current account adds receipts and payments for services to the surplus or deficit in the trade account.

(c) The Basic Balance

The Basic Balance adds to the current account those capital transactions which are long-term on the assumption that these capital transactions are unlikely to be reversed quickly. This sub-total thus attempts to measure the surplus or deficit of stable transactions,which reflect underlying balance of payments developments.

(d) The Overall Balance

The overall balance is the total of capital transactions and current account. This sub-total is the widest measure of the surplus or deficit in the balance of payments. The overall balance is thus (in principle) a mirror image of movements in foreign exchange reserves, i.e. a surplus in the overall account implies that monetary reserves will have risen as foreign exchange earnings and other receipts exceed payments. In practice, the overall balance is used more frequently than the basic balance as an indicator of the balance of payments, because the distinction between shor-term and long-term capital is often arbitrary.

1.3 The Importance of Balance of Payments

Imports of goods and services are essential to economic growth in most developing countries, particularly those in Sub-Sahara Africa where economic development problems are most critical and average welfare levels low. Most developing countries are unable themselves to produce efficiently many of the goods and services required to promote economic strength and attain acceptable living standards. This means that these countries must look beyond their borders for items necessary to develop their economies to levels at which they can produce these goods and services.

Imports of capital equipment and raw materials are required for economic development. They are required in manufacturing,agriculture, transport, energy, communications, etc. Imports of raw materials and semi-finished goods are necessary for industrial activity, e.g. spare parts for machinery, and oil for transport and electricity generation. Other goods are of course imported for direct consumption.

Imports must be paid for. Much of the foreign exchange needed to buy them must be obtained from export earnings. In the face of overwhelming balance of payments problems, many non-oil developing countries have resorted to increased external borrowing on ever-hardening terms, thus raising their debt servicing burdens to almost unmanageable proportions. Faced by this situation, non-oil developing countries such as Kenya have found it necessary to introduce foreign exchange control regimes in an attempt to conserve foreign exchange. These measures are intended to monitor transactions in foreign exchange by residents and transactions in domestic currency by non-residents of the country concerned. Exchange control systems are unpopular with some international lending agencies such as the International Monetary Fund because they see them as interferring with the pursuit of a liberal system of trade and payments and as discouraging effective balance of payments adjustment policies[7].

Different regimes have been adopted by different countries in their management of foreign exchange reserves, and some of these are discussed in the following section.

1.4 Some Techniques in Management of Foreign Exchange Reserves

(a) The Multiple Exchange Rate System

The multiple exchange rate system is a method which can be used in the management of foreign exchange reserves. This method uses multiple exchange rates which aim to increase the supply of foreign exchange by raising the domestic buying price per unit of foreign currency for specified international transactions, especially exports. By raising the price for a foreign currency, demand for exports can be curtailed. A multiple exchange rate system is usually combined with import duties and excise taxes.[8]

---

7. Killick, Tony, The Quest for Economic stabilization: The IMF and The Third World.Heinmann Educational Books Limited, London,1984, P.119

8. Kanesa - Thasan S Multiple exchange Rates: The Indonesian Experience IMF Staff Papers,Vol. 13 No. 2, July 1966, P.364.

In applying multiple exchange rates, two main variables have evolved:

i) a differentiation according to the set of a transaction e.g exports, imports, invisibles, capital movements, where each item in the balance of payments might have its own price per unit of foreign exchange.

ii) a differentiation according to countries, currencies or currency areas.

Irrespective of the differentiation used, the exchange control administration bases its decision on the price per unit of foreign currency prevailing against which the individual rates used indicate either a devaluation or revaluation. Thus over-valued exchange rates for imports may be applied to capital goods and non-essential materials; consumer goods are imported at the normal rate, whereas luxury imports meet high "penalty rates". Exports on the other hand are encouraged by raising local receipts per unit of foreign exchange.

By using an over-valued exchange rate, private foreign investments can be attracted for investment in specific industries. On the other hand profit outflows and repatriation of capital might be discouraged by applying unfavourable rates to foreign exchange.

The following are some of the advantages of a multiple exchange rate system:

i) It is a more advantageous method of meeting the balance of payments problems of a country with relatively low elasticity of world demand for its export than a straight forward devaluation of a unified exchange rate.

ii) Given such elasticities of demand and supply, it represents one way of meeting the balance of payments deficit with the least unsettling effects on domestic prices, cost of living, income distribution and production.

iii) The undeveloped tax structure of a country, in particular the customs tariff structure, makes it imperative to rely on multiple exchange rates as an option and as a means of anti-inflationary pressure and revenue problem.

iv) Other advantages often claimed for multiple exchange rates as a source of government revenue are that they are more flexible and easier to enforce than customs duties and are less likely to meet with political resistance because they are operated as part of the foreign exchange system.

The main disadvantage of multiple rates system is that it is not capable of handling the techniques used by the multinational corporations on transfer pricing in developing countries.

Transfer pricing offer multinational corporations a wide scope to divert profits from one country to another.

(b) Barter

Barter is a traditional form of trading. It involves trading goods and services against each other. In other words, if someone wanted to take advantage of his special ability to produce say, corn, he would have to try and find someone with whom he could barter his surplus output in exchange for other necessities of life, for example building materials, clothes, meat, fuel, etc. The general disadvantage of a barter economy is that, in order to acquire an article he cannot make for himself, a man has first to find someone who can make it, and who is prepared to swap it for something he has available to give in exchange. Furthermore, both parties to the trade have to want the right quantities of the goods on offer and be prepared to exchange them at the same time. Finally, they have to agree on mutually acceptable rate of exchange for the commodities in question. These requirements can be stated as the need for a double coincidence of wants if a transaction is to take place.

Barter is another option which could be adopted as an alternative method in the management of foreign exchange reserves by developing countries subject to the problems cited above. This method may not work efficiently in developing countries because they are more or less at the same level of economic development. Most of the developing countries are exporters of primary and agricultural products and are importers of capital goods.

However the question of barter trade should not be ignored. It is an area which needs to be explored as an alternative strategy to solve foreign exchange problems. One way in which it can be practised is to encourage economic co-operation among developing countries themselves by exploiting their economic comparative advantage. For example, the Preferential Trade Area (PTA) for Eastern and Southern African Countries which was established in 1981 can be used to promote barter among the member countries. The main objective of the PTA is to reduce and eliminate trade barriers with respect to trade within member states of the sub-region.[9] The PTA encourages economic

9. Treaty for the establishment of PTA for Eastern and Southern African States article 3, p.4.

co-operation arrangements within member countries. So far, there are 15 member countries which include Burundi, Comoros, Djibouti, Ethiopia, Kenya, Lesotho, Malawi, Mauritius, Rwanda, Somali, Swaziland, Tanzania, Uganda, Zambia and Zimbabwe. The PTA arrangement is aimed at promotion of co-operation and development in all fields of economic activities in the sub-region including trade, customs, agriculture, industry, transport and communications, natural and human resources as well as financial and monetary affairs. Member states will reduce and gradually eliminate customs duties and barriers with respect to trade among themselves. The eventual aim of their progressive process is the establishment of a common market and ultimately an economic community.

The PTA members have also established a protocol on clearing and payments arrangements. The main objectives of this protocol are to:

1. Promote use of national currencies for settlement of intra-PTA trade.

2. Provide machinery for multi-lateral settlement of payments among PTA members states.

3. Reduce as much as possible the use of foreign exchange by member states in their intra-PTA transactions.

To achieve the above goals a 'Clearing House' was established in Harare, Zimbabwe, in February 1984.

UAPTA is the unit of account of the PTA and is equal to one SDR. Intra-regional settlements are expressed and recorded in terms of UAPTA.

Within this framework, the member states of the PTA can use the barter system when trading among themselves. This should help to relieve the problem of the need for convertible and acceptable foreign currency reserves in this sub-region.

For barter to succeed, there has to be a high degree of economic co-operation among the countries concerned. For example the history of economic co-operation in the African continent can rightly be described as a history of failure because most of the experiments initiated have failed for one reason or another. Major failures in recent years, have included the collapsed East African Community and what appears to be an unpromising, or at least very slow and unsteady, start of Economic Community of West African States (ECOWAS). The reason for these failures are many, and ideally each case should be studied individually in order to examine the cumulative causes and the actual immediate problem or event that triggered the process of disintegration. Efforts must therefore be intensified to promote economic co-operation. However, this should be on the basis of a strategy which makes use of past experience so that the co-operation arrangements established can be more effective than past efforts.

The following are some factors which may inhibit growth of trade in the PTA sub-region:-

a) imbalance in industrial development of PTA member states so that only very few countries have exchangeable processed products.

b) insistence by some countries, e.g. Tanzania, on reciprocal trade on company to company basis is an impossibility in practice.

c) lack of reciprocity in needs between two countries.

d) past prejudices and beliefs in that goods made abroad, e.g. Europe, U.S.A. etc, are superior to those made within the member states of the sub-region.

(c) <u>Countertrade</u>

Similar to barter is countertrade. What precisely is countertrade? The concept refers to a situation where a conditional link is established between import and export flows and embodies different categories: counter purchase; barter; buy-back; bilateral clearing agreements; switch trading and offsets. Essentially, countertrade is based on the priciple of reciprocity, each party in a transaction being a buyer/seller of goods or services sold/bought by the other partners. It should be noted that countertrade is a nice euphemism for barter or barter-like trade. It may involve balancing trade between the two countries involved, although not always, in which case the process may be governed by "proportionality".

A counterpurchase transaction occurs when an exporter accepts to take products from the importing country in payments for goods sold. The most conspicuous example in Africa is the case of Nigeria, which has traded an estimated US $ 4 billion in oil for manufactured goods or parts from Brazil, France, Austria and Italy, among others.[10] In counterpurchases, the lifting of local exports might come first; alternatively the import of foreign goods might come first. In the case of the former, the process from the sale made by the importing partners are put in an escrow account and credited to the exporter when he ships his own goods. This has been the format with the

10 Kenya Export News,Vol.37, No.370, January 1986.

Nigerian deals. Sometimes a counterpurchase or compensation ratio is set; this is the percentage of the value of the export that will be the subject to counter-purchase.

Product buy-back/pay-back arrangements usually occurs where sellers of plant, equipment or technology agree to accept payment in products manufactured with the equipment they have supplied be they related to the supplier's industry or otherwise.

Bilateral inter-governmental agreements range from broad statement of "best intentions" to foster mutual trade to rigidly defined agreements to balance trade, in which two countries agree to establish a clearing mechanism which may include elements such as a clearing currency, owing credits and specified product lists. One of the motivations in such arrangements is the balancing of overall trade payments.

(d) Tariffs

A country may opt to impose high tariffs to restrain imports. Imposing high tariffs on imports is an attempt to reduce the import bill and may also be used to protect local industry. The following are major advantages of the use of tariffs:-

(i) Increased revenue and a corresponding reduction in the incentive to import.

(ii) Lower administrative costs, since case-by-case judgements on individual requests for foreign exchange are not needed.

(iii) Reduced scope for corruption.

One objection to reliance on tariffs is the danger of dumping. Broadly defined, dumping is the practice of exporting goods at a price below the costs of production. It is a threat to the growth of any industry that competes freely on the basis of price. From the point of view of the country into which the goods are dumped, this practice can be seen as both a problem and as a gift. On the one hand, the goods are obtained cheap for less than they could be produced locally; on the other hand a local industry may be wiped out or prevented from developing. On balance, the problem is more important than the gift, since a country such as Kenya also puts a high value on foreign exchange, and wishes to develop export and import-substituting industries. There is never any gurantee that the low dumping prices will continue to be available. Once the dumper has captured the market or simply disposed of an unwanted stockpile of goods, the price may well rise. Therefore, tariffs must be used with care and adequate precautions must be taken to guard against dumping which might materially retard progress and the establishment of local industries. Tariffs must also be appropriate enough to restrain imported items.

(e) The Quantitative Restriction System

The exchange control system mainly used in non-oil developing countries, particularly in Africa, is quantitative controls. In Kenya, the quantitative control system is administered through the import licensing system. The import licensing system in Kenya was effectively developed in 1971 in response to the need to conserve foreign exchange and to protect local industries. By definition a quantitative control system restricts imports into the country through the import licensing system. The restriction is normally done on a selective basis. Some commodities may be totally banned for importation while others are allowed.[11] For the latter commodities, foreign exchange is made available while for the former commodities no foreign exchange is allocated. The chief purpose of quantitative control is to reduce imports below what they would otherwise be thereby reducing the effective demand for foreign exchange.

Several types of classification are used to categorise imports. Imports are divided into three broad categories according to the restrictions applied. These categories are prohibited, restricted and free imports. Another comparable classification groups imports as luxuries, less essentials and essentials. For trade control purposes, imports can also be divided into consumer goods and producer goods, with sub-groups in each of the main two groups - essential, semi-essential and non-essential goods.[12]

1.5 Merits and Demerits of the Quantitative foreign exchange control system

Advocates of the quantitative control system claim a number of advantages for the system over alternative policies such as devaluation, use of tariffs etc. The claimed advantages are:[13]

---

11 Vinnae, Volker, The system of exchange control in Kenya . I.D.S. Discussion Paper No.148, University of Nairobi, p.1

12 Swidrowski, Josef, Exchange and Trade Controls: Principles and procedures of International Economic Transactions and Settlements Gower, Epping, 1975, p.11

13 Killick, Tony. The Quest for economic stabilisation: The IMF and the third world. Heinmann Educational Books, Nairobi, 1984, P.119

(a) Quantitative controls exert a prompt, direct and predictable effect on imports; they do not rely on the intermediation of a price change and therefore on the size of price elasticities to improve the balance of payments.

(b) They may be imposed selectively, allowing the authorities to discriminate between imports. Normally discrimination is exercised against the importation on non-essential consumer goods. From the development point of view, therefore, quantitative controls appear to make the most effective use of scarce foreign exchange.

(c) Quantitative controls may be used to protect the domestic industry. When producers are assured that the home market is secure they may concentrate more on developing export markets although they may prefer to languish behind absolute licence protection and not venture into foreign markets.

On the other hand, a quantitative control system has the following significant problems:

(a) A quantitative control system requires a complete administrative system which even if it works as intended,will be expensive in resource costs. The resource costs include the case-by-case decision making on all the import licence applications. In Kenya, for instance, there is an average of 2000 applications which are considered every week by the Import Management Committee in the Ministry of Commerce and Industry.

(b) It tends to lengthen the time-lag between the need for particular imports and their delivery. Such delays cause shortages and the under-utilization of capacity. Controls may also encourage firms to build larger than an optimum scale of plants in order to obtain extra allocation of foreign exchange.

(c) The system of quantitative controls may cause over-invoicing of imports in which a "fictitious" amount is added to the actual invoice value of imports. The aim of over-invoicing of imports is either to transfer funds abroad or to reduce the costs of goods imported by selling the illegally acquired foreign exchange at a higher "black" market rate.

(d) Reduced shipments from other countries may lower their ability to buy the exports of the restricting country.
Import controls may also bring retaliation from other countries and may be used as a tool in the bargaining power.

(e) Quantitative restrictions deprive the Treasury of revenue which would otherwise be obtained through tariffs.

(f) Execssive administrative controls may be a big source of bribery and corruption.

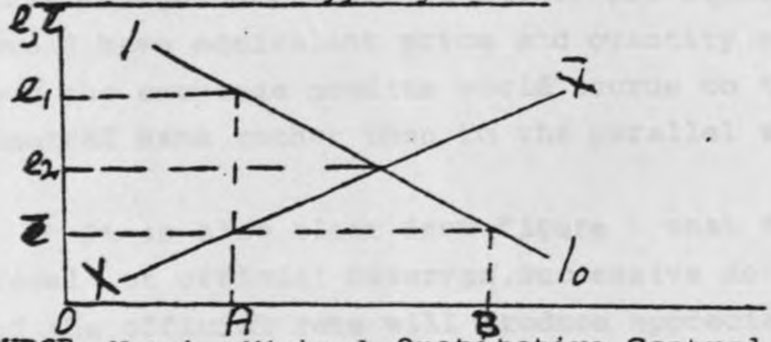
---

14. Miller, Elwood L., Accounting problems of Multinational Enterprises. D.C. Heath and Company, Toronto 1980, P.113 .

(g) Another major drawback of the quantitative import restriction regime is that a portion of demand is not satisfied. The unsatisfied demand may give rise to a black market where foreign exchange is bought and sold illegally. The implications of the system on unsatisfied demand is discussed below.

Let us assume that the economy consists of the official sector and unofficial sector. The official sector comprises a government and the Central Bank. The Central Bank operates an official foreign exchange market in which all transactions are conducted at a fixed price. Both the government and the parallel sector (unofficial sector) participate in the market. The excess demand created by import restriction will be satisfied in a parallel market.[15] The source of foreign exchange in the parallel market consists of proceeds from smuggling the export good. The illegality of such transactions involves a cost that is partly reflected in a premium of the parallel market price over the official price.

a) Prohibitive Smuggling Costs Figure 1



SOURCE: Nowok, Michael, Quatitative Control and Unofficial Markets in Foreign Exchange: A Theoretical Framework. IMF Staff Papers, V.31, No.2, June 1984, P.408

15. Nowok Michael, Quantitative Controls and Unofficial Markets in Foreign Exchange: A Theoretical Framework IMF Staff Papers Vol.31, No.2, June 1984, P. 404 - 420.

Determination of the parallel market Exchange Rate: Without smuggling

The consequence of quantitative import controls when prohibitive costs rule out smuggling are illustrated in figure 1 above. Demand for the imported good, ll_0 ,and the supply of the export good to official market, XX_0, are depicted as functions of the unofficial exchange rate, e(defined as the price of foreign currency in domestic currency) at the official exchange rate $\bar{e}1$, the prevailing demand for imports will be fully satisfied if official reserves equal to AB are sold each period. If the quantity of imports is restricted to OA through, say, a licensing system, then no reserves sales are necessary at e1. Consequently, at this rate, there is an excess demand for imports. But imports purchased at $\bar{e}1$ will be resold at the premium price of e1, the profits from this activity being given by the product of(e1-$\bar{e}1$) and OA. Thus, although no foreign exchange is transacted outside the official market, e1 may be interpreted as a "shadow" parallel market exchange rate. A discriminatory arrangement that charges importers e1 but offers exporters, $\bar{e}1$ would have equivalent price and quantity effects, but the exchange profits would accrue to the Central Bank rather than to the parallel sector.

It is also clear from Figure 1 that for a given level of official reserves,successive devaluations of the official rate will produce appreciations of the shadow parallel rate, and therefore, will cause a decline in the price of imports until the foreign exchange market clears at e2. This deflationary effect simply reflects an expansion in the suppy of imports arising from increased availability of foreign exchange.

b) Non Prohibitive Smuggling Costs

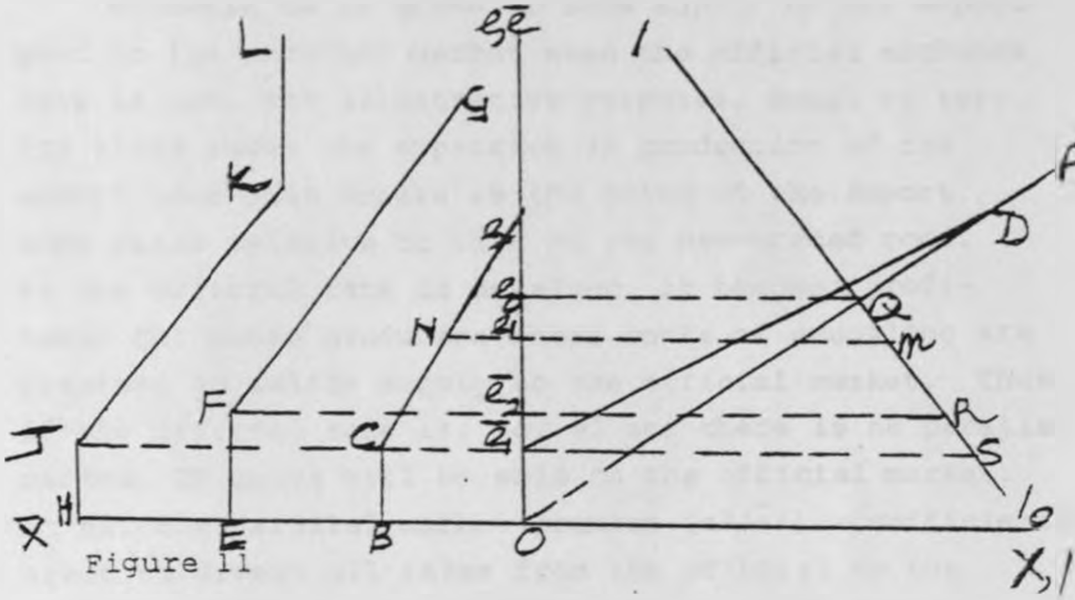


Figure 11

SOURCE: Nowok, Michael, Quantitative Control and Unofficial Markets in Foreign Exchange: A A Theoretical Framework. IMF Staff Papers. Vol.31, No.2, June 1984, P.410.

Determination of Parallel markets Exchange Rate: With smuggling

Let us now look at a case in which costs of smuggling are not prohibitive.

The left-hand quadrant of Figures 11 depicts, as a function of the parallel market exchange rate e, the foreign currency value of sales of the export good to the official market, $\bar{X}$, whereas the right hand quadrant shows the export good to the parallel market also as a function of e. The schedules are drawn for given value of other prices, including the official exchange rate $\bar{e}$.

Schedule OA is drawn to show supply of the export good to the parallel market when the official exchange rate is set, for illustrative purposes, equal to zero. Its slope shows the expansion in production of the export good that occurs as the price of the export good rises relative to that of the non-traded good. As the official rate is devalued, it becomes profitable for those producers whose costs of smuggling are greatest to switch supply to the official market. Thus, if the official rate is, say $\bar{e}1$ and there is no parallel market, OB units will be sold on the official market. At e2, the parallel market premium ($e2/\bar{e}1$) is sufficiently great to divert all sales from the official to the parallel market. The official and parallel market supply curves corresponding to $\bar{e}1$ are, therefore, BCe2 and e1DA, respectively. Curve e1D is flatter than OD because as the parallel rate rises, sales of the export good are diverted from the official to the parallel market. An increase in the official rate, from $\bar{e}1$ to $\bar{e}2$, produces an outward shift of the official market supply curve from BCe2 to EFG.

To see how the parallel market is determined, consider an initial situation in which all of the export goods are sold in the parallel markets because the official rate is "too low" and in which there are no reserve sales or reserve sales are restricted by the central bank. The equilibrium parallel rate will be e0 when, for illustrative purposes, the official rate is set to zero. This rate corresponds to the intersection of the supply schedule OA and the demand schedule 11_0

Note that at $\bar{e}2$, the quantity of foreign exchange demanded ($\bar{e}2$R) is equal to the quantity supplied in the offical market (F$\bar{e}$2). Both e1 (parallel rate consistent with an official rate $\bar{e}$1) and $\bar{e}$2 are equilibrium exchange rates in the sense that, at these prices the demand for foreign exchange is equal to supply. Only $\bar{e}$2, however, is consistent with the absence of binding restrictions on the availability of foreign exchange in the offical market. In this regard, $\bar{e}$2 may be referred to as a "restriction-free" equilibrium.

An important implication of the above illustrations is that the imposition of quantitative import controls as a substitute for a formal devaluation does not avoid the adverse repercusions that a devaluation has on the rate of inflation or real wages. The emergence of a parallel market in response to such controls and the depreciation of the exchange rate in this market have inflationary consequences similar to those of an official devaluation. Furthermore, the illegality of transacting foreign exchange in the parallel market gives rise to real resource costs, that are absent in a unified exchange system. Such a dual market also provides an environment conducive to corrupt practices and permits economic rent to accrue to certain groups that are in a position to exploit the exchange rate differential between the two markets.

It is therefore important that any quantitative foreign exchange system be used with extreme care. Its weaknesses and strengths should be evaluated to minimise its adverse effects to society and economy.

As indicated above, the current account is a record of commodity imports and exports, and transactions in invisible services and transfer payments to and from abroad. The current balance is the net sum of these items. Most non-oil developing countries experience foreign exchange reserve shortages and deficits in their current accounts. As we shall see later, this also applies to Kenya. This calls for corrective action by the government. Whether action is needed will also depend on the ability of the country to attract inflows of capital investments from the rest of the world on reasonable terms. Many non-oil developing countries have already increased their external debt to almost unmanageable proportions and on severe terms. Thus, a government would be advised to try to manage foreign exchange at the level of the current account, that is relate imports to earnings from exports.

This paper attempts to analyse the quantitative foreign exchange control system as a tool of managing foreign exchange reserves in Kenya. The paper examines the current account items from 1982 to 1986. The import liberalization process in the country is also examined. The question of whether or not the system fulfils the purpose for which it was designed is also discussed.

1.6 Statement of the problem

The import licensing system is one of the measures which the Kenya government adopted as a result of a tight foreign exchange position. Naturally, the performance of any system must be reviewed to see if it achieves the objectives for which it was instituted. The paper attempts to appraise the performance of the system since 1982, about a year after the announcement of its liberalization.

1.7 Objectives of the study

As already indicated, this study is concerned with the management of foreign exchange reserves through a quantitative control system on imports. The objective is to critically examine the administrative framework within which the system operates.

1.8 Significance of the study

(a) The study should be of benefit to the Central Bank of Kenya and other relevant government authorities in policy making and management of foreign exchange reserves.

(b) The study should offer a basis for further academic research.

(c) Finally, it is hoped that the study will generate information about the current management of the import licensing system which should add to the existing stock of knowledge.

CHAPTER 2

THE KENYAN FOREIGN EXCHANGE CONTROL SYSTEM

2.1 The Historical Background of the Foreign Exchange Control System in Kenya: An Overview

Exchange controls made their appearance in developed countries during the Great Depression. Their aim was to achieve a balance of payments equilibrium by suspending the market forces in the foreign exchange market, thus curtailing the outflow of foreign exchange reserves. By restricting demand it was hoped that a balance of payments equilibrium will be achieved[1].

Restrictions of some kind or another on foreign exchange transactions in Kenya have been in existence for over half a century. In the early 1920s, there were quite restrictive exchange control rules regarding transactions between Kenya, which was then a part of the sterling area,and the rest of the world[2]. Transactions within the sterling area were, however free from restrictions. Since in those days people in Kenya had very few transactions outside the sterling area, the stringency of these restrictions was not felt by many people or businesses.

Local legislation providing specifically for exchange control was introduced in 1951 and the main provision of the current exhange control act have been inherited from it. Again, the 1951 statute controlled transactions with non-sterling countries only. By leaving remittances to sterling area free of control, Kenya began to experienc

---

1. Ellis, H.S.: Exchange Control in Central Europe. Cambridge (Mass), 1941

2. Central Bank of Kenya: Its evolution, Responsibilities and organization, September 1986.

strong pressure on its reserves after independence in 1963. A number of people at that time decided to take out all their assets and to transfer large amounts of funds to other countries like the United Kingdom, Canada, Australia, India and Pakistan. The impending break-up of the East African Currency Board in 1965 greatly increased such activity because of fears about the new currencies. In June 1965, it became necessary to impose exchange control on transactions with other countries except Tanzania and Uganda, which also took a similar action. Exchange control restrictions were extended to the two neighbouring countries in August 1977 after the collapse of the East African Community.

Although Kenya experienced some problems on her reserves after independence in 1963, these problems were not severe until in 1971 when the country experienced its first post-independent payments crisis. In 1971, the county experienced an abnormally large current deficit of which only about a third was covered by long-term capital as shown in table 1 below.

TABLE 1

SELECTED ACCOUNTS IN THE BALANCE OF PAYMENTS IN KENYA K£ MILLION

	(1)	(2)	(3)	(4)	(5)	(6)
Year	Visible Balance	Invisible Balance	Current Account Balance	Net long term Capital inflow	Basic Balance	Overall Balance
1964	-9.4	26.9	17.5	15.60	1.9	1.6
1965	-19.4	19.6	0.2	8.10	8.3	7.7
1966	-26.7	20.1	-6.6	14.6	8.0	6.0
1967	-37.5	16.0	-21.5	16.5	-5.0	-9.9
1968	-37.0	22.6	-14.4	17.7	3.3	3.5
1969	-31.6	28.7	- 2.9	19.7	16.8	17.6
1970	-50.5	33.0	-17.5	28.90	11.4	14.2
1971	-91.4	51.5	-39.9	16.7	-23.2	-24.5
1972	-66.4	42.1	-24.3	30.6	6.3	8.5
1973	-54.5	7.7	-46.8	48.10	1.3	6.6
1974	-160.1	45.8	-114.3	71.70	-42.6	-32.2
1975	-125.0	41.1	83.9	57.40	-26.5	-15.0
1976	-77.3	25.4	-51.9	90.70	38.8	36.7
1977	-61.3	72.7	11.4	83.90	95.3	113.8
1978	-355.5	100.2	-255.3	168.0	-87.3	-80.5
1979	-299.4	113.1	-186.3	189.50	3.2	67.5
1980	-526.6	197.9	-328.7	203.10	-125.6	-75.9
1981	-497.0	160.9	-336.1	193.90	-142.2	-99.8
1982	-430.4	169.8	-260.6	136.6	-124.0	-107.6
1983	-313.3	224.3	-89.0	133.9	44.9	69.5
1984	-317.0	242.7	-128.3	136.2	7.9	39.6

Source: Statistical Abstracts.

As indicated in Table 1, there was a substantial fall in reserves to which the government responded by imposing restriction on imports and domestic credit by cutting its own spending[3]. Several factors contributed to the drainage of foreign exchange reserves of the country. For instance, during 1971 the prices for imports into Kenya as a whole rose by 9.5% while export prices fell by 3.8%, an adverse swing in the terms of trade[4]. There was also a build-up in the level of stocks on imported commodities towards the end of 1971. This overstocking was another factor explaining the decrease in the level of reserves.

During the course of monitoring the foreign exchange reserves behaviour, it was felt that overinvoicing was making such a significant contribution to the drain on the foreign exchange reserves as to warrant remedial action. With the exception of certain categories of imported items, all imports in excess of an invoice value of twenty thousand Kenya shillings on and after the 1st January 1973 were to be subject to preshipment quality and quantity inspection and price comparison on behalf of and for the Central Bank of Kenya by General Superintendance Company Limited or its representative. Banks were required to bring the revised regulations to the notice of their importing customers who in turn would advise overseas sellers of the new requirements.

---

3. Killick, Tony; Papers on the Kenyan Economy: performance, problems and policies, Heinemann Educational Books, Nairobi 1981, p.60

4. Macrae, David S., Import licensing in Kenya. Institute for Development studies, University of Nairobi. I.D.S. Working Paper No.90, p.10

The import licencing system imposed in late 1971 classified imports on the basis of their assumed necessity into five categories: items already subject to licencing were included under either schedules A, B, or C, while schedules D and E contained items which had previously been freely imported under open General Licence[5].

The aim was to protect local industries by putting imports in schedule A, to conserve foreign exchange by putting imports in schedules D and E, while putting imports in schedules B and C was designed both to protect local industries and conserve foreign exchange respectively. The items under schedule A were to continue to be imported as before, no foreign exchange was to be provided for items in schedules B and E, while imports in schedules C and D, were subject to quota restrictions based on past performance. The regulation of schedule D imports was intended to restrict the speculative accumulation of stocks by rationing foreign exchange to imports, with no actual reduction in the average absolute amount. This was achieved through the issue of "no objection certificate" by the Central Bank of Kenya.

2.2. The legal framework of the exchange control system in Kenya

Exchange control in Kenya was initiated under the Colonial Administration as part of the British exchange control system and was continued by the Kenya government after independence in 1963. In 1967, all previous legislation was summarised in the revised exchange control act which gives the authorities the power to exercise almost complete control over all transactions in gold and foreign exchange by residents and transactions in domestic currency by

---

5. Macrae, D.S., The Import Licencing System in Kenya. Journal of Modern African Studies. Vol.1, 1979, P.37

non-residents[6].

For the implementation of the Exchange Control Act, the government issued a set of exchange control administrative notices and instructions (EN)[7] which define the policy decided by the Ministry of Finance in co-operation with the Central Bank. Subsequent changes are announced through exchange control circulars (E C)[8] issued by the Exchange-Control Department of the Central Bank to whom the Minister for Finance delegated the administration of exchange control. The bank in turn delegated most of the routine decisions to "Authorised Dealers" (Commercial Banks).

In order to enforce the provisions of the Exchange Control Act, the Act provided legal sanctions in the form of fines and imprisonment for offenders. It should be noted that the exchange control system of Kenya relies on foreign exchange restrictions determined in quantitative terms. Hence the system only limits or curtails demand for visible and invisible payments and capital outflows.

According to the provisions of the Exchange Control Act, the exportation of goods of any class to any place outside Kenya is prohibited unless the Central Bank gives its consent. These powers have been delegated to the Commissioner of Customs on certain conditions, e.g. he can only allow the exportation of goods which are going to
be sold abroad if he is

6. Exchange Control Act (Revised)1967 , CAP.113, p.3

7. "EN" is a code for administrative notices and instructions for exchange control.

8. "EC" is a code for exchange control circulars.

satisfied that the proceeds from goods will be received within a specified period; and that payment will be made in an authorised manner. Registered exporters are not required to obtain preshipment approvals from the Central Bank, but are, however, required to account for proceeds of sale for exchange control purposes.

Export documents (CD3 forms)[9] are channelled through the Commercial Banks which retain copies of these forms, the original one being released to the exporter for the purpose of clearing the goods with the customs authorities. One of the copies is sent to the Central Bank by the exporter's bank to give the Central Bank notice of an impending export. When the goods have been cleared through customs the customs copy is sent to theCentral Bank. When the proceeds of sale of the goods are received a certificate to that effect is prepared by exporter's bank and again dispatched to the Central Bank. The Central Bank tries to ensure that not only does the country get a fair return for the goods, but in particular that the money is actually received within a reasonable time.

Under the Exchange Control Act, no resident, be it an individual, a private or a public institution, can borrow foreign currency without the consent of the Central Bank. While borrowing by the government does not require exchange control consent, the Central Bank is duly informed of it; borrowing by other parties requires the express prior approval of the Central Bank. Borrowing by government corporations require Treasury's approval. The main concern of the Central Bank in this area is to satisfy itself about the purpose for which the loan is being raised and other terms and conditions of the loan

9. "CD3" is a code used for export forms.

including the interest rate being charged, and the repayment periods. One of the major considerations in foreign borrowing is to spread the repayment period of the loans over as long a period as possible.

Complementing the management of the foreign exchange reserves in Kenya is the Import, Export and Essential Supplies Act [10]. This act empowers the Ministry of Commerce and Industry to prohibit or restrict the importation of any given commodities. The provisions of this Act have been used for a variety of purposes including the protection of domestic industries and conservation of foreign exchange. However, the use of import control as a protective measure for domestic industries is being phased out gradually under the liberalization of the import licensing system.

The total amount to be spent on imports in any financial year and the broad priorities for the import of different categories of goods are decided by the government. The global foreign exchange allocations are decided in advance. To give effect to these decisions, and under current arrangements exchange procedures are devised by the Central Bank to ensure not only that the goods so authorised for importation come into the country, but also that the price paid for them is in accordance with market prices for such goods in international markets.

In order to ensure that contractual requirements in price, quantity and quality are met, the Central Bank, in consultation with the government, has made arrangements with the General Superintendence Company (S.G.S)[11] to check and make comparisons. S.G.S.

---

10. The Import, Export and Essential Supplies Act, (Revised)1980, CAP. 502, P.17

11. The General Superintendance Company is generally known as the "S.G.S."

is charged with the responsibility of conducting price comparisons as well as quality and quantity inspection before certain range of goods are shipped to Kenya. When these requirements are met, a "clean report of findings" is issued which enables local banks in Kenya to effect payment to the suppliers abroad. When a "non-negotiable report of findings" (N.N.R.F.) is issued, commercial banks cannot effect payment as the report is not negotiable. If S.G.S. is not satisfied, the goods will not be shipped and therefore no payment is made.

2.3 Liberalization of the Quantitative control System in Kenya

During the course of the implementation of quantitative restrictions on imports, the government recognised that some problems were generated by the system. The idea of liberalising the import control system is contained in the Development Plan for 1974-1978[12]. This Development Plan stated that the use of import controls as a protective measure for domestic industries is to be phased out gradually. The import licensing measures covering a wide range of items that were put into effect during the previous plan for conservation of foreign exchange were to be relaxed. A liberal import policy which avoided unwarranted profiteering was to be pursued during the plan period.

The Development Plan for 1979-1983 explicitly recognized the problems generated by the use of quantitative restrictions on imports. The adverse effects of the quantitative restrictions were that domestic prices of imports rose above world prices[13].

---

12. Development Plan of Kenya for 1974-1978, p.374

13. Budget speech for fiscal year 1981/82, Republic of Kenya, P.11

This made the county's exports less competitive in the world market. The increasing differentiation between world and local prices was as a result of local monopolistic conditions created by the quantitative restrictions rather than a result of tariffs. The revenue realised thus accrued to commercial beneficiaries of the system rather than to the Treasury or the Central Bank. Another reason for the government to liberalize the system was to create an efficient industrial sector which should produce goods of high standards and quality. Such goods would be well competitive in the world market in terms of quality and this should earn the country foreign exchange.

Inherent in the initial logic for widespread quantitative restrictions on imports, with their removal of international competitive pressure on Kenyan prices, was the notion that domestic prices could readily be controlled by legislation. Official attempts at general price control for manufactured products were introduced specifically to combat the price effects of the introduction of quantitative restriction as the major protective device for manufacturing firms in the country[14].

In announcing the introduction of general price controls on 22nd December 1971, the press release of the Minister of Finance and Planning included the following statement by way of justifying the legislation:

---

14. Mukui J. T.: Price Controls in Kenya. Unpublished M. A. thesis University of Nairobi, June 1978, p.43

> ....The recently announced measures to control foreign allocations for imports (i.e the bans and quantitative restrictions on imports) and the already existing tariffs and other protective measures will mean that the protection enjoyed by local producers, especially of manufacturing goods, has been increased ....[15]

The legislation prohibited any increase in wholesale or retail prices above those "ordinarily charged" at that date for a wide range of goods and services. To police the legislations meant more manpower to review applications for price increases and a Price Advisory Committee representing a number of different interest groups in society was established. This of course meant a drain on the country's resources and an increase in public expenditure.

The specific objectives of the liberalization plan as contained in the Development Plan of 1979 - 1983 are the following:

(i) to introduce a degree of automaticity in import licensing by placing essential raw materials in the open general licence;

(ii) to ensure that import policy is consistent with the development of local industries which must be competitive in the domestic as well as international markets; and

(iii) to discontinue the use of quantitive restrictions of imports as an instrument for industrial protection.

The plan also discussed the discontinuation of the "No Objection Certificate". Previously some importers were required to obtain a "No Objection Certificate" from local manufacturers before securing an import licence for competing goods . This practice led to a number of anomalies when firms

---

15. Quoted in Mukui, ibid, P.43

competing among themselves were required to obtain a "No Objection Certificate" for the import of raw materials and intermediate inputs from competitors.

In the Sessional Paper No.4 of 1980 on Economic Prospects and Policies, the government announced the change in the industrial policy. This emanated from the adverse effects of the quantitative restrictions on the economy. In this Sessional Paper the government said:

> ...... Our industrial promotion techniques will need to be changed inorder to encourage industrial exports. Import substitution industrial development has relied on high tariffs and quantitative restrictions on imports inorder to protect local manufacturers from foreign competition. The higher prices paid by Kenyans for domestic manufactured goods represent a sacrifice that has been made to develop local industries, create employment and train local technicians. However, the high protection afforded against competing imports has encouraged slack management and high costs which make many industries uncompetitive in foreign markets. In order to improve our competitiveness, policy changes are required in the method and level of protection for domestic industry, in export incentives, and in administrative measures of industrial promotion.
>
> It has been decided that all existing quantitative restrictions and restrictive import licencing will be replaced with tariffs as soon as practicable. The substitution of tariffs for quantitive restrictions will be done systematically with emphasis initially on imported consumer items ....[16]

The paper also stated that after the removal of the quantitative restrictions the next stage was to standardize and reduce the levels of protection. The goal would be to reduce the wide

---

16. Sessional Paper No.4 of 1980 on Economic Prospects and Policies, Republic of Kenya, p.21.

variation in protection given to different industries, and to eliminate the bias that exists in favour of import substitution against exports. This would ensure that industrialization is neither too import-intensive nor hampered by high-cost domestic input industries.

In its Sessional Paper No.1 of 1986 on Economic Management for Renewed Growth, the government reiterated its policy on export-led industrialization. In this paper the governement stated that:

> ...... Kenya's industry must be restructured to become much more efficient, capable of competing against imported goods in Kenya with moderate protection and exporting profitably within the Preferential Trade Area and further abroad ....[17]

As indicated in the above discussions,the quantitative restriction on imports does not necessarily achieve the objective for which the system was instituted; that is protection of domestic industries and conservation of foreign exchange. The costs may be higher than the benefits in the long run. "Efficient" protection and export-oriente industrialization encouraged by market-based incentives may be better means of managing foreign exchange reserves especially for a developing country like Kenya. To achieve the objectives of the industrial policy, the government has laid down market-based incentive structure and features which include the following:-

---

17. Sessional paper No.1 of 1986 on Economic Management for Renewed growth of the Republic of Kenya, p.3.

(i) More uniform import duties and more liberal import licencing will together make industrial inputs readily available at lower cost while inducing manufacturers to produce for export markets and to provide import substitutes at prices much closer to world standards thus benefiting consumers.

(ii) Special export incentives such as export compensation, manufacturing in bond, and the green channel, will help exporters to overcome the particular problems and costs of breaking into foreign markets. The green channel is a means of simplifying and speeding up the procedure required for an exporter to receive the necessary administrative approvals. Qualifying exporters should be given documents with green borders that require priority action by those responsible for import licensing, foreign exchange allocations, and export approvals.

2.4 Implementation of Import Liberalization Policy

In his Budget Speech of June 1980, the Finance Minister announced a new policy of import liberalization as part of broader program of structural adjustment. As indicated earlier, the goal of this program was to shift from heavy reliance on ad hoc direct controls (including bans on some imports), to greater emphasis on indirect control over imports through an appropriate exchange rate combined with a rationalised tariff and sales tax structure.[18]

The process of import liberalization involves five overlapping policies. First, tariff (and to a lesser extent sales taxes) are raised in order to restrain import demand for balance of payments purposes and to provide adequate protection to domestic producers. Second, quantitative restrictions over imports (such as import licensing) have been streamlined in the short run and gradually reduced in the long run. Third, the tariff and sales tax structures are rationalised, by moving toward a more uniform tax rate. Fourth, excessive protection to domestic producers is gradually reduced by a judicious combination of lowering tariff rates and adjusting sales tax rates to encourage more competition, greater efficiency and higher quality goods in domestic production. Fifth, and finally, the external value of the domestic currency is monitored in order for it to maintain an appropriate relationship with the country's major trading partners' rate of inflation and exchange rate. This is further explained by Table 2 below for Kenya:

---

18. Budget Speech for fiscal year 1980/81, Kenya, P.4

Table 2 Currency Equivalents
Annual averages

1980	US$ 1.00	= KSh. 7.45
1981	US$ 1.00	= KSh. 9.05
1982	US$ 1.00	= KSh.10.92
1983	US$ 1.00	= KSh.13.31
1984	US$ 1.00	= KSh.14.41
1985	US$ 1.00	= KSh.16.43

SOURCE: World Bank Report

Table 2 above indicates the extent to which the external value of the Kenya shilling has changed over a period of five years, since the liberalization policy was announced. Although the purpose of this study is to focus on the success of the quantitative restriction on imports, this should be viewed and understood against the broader background of all aspects of import liberalization.

2.5 Administration of Import liberalization and Import Licensing

There are four phases of import administration::

(i) Licence approval by the Import Management Committee (formerly known as Import Quota Allocations Committee) and its secretariat. This is the initial stage of the import licensing in the Ministry of Commerce and Industry.

(ii) The second phase is the ministerial approval especially on import schedule IIA. This is a supreme committee which consists of the Minister for Finance (Chairman), Secretary to cabinet affairs, the Minister of Commerce and Industry and governor of Central Bank. This committee reviews the applications discussed and approved/ disapproved by the Import Management Committee.

(iii) The third phase is the foreign exchange release by the Central Bank of Kenya.

(iv) The last stage is the clearance and handling procedures at the port by customs and by the port authorities.

The first major step taken in the implementation of the import liberalization process was the elimination of import bans and "no-objection certificates" announced in the Budget Speech in June 1980. Then in November 1981, the Red-book of import licencing schedules(reviewed every year) was published which assigned every item which could possibly be imported to one of four schedules, each with a different underlying principle of control. The publication of the Red-book of Import licencing schedules was a great-improvement in the import licencing system because it made things "transparent" to the importers.

The list of imported items is presently divided into four scheduled [19].

---

19. Development plan 1984 - 1988, p.64 also refers to the Import licencing schedules.

Schedule 1A

Contains items that can be imported freely, with licences issued and foreign exchange released virtually automatically subject to monitoring for excessive stocking. This schedule consists of essential priority imports such as raw materials, capital goods, spare parts and medicines. The combination of tariffs and sales taxes on these items should be appropriately high to restrain demand for both balance of payments and protection purposes. Initially, this schedule was limited to high priority items not produced locally. However, as import liberalization proceeds and as tariff and sales taxes are adjusted, more items continue to be added to 1A, including items of lower priority and those produced in Kenya (although both of these categories would, of course, attract higher tariff duties).

Schedule 1B

Contains items of slightly lower priority than those in 1A, whose importation is intended to be subject to an annual allocation of foreign exchange to importers, the amount depending on the overall balance of payments situation. Within this global amount, each importer is to be granted an annual shilling allotment, within which he can import any item on 1B at any time during the year. The system has not been implemented to-date.

Schedule 11 A

While most high priority items were placed on 1A, to be freely licenced, there are some sensitive items which are under the jurisdiction of specific ministries. These items are under this schedule and include imports of oil which are regulated by the Ministry of Energy and Natural Resources, and imports of food grains and fertilizer which are controlled by the Ministry of Agriculture and Livestock Development. Prior to applying for an import licence, an importer must get approval from the relevant Ministry. Once this approval is forth coming, however, the licence approval by Import Management Committee and the foreign exchange release by the Central Bank of Kenya are to be granted expeditiously.

Schedule 11 B

This is the most restrictive schedule. This schedule includes those items whose importation is discouraged because:

(a) they can be produced locally and require protection greater than that provided by the current level of tariffs;

(b) they are luxury goods; or

(c) they are goods regulated on grounds of public health, safety, morality, or national defense. For each of these items, an importer is to be granted an annual shilling quota, within which he can schedule his imports according to that timing which is most economical and best fits his inventory and production schedule. Similar to schedule 1B, annual quotas, by item, have never been determined, so this system has not been implemented. Foreign exchange applied for is approved specifically by item.

As noted in the above discussion, the implementation of the system is more theoretical than practical. The developments in practice are analysed in chapter 4. It suffices at this stage to say that, in theory, liberalization of import administration is based on the above discussed four schedules, with gradual movement of items from schedule 11B to 1A (as tariff duties and sales taxes are appropriately adjusted). The degree of control by the government over the foreign exchange release by the Central Bank of Kenya is also analysed in chapter 4.

CHAPTER 3

RESEARCH METHODOLOGY

Population of the study

The population in this study consists all the approved applications for the allocation of foreign exchange for the period 1982 to 1986. This means the sample is the same as the population.

The liberalization of quantitative restrictions was announced in the Budget speech of June 1980, and the effective implementation of the new policy started in 1980/81. At this stage there was a lot of paper work which was intended to document the new system. The system was finally documented and computerised during 1981. This made the sytem simple in terms of availability of data. For instance, the first Import schedule was published in 1981, which was an attempt to make the system transparent. It is for this reason that the researcher was only able to collect data starting from 1982.

Data collection method

The collection of data was personally done by the researcher. The data collected in this study include licence approvals by the Import Management Committee; Central Bank of Kenya foreign exchange releases; Classification of import items by schedules; global allocations of foreign exchange by schedules and the value of actual imports as provided by Customs Office. The data was in the form of computer print-outs. It was on weekly, monthly and annual basis.

Most of the data collected was provided by the Ministry of Economic Planning and National Development which has very reliable computerised data on the import licensing system. This Ministry receives its input data from the Ministry of Commerce and Industry and the Central Bank of Kenya.

Data Analysis Method

Data is analysed and summarized by using tables, percentages, ratios and a graph. Comparisons of the results is made. The objectives of the data analysis include the following:-

(a) To compare the Ministry of Commerce approvals with the Central Bank foreign exchange releases.

(b) To analye the trend in the authorisation of foreign exchange over the period under study.

(c) To compare the global allocations of foreign exchange with the Ministry of Commerce approvals and the Central Bank foreign exchange releases to see whether import licences are granted within global limits.

(d) To compare actual imports by schedules to see which import items absorb a bigger share of foreign exchange. This will indicate the weight and the significance of such items in the balance of payments.

(e) To compare import items by schedules. This should indicate the degree and rate of liberalizing the quantitative restriction system over the period in question.

CHAPTER 4

THE LIBERALIZATION PROCESS AND FOREIGN EXCHANGE ALLOCATIONS

4.1 The liberalization Progress

Substantial progress has been made in the liberalization of imports since 1980. However, implementation of the government reform program has lagged behind the schedule originally envisaged.

Due to a severe foreign exchange shortage in 1982, the governement responded by re-restricting some of the import items which had been liberalized.[1] However, progress on reforming the quantitative restrictions on imports has resumed as indicated in Table 3 below.

Number of Imported Items By Import Schedule (and in Fiscal Years[2])

TABLE 3

Import schedule	1982/83		1983/84		1984/85	
	No.of items	% of total	No.of items	% of total	No.of items	% of total
1A	780	28.68	803	29.52	1119	40.88
1B	671	24.67	961	35.33	661	24.15
Sub-total	1451	53.35	1764	64.85	1780	65.03
IIO	315	11.58	-	-	-	-
IIAS	90	3.31	92	3.39	97	3.54
IIB	864	31.76	864	31.76	860	31.43
TOTAL	2720	100	2720	100	2737	100

SOURCE: Ministry of Planning and National Development.

1. World Bank Report, 1986, p.37

2. Fiscal year in Kenya runs from 1st June to 31st July.

Table 3 shows that in 1982/83, there were 780 items on schedule 1A, compared to 1119 items in 1984/85; a 12% increase during that period. Items in schedule 1B decreased from 671 in 1982/83 to 661 in 1984/85; a 1% decrease in the period. This means that there was a relative shift to schedule 1A (the most priority schedule). Schedule 2A had 405 items in 1982/83 as compared to 97 in 1984/85; an 11% decrease, indicating a shift from 2A to the most priority schedule. There has been little relative shifting of items from schedule 2B (the least priority schedule) to the most priority schedule. Out of 864 items in 1982/83, there has been a total shift of 1% by the end of 1984/85, resulting in 860 items in this schedule. It will be seen from the Table that schedules 1A and 1B (the priority schedules) account for more than 65% of the import items as compared to 53% in 1982/83.[3]

4.2 Import liberalization developments by import schedules

(i) Schedule 1A

Licences under 1A are individually vetted by the Import Management Committee which meets once a week. Some of the import licence applications are rejected. The reasons for rejection vary from case to case. These include the reasons that the Import Management Committee believes that: (a) there is over-stocking, (b) the item in question should be purchased locally, and (c) the firm is not an established or legitimate importer.

---

3. In his Budget Speech for 1985/86, the Minister for Finance also announced that the import licencing system has been liberalized and greatly improved the efficiency of its administration. The Minister further stated that through the progressive shifting of import items from more restrictive schedules (2A and 2B) governement has reached the point where 65% of all items are now on the less restrictive schedules (1A and 1B).

In the case of "overstocking", it is not clear what is meant by this term. The researcher was unable to obtain information on the criteria used to measure overstocking. Neverthless, the best way to minimise the problem of "overstocking" is to have a consistent and reliable import policy, based on clear and reliable principles to minimise the chances of bribery and corruption.

Rejecting schedule 1A import licences on the ground that the item should be purchased locally runs counter to the fundamental concept of import liberalization. That is, items are moved to schedule 1A when the combination of tariff duty and sales tax is considered adequate to restrain import demand for proper balance of payments management and for adequate protection to domestic producers. If the tariff and sales tax rates are inadequate or inappropriate to restrain the import demand of such items, then they should be shifted from schedule 1A, or their tariff and sales tax rates be adjusted accordingly.

In the cases of import schedules 1B, 2A and 2B, it might be desirable to ensure that only legitimate or established importers are granted licences. However, for schedule 1A, licences should be freely approved for newcomers as well as older importers, as a way for newcomers to enter the trade so that they can eventually become "legitimate" importers.

The import administration of schedule 1A can be improved by avoiding the rejection of import licence applications on any grounds, thus moving closer to automatic licencing.

The other factor which the government considers when processing the import licence applications is the availability of foreign exchange reserves. The actual value and the approved value of applications in the last six months of 1986 are shown in Table 4. The table indicates that about 50% or more of the value of import applications (in every schedule are rejected). The researcher was unable to get data on actual value of applications received prior to the last six months of 1986.

TABLE 4

ACTUAL VALUE OF APPLICATIONS RECEIVED AND COMMERCE APPROVALS

JULY - DECEMBER 1986

(KSHS MILLIONS)

Month	Schedule 1A		Schedule 1B		Schedule 2A		Schedule 2B	
	actual application	approved	actual application	approved	actual application	approved	actual application	approved
July	2236.76	1276.11	725.92	292.42	1567.82	783.72	227.38	113.17
August	1504.14	910.46	1029.07	233.18	836.17	237.56	214.66	39.86
September	1483.88	948.34	748.03	258.36	1573.18	623.55	194.22	40.74
October	1724.26	1103.74	933.64	259.94	848.12	446.56	394.45	55.86
November	1684.78	885.88	871.47	225.60	1008.12	365.11	422.47	40.64
December	1348.77	637.20	698.14	145.23	927.60	347.07	592.81	32.96
TOTAL	9982.59	5761.73	5006.27	1414.73	6761.01	2803.57	2045.99	303.23
Approved as % of Demand	100	57.71	100	28.24	100	41.46	100	14.82
Rejections as % of Demand	100	42.29	100	71.76	100	58.54	100	85.18

SOURCE: Ministry of Economic Planning and National Development

Table 4 above shows that 58% of the actual applied import licence value in schedule 1A was approved; 28% of the values in schedule 1B were approved; 41% in schedule 2A; and only 15% in schedule 2B. This indicates that, to a certain extent the government frustrates the revealed demand of foreign exchange by importers through the quantitative restriction system. However, such a statement requires qualification. Knowing that foreign exchange is "rationed", importers may decide to overstate their needs. Importers may also find it difficult to predict future availability of goods so that they may want to have plenty on hand at any give time (in case of a shut-down, or slowdown of licencing in the future). For these reasons the actual amount of foreign exchange applied for is not necessarily a reliable indicator of import demand but it does show the degree of control the government exercises over foreign exchange reserves, given its priorities.

(ii) <u>Schedule 1B</u>

Theoretically, schedule 1B is assigned an annual global allocation of foreign exchange, the amount depending on the overall balance of payments situation. Within this global amount, each importer is to be granted an annual shilling allotment, within which he can import any item on schedule 1B, anytime during the year. However the allotment system has not been implemented to-date.

The schedule 1B allotment system would have the following advantages.[4]

---

4. Extensive discussions were held with officials in both the Ministry of Economic Planning and National Development and Ministry of Commerce and Industry. The discussions were mainly on the operation of the import licencing system. The import schedules were also discussed extensively.

(a) The balance of payments is protected by the overall global allocation and by the individual firm's allotment.

If foreign exchange reserves are low, this allocation can be curtailed (and vice-versa).

(b) Once the allotments are established, it would no longer be necessary for the Import Management Committee to spend time reviewing each licence.

(c) Firms would have a longer time-horizon for planning and implementing a more cost-effective inventory policy.

The annual allotment system has not been implemented for reasons that includethe following:

(a) There was no systematic way for the Import Management Committee to determine each importer's allotment. This deficiency is gradually being overcome, as importers have provided information about past imports records to the Import/ Exports Office.

(b) More importantly, there are fears that if a firm is granted an annual allotment, this will become an entitlement or "right" for that particular firm, and any attempt in the future to reduce or eliminate the allotment will be strongly resisted. If such an entitlement were created a firm could sell its "right" to import under schedule 1B to another firm which lacked any allotment or which wanted to import more than its own allotment. Even if this type of sale were made illegal, it would be difficult for government to prevent a "black market" from developing in such rights.

(ii) <u>Schedule IIA</u>

It should be remembered that schedule IIA consists of "sensitive" items which are under the control of specific ministries. These items include petroleum, fertilizer and food grains. The main criticism of this schedule is that there are no "transparent" criteria or guidelines for ministerial approval (which is required for these items before an import licence application can be submitted to the Import/Export Office). For example, it is not clear why a high priority item like fertilizer should be subject to approval by the Ministry of Agriculture and Livestock Development. What is the criteria in determining the success of an application? Is it not better to shift fertilizer to schedule 1A, with licences freely granted?

(iii) <u>Schedule IIB</u>

An analysis of IIB faces a problem similar to that discussed above in connection with Schedule 1B. Annual <u>quotas</u>, by <u>item</u> for <u>each firm</u>, have never been determined. This system has not yet been implemented. However the government plans to implement it in the near future. Once again, the disadvantage of "rights" possibly being created must be weighed against the advantages of the more orderly arrangement of quotas, which would facilitate annual foreign exchange planning.

4.3 The Foreign Exchange Allocations for Import Licences

Decisions on import licence applications are made at the weekly meeting of the Import Management Committee, an inter-ministerial committee chaired by the Ministry of Commerce and Industry. There is also a Foreign Exchange Allocation Committee (FEAC) which is senior to the Import Management Committee. It consists of the Minister of Finance, Secretary to Cabinet Affairs, the Minister of Commerce and Governor of the Central Bank. The main function of this committee is to review the decisions of the Import Management Committee.

The decisions of the Import Management Committee in approving the import licence applications are guided by the pre-planned global allocations of foreign exchange. In deciding the global allocations the Central Bank of Kenya ,the Ministry of Finance,and the Ministry of Economic Planning are the major participants. The global allocations are in turn influenced by the projected availability of foreign exchange reserves.

After approving the import licence applications, the next phase is the release of the foreign exchange by the Central Bank.

(i) Ministry of Commerce Approvals and Central Bank of Kenya Foreign Exchange Releases

If the Ministry of Commerce approvals are compared with the Central Bank foreign exchange releases, one will find that the two amounts are not the same (refer to Tables 5 to 9).

TABLE 5

MINISTRY OF COMMERCE APPROVALS AND THE CENTRAL BANK OF KENYA FOREIGN EXCHANGE RELEASES FOR 1982

(KShs Millions)

	Import Schedules	Commerce approvals	% of Total	Central Bank Releases	% of Total
	(1)	(2)	(3)	(4)	(5)
a)	1A	-	-	-	-
b)	1B	-	-	-	-
c)	I	5971.91	51.57	5655.45	44.74
d)	IIA	5369.17	46.36	6871.55	54.36
e)	IIB	239.25	2.07	113.99	o.90
	Total	11580.33	100	12640.99	100

Source: Ministry of Economic Planning and National Development.

TABLE 6

MINISTRY OF COMMERCE APPROVALS AND THE CENTRAL BANK OF KENYA FOREIGN EXCHANGE RELEASES FOR 1983

(KShs Millions)

	Import Schedules	Commerce approvals	% of Total	Central bank Releases	% of Total
	(1)	(2)	(3)	(4)	(5)
a)	1A	3572.89*	N/A	3573.13**	N/A
b)	1B	1885.30*	N/A	1559.85**	N/A
c)	I	11744.36*	74.93	9243.86**	46.62
d)	IIA	3566.0	22.75	9035.08	48.50
e)	IIB	362.87	2.32	351.95	1.88
	Total	15673.24	100	18630.89	100

Source: Ministry of Economic Planning and National Development
The import schedules were revised with effect from 1st July, 1983 and introduced IA and IB. The approval amounts indicated in I and IB* only include amounts for the period 1st January to 30th June, 1983 while KShs.6,286.17 (1* + 1B*) is for the period 1st July, 1983 to 31st December 1983. ** The approval amounts indicated in 1A** and 1B** only includes amounts for the period 1st January to 30th June, 1983; while KShs.4110.88 (1** - (1A** + 1B**)) is for the period 1st July to 31st December, 1983.

TABLE 7

GLOBAL ALLOCATIONS, MINISTRY OF COMMERCE APPROVALS, CENTRAL BANK OF KENYA FOREIGN EXCHANGE RELEASES AND ACTUAL IMPORTS IN 1984

(KShs Millions)

	Import Schedule	Global allocations	Commerce approvals	% of total	% of Global allocations	Central Bank Releases	% of total	% of Global allocations	Actual Imports	% of Total
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
(a)	1A	6588.48	6637.71	48.34	100.75	7475.17	33.06	113.46	8968.09	40.53
(b)	1B	3755.85	4057.38	29.55	108.03	4901.59	21.68	130.51	2114.03	9.56
(c)	IIA	10787.31	2259.88	16.46	20.95	9115.76	40.31	84.50	9719.62	43.9
(d)	IIB	869.82	777.11	5.65	89.34	1119.38	4.95	128.69	1330.16	6.01
(e)	Total	22001.46	13732.08	100	62.41	22611.88	100	102.77	22131.90	100

Source: Ministry of Economic Planning and National Development.

TABLE 8

GLOBAL ALLOCATIONS, MINISTRY OF COMMERCE APPROVALS, CENTRAL BANK OF KENYA FOREIGN EXCHANGE RELEASES AND ACTUAL IMPORTS IN 1985

(KShs Millions)

	Import Schedules	Global allocations	Commerce approvals	% of Total	% of Global allocations	Central Bank Releases	% of Total	% of Global allocations	Actual Imports	% of Total
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
(a)	1A	9070.12	9534.42	52.69	105.12	8696.59	38.31	95.88	9713.38	49.64
(b)	1B	2922.69	3275.00	18.09	112.05	4012.13	17.68	137.28	2389.79	12.22
(c)	IIA	11704.57	4605.55	25.46	39.35	9391.70	41.38	80.24	6076.07	31.05
(d)	IIB	834.56	680.64	3.76	81.56	597.27	2.63	71.57	1387.95	7.09
(e)	Total	24531.94	18095.61	100	73.76	22697.69	100	92.52	19567.19	100

Source: Ministry of Economic Planning and National Development.

TABLE 9

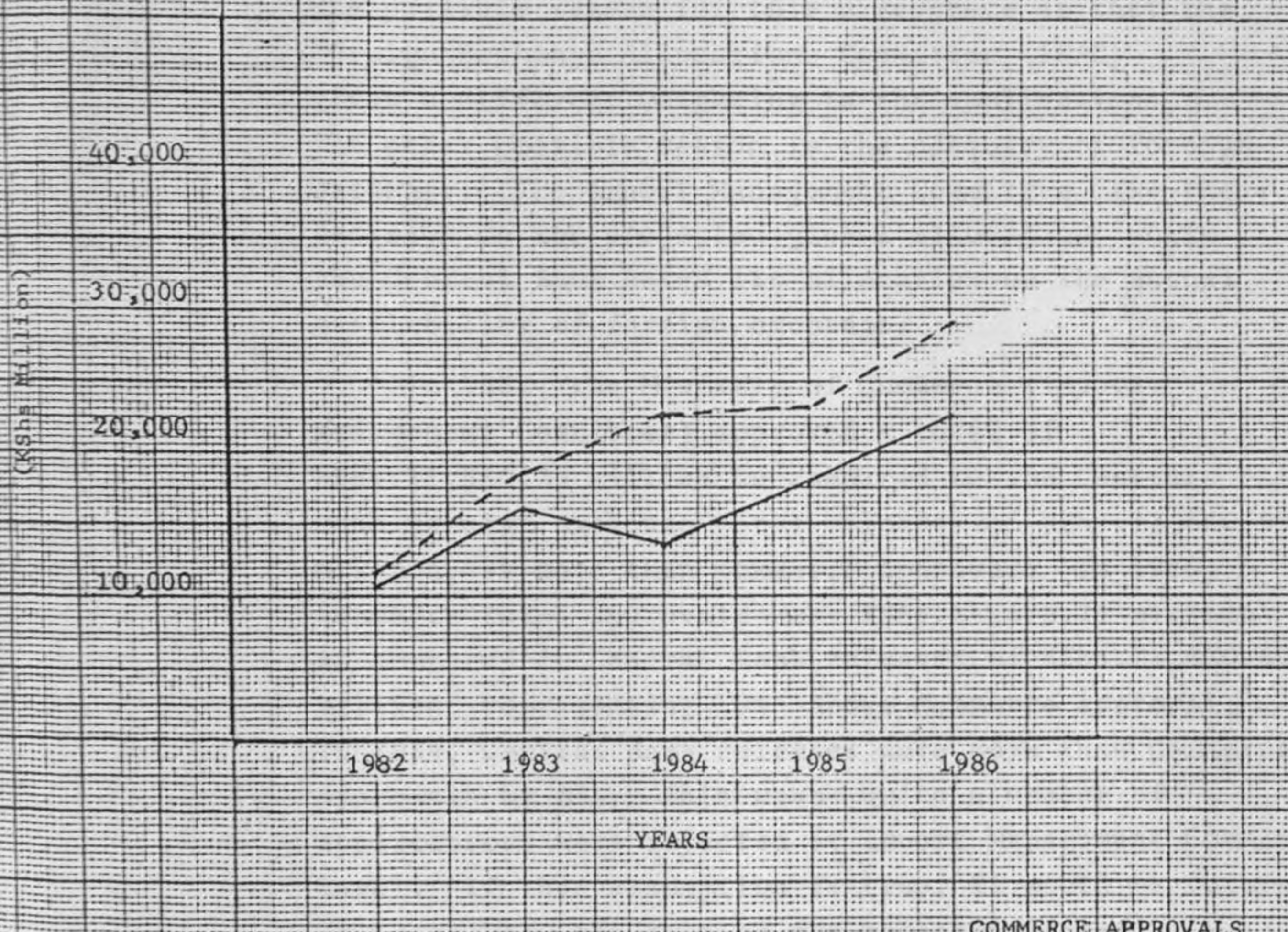
GLOBAL ALLOCATIONS,MINISTRY OF COMMERCE APPROVALS,CENTRAL BANK OF KENYA FOREIGN EXCHANGE RELEASES AND ACTUAL IMPORTS IN 1986

(KShs Millions)

	Import Schedule	Global allocations	Commerce Approvals	% of Total	% of Global allocation	Central Bank Releases	% of Total	%of Global allocation	Actual Imports	% of Total
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
(a)	1A	10910.90	12274.78	55.79	112.50	12783.74	53.14	117.17	14729.36	54.21
(b)	1B	2544.66	2682.56	12.19	105.42	2665.03	11.08	104.73	2734.57	10.07
(c)	IIA	8909.98	6002.06	27.28	67.36	7780.93	32.35	87.33	7970.55	29.34
(d)	IIB	865.50	1043.63	4.74	120.58	825.04	3.43	79.05	1734.41	6.38
(e)	Total	23231.04	22003.03	100	94.71	24054.98	100	103.55	27168.89	100

Source: Ministry of Economics Planning and National Development.

FIGURE 3



Graph showing Import licence approvals by Ministry of Commerce and authorization of Foreign Exchange by Central Bank

As can be seen from the tables, the Commerce approval amount, by import schedules, is greater or less than the Central Bank foreign exchange released amount. However, the overall amount released by the Central Bank is greater than the overall amount approved by the Ministry of Commerce. One possible reason for this divergence is that the Foreign Exchange Allocations Committee (FEAC) gives a different weighting to the applications. The other possible reason is the adequacy of foreign exchange. The Import Management Committee base their decision on the projected global allocation; while the Central Bank bases its allocation on the actual availability of foreign exchange.

In 1982, the Ministry of Commerce (Import Management Committee) approved a total of KShs.11,580.33 million as compared to the Central Bank foreign exchange total releases of KShs.12,640.99 million, 9% more than commerce approval. In 1983, Commerce total approvals were KShs.15,673.24 million as compared to Central Bank releases of KShs.18,630.89 million, representing 19% above Commerce approval. In 1984, Central Bank releases were more than Commerce approvals by 65%. This means quite a number of applications were rejected at Import Management Committe level. If this assumption is true, it would be interesting to know the reasons for rejecting these applications because the total global allocations is KShs.22,001.46 million within which applications can be considered. The Commerce approval represented 62% of the foreign exchange global allocation.

In 1985, Commerce approvals amounted to KShs. 18,095.61 million or 74% of global allocations as compared with Central Bank foreign exchange releases of KShs.22,697.69 million or 92% of the global allocation. In 1986, Commerce approvals amounted to KShs.22,003.03 million or 95% of the global allocation while the Central Bank releases amounted to KShs.24,054.98 million or 104% of the projected global allocation. The analysis of these tables indicates inadequate co-ordination between the institutions responsible for processing and approving import licence applications. Such lack of co-ordination may easily lead to dissatisfaction about the system among importers and bribery and corruption. Therefore the institutions involved in the import licensing system should be properly synchronized. Guidelines should be made very clear and transparent to all people concerned, particularly the import administration.

Tables 7 and 9 also show the value of actual imports of the items by schedules. It will be noted from these tables that schedules IA and IIA are the most significant in the balance of payments. In 1984, the total value of actual imports in schedule IA was KShs.8,968.09 million or about 41% of the total imports in schedule IB, KShs.2,114.03 million or about 10% of total value; schedule IIA, KShs.9,719.62 million or about 6% of total value. In 1986, the total value of actual imports in schedule IA was KShs.14,729.36 million or about 54% of the total value; schedule IB, KShs.2,734.54 million or about 10% of the total value, schedule IIA KShs.7,970.55 million or about 6% of the total value, and schedule IIB, KShs.1,734.41 million or about 6% of the total value. Although schedule IIA contains about 4% of the total imported items, it consists of about a third of the total value of imports. This means prices and/or quantities of these items are relatively high. It could be for this reason that these items were placed under the jurisdiction of specific ministries instead of placing them in schedule IA to help conserve foreign exchange.

The analysis of the Tables further reveal that there has been an increase in the authorization of foreign exchange in the period 1982 to 1986. In 1982, Commerce approvals amounted to KShs.11,580.33 million as compared to KShs.22,003.03 million in 1986, an increase of 90%. In the same period the Central Bank releases increased from KShs.12,640.99 million to KShs.24,054.98 million, a 90% increase. This is further portrayed in the graph of figure 3 above. The graph shows that licence approvals by Commerce Ministry and authorisation of foreign exchange by Central Bank are increasing. It should also be noted that authorization of foreign exchange by Central Bank also exceeds Commerce approvals. As mentioned earlier, this is a reflection of inadequate co-ordination of the import licensing system.

The increase in the import licence approvals and authorization of foreign exchange may be attributed to several reasons. The main reason is the liberalization of the quantitative restriction system and increased availability of resources. As indicated in Table 3 above, more than 65% of the imported items have been liberalized.

CHAPTER 5

SUMMARY AND CONCLUSIONS

5.1 Summary

This paper has attempted to critically examine the management of foreign exchange preserves through quantitative controls and the liberalization process in Kenya. It also discusses the problems which the government recognized in the use of quantitative control.[1] Recognising these problems, the government decided to liberalize the system. The imports were to be restrained through the market mechanism by the use of tariff duties and the sales tax. The main criticism of the quantitative control system was that it encouraged slack management and inefficiency which reduced the ability of local firms to export. This made the country's exports less competitive in world markets both because of high prices (as a result of high production costs) and poor quality. The paper has also attempted to show that the costs of quantitative controls can turn out to be more than the benefits to the economy and society. In short a quantitative control system may not be successful in managing foreign exchange reserves in the current world markets due to its negative effects.

The government has adopted the use of tariff and sale tax rates to restrain imports. It is too early to fully assess the performance of the new system. It must be pointed out that a major objection to the use of tariffs is the danger of dumping. Therefore, in implementing the liberalization policy, the government must take adequate precautions against dumping which might materially retard the progress and the establishment of an industry in Kenya.

1. Sessional Paper No.4 of 1980 on Economic Prospects and policies, Republic of Kenya, p.21

5.2 Conclusion and Recommendations

In conclusion, there is no doubt that the government has made substantial progress towards the liberalization of Import administration. More than 65% of the imported items are now in Schedule I in general and in 1A in particular. The shifting of items to the "free" list has led to the substantial increase in the authorization of foreign exchange allocation. However, there is still room for improvement along the following lines:-

(a) The system ought to be made as transparent as possible to reduce opportunities for bribery and corruption. The criteria used by Ministries for their approvals especially of Schedule IIA items ought to be established and made clear. The government should consider shifting some of the priority items such as fertilizer from Schedule IIA to Schedule IA. Shifting fertilizer to Schedule IA, licences will be freely granted, so that as much fertilizer is imported as farmers demand at world market prices.

(b) The government should reduce, and ultimately eliminate, the vetting of Schedule IA items, and the rejection of Schedule IA applications. Rejecting Schedule IA import licences on the ground that the item should be purchased locally runs counter to the fundamental concent of import liberalization. If the tariff and rates tax rates are inappropriate or inadequate to restrain the import demand of such items, then they should be shifted from Schedule IA, or their tariff and sales tax rates be adjusted accordingly.

(c) The government should attempt to implement the Schedule 1B allotments and the Schedule IIB quotas. Once the allotments and quotas are established, it would not be necessary for the Import Management Committee to spend time reviewing every licence; considering that there are at least 2,000 applications per week. This would also give adequate time to importers in planning and implementing a more cost-effective inventory system. However, the allotment and quota system should be made clear to importers that it is not a "right" and the government reserves the right of altering or withdrawing it should circumstances deem so. Precautions should be made however to avoid misuse of the system, for example, an importer selling his "entitlement" to another.

(d) There should be adequate co-ordination between the institutions involved in the processing of import licences. The institutions involved are the Import Management Committee, the foreign exchange allocation committee and the Central Bank. Co-ordination of these institutions may reduce any potential discrepancies which may easily lead to a shortage of foreign exchange.

Synchronization of the system may not be achieved without clear guidelines so that divergent decisions are minimized. Importers should have confidence in the system.

5.3 Limitations of the study

(i) This study does not analyse the aggregate demand for foreign exchange. An analysis of the foreign exchange aggregate demand would assist in assessing the adequacy or appropriateness of the current tariff and sales tax rates especially for Schedule IA. In this context demand refers to the value of applications for import licences to the Ministry of Commerce and Industry. Such data, if collected for over a number of years, would have been compared to rejections. The higher the proportion of rejections, the more is the indication that the tariff and sales tax rates are inadequate to restrain demand for imports. However, such a conclusion is subject to the following observations:

(a) Knowing that foreign exchange is rationed importers may overstate their demand so that even if the government decides to "slash" the amount, it comes to near the "real" amount in terms of needs.

(b) Importers may also apply for high foreign exchange to import more items than needed at the time because it is difficult to predict future availability of those goods. In short, importers may wish to overstock goods for their future use.

(ii) The time period available to the author to assess the current system was relatively short.

(iii) A comparison of the former system before 1980 and the current one would have given a good basis for assessing the present system.

5.4 Recommendations for further Research

Liberalization is one of the strategies which has been adopted by the government for export-oriented industrialization. The objective is to manage the balance of payments through the market mechanism with a minimum of government intervention. Therefore, there should be further research to assess the performance of the strategy along the following lines:

(a) To what level are tariff and sales tax rates adequate to restrain imports?

(b) To what extent do local producers respond to the market-based incentives which the government has provided as a policy towards an export-oriented industrialization? These are detailed in sessional paper

No.1 of 1986 and the Development Plan for 1984 - 1988. Such research would provide the government with feedback on the implementation of both the industrial strategy and the liberalization system.

SELECTED BIBILIOGRAPHY

Balassa, Bela, Changing Patterns in Foreign Trade and Payments. W.W. Norton & Co., London. 1978 (3rd Edition).

Beenstock, Micheal, The Foreign Exchange Theory, Modelling and Policy. Macmillan, London, 1978.

Bhagwati, J. M., and Srinivassan, T. N., Foreign Trade Policy Regimes and Economic Development in India. National Bureau of Economic Research, New York, 1975.

Blackman, C., Managing Foreign Exchange Reserves in Small Developing Countries. Group of Thirty, New York, 1982.

Central Bank of Kenya, Its Evolution, Responsibilities and Organisation. September 1986.

Cordon, W. M., The Theory of Protection. Oxford University Press, London, 1979.

Crocket, Andrew, Money: Theory, Policy and Institutions. Thomas Nelson and Sons Ltd., Melbourne, 1979 (3rd Edition).

________________ Control over International Reserves. IMF Staff Papers, Vol 25, 1978, P. 1-24.

________________ Stablization Policies in Developing Countries: Some Policy considerations. IMF Staff Papers Vol 28, No.1, March 1981, P. 54-79.

Eiteman, D. K., and Stonehill, A.T., Multinational Business Finance. Addison - Wesley Publishing Co., Manila, 1979 (2nd Edition).

Evitt, H.t and Pither R.F., A Manual of Foreign Exchange. Sir Isaac Pitman & Sons Ltd, London, 1971 (7th Edition).

Fenwick, A.C. and Lesiit, M.L., Kenya's Balance of Payments: Performance, Perspectives and Policies. Central Bank of Kenya Staff Papers, Vol. 2, September 1986.

Flemming, J.M., Floating Exchange Rates, Asymmetric Intervention and the Management of International Liquidity IMF Staff Papers, Vol 22, 1975, P. 263 - 283.

George A.M., Foreign Exchange Management and the Multinational Corporation: a Manager's guide. Praeger Publishers London, 1978.

Graham, Bird, The IMF and the Developing Countries: Evolution Reaction the Debate over Conditionality; Overseas Development Institute, London, ODI Working paper No.2, 1981.

Hirsch, Fed, The Exchange Rate Regime: An analysis and a possible scheme, IMF Staff Papers Vol 19, July 1972, P. 259 - 285.

Holgate, N.C.F., Foreign Exchange: An Introduction. Isaac Pitman, London, 1936.

Hom, George N., A Guide to International Monetary Reforms. Seseington Books, New York, 1975.

International Monetary Fund, Exchange Arrangements and Exchange Restrictions. Annual Reports 1983 - 1985.

Kenen, B and Labutz, International Economies. Prentice - Hall Inc., London, 1971 (3rd Edition).

Kenya Budget Speeches, Various

Kenya, Central Bank Exchange Control Administrative Notices and Instructions, 1972.

Kenya, Central Bank of Kenya Act, 1966, CAP 491, Section 26.

Kenya, Import Licensing Schedules 1981 - 1985.

Kenya, Imports, Exports and Essential Supplies ACT (Revised 1980) CAP. 502.

Kenya, Kenya Export News Vol.37, No. 370, January 1986.

Kenya, Development Plan 1974 - 1978; 1979 - 1983; and 1984 - 1988.

Kenya, Sessional Paper No.4 on Economic Prospects and Policies 1975.

Kenya, Sessional Paper no.4 on Economic Prospects and Policies 1980.

Kenya, Sessional Paper No. 1 on Economic Management for Renewed Growth, 1986.

Kenya, The Exchange Control Act CAP 113.

Khan, Mohsin S. and Knight, Malcolm D., Stabilization Program in Developing Countries. A formal framework. IMF Staff Papers, Vol 30, No. 4, December 1983, P. 819 - 842.

__________ Determinants of current account balances of Non-Oil Developing Countries in the 1970s: An analysis IMF Staff Papers ,Vol. 30, No.4, December 1983, P. 819 - 842.

Killick, Tony, Papers on the Kenyan Economy Performance, Problems, and Policies. Heinmann Educational Books, Nairobi, 1981.

__________ The Quest for Economic Stabilization: the IMF and the Third World. Heinmann Educational Books, Nairobi. 1984.

__________ The Influence of Balance of Payments Management on Employment and Basic Needs in Kenya. Eastern Africa Economic Review. Vol 1, No. 1, December 1985, P. 57 - 70.

Macrae D. S., The Import Licensing System in Kenya. Journal of Modern African Studies, Vol. 17, 1979 P. 29 - 46

__________ Import Licensing in Kenya. Institute for Development Studies, University of Nairobi, Working Paper No.90, March 1973.

Macklup, Fritz, Plans for Reforms of International Monetary System.International Finance Section, Department of Economics, Princeton University, 1964 (2nd Edition).

Mandich, D.R., Foreign Exchange Trading: Techniques and Controls. American Bankers Association, Washington, D. C., 1976.

McKenzie, George, The Monetary Theory of International Trade. Macmillan, London, 1974.

Meir, Gerald M., Problems of Trade Policy. Oxford University Press, London, 1973.

Miller, Elwood L., Accounting Problems of Multinational Enterprises. D.C. Health and Co., Toronto, 1980.

Norman, Crump, The ABC of the Foreign Exchange. Macmillan, London 1963, (13th Edition).

Nowok, Michael, Quantitative Control and Unofficial Markets in Foreign Exchange: A theoretical framework. IMF Staff Papers,Vol 3, No 2, June 1984, P.404-420.

Parker, Anthony,Exchange Control. Jordan, London, 1978 (2nd Edition).

__________ A guide to International Exchange and Trade Regulations. Jordan, Bristol, 1980.

Paul, Einsig, The History of Foreign Exchange. Macmillan, London, 1965 (2nd Edition)

Richard, Lassen, Current Management. Woohead - Faulkner Ltd., London, 1982.

Rita Rodrigue and Heinz Ried, Foreign Exchange Market. MacGraw Hill Book Co., London, 1977.

Smith, J. S., and Bouter, A.C.,The Treatment of Reserves and Reserve Creation in Balance of Payments Account. IMF Staff Papers, Vol. 16, 1969, P. 202 - 219.

Swidrowski, Josef, Exchange and Trade Controls: Principles and Procedures of Economic Transactions and Settlements. Gower, Epping, 1975.

Sodersten, B. O, International Economics. Macmillan, London 1980 (2nd Edition).

Timberlake, Lloyd, Africa in Crisis: The Causes, the Cures of Environmental Bankruptcy. Earthscan, Nottingham, 1985.

Tram, Vinh Quany, Foreign Exchange in Multinational Firms. UMI Research Press, 1980.

Vinnae, Volker, Exchange Control system in less Developed Countries. Institute for Development Studies, University of Nairobi Working Paper No. 49, July, 1972.

______________ Exchange Control: The case of Kenya. Institute for Development Studies,University of Nairobi Working paper No. 50 July, 1972.

______________ The systems of Exchange Contrcl in Kenya. Institute for Development Studies, University of Nairobi Discussion Paper No. 148, September 1972.

______________ Kenya's External Trade 1964-71. Institute for Development Studies,University of Nairobi Discussion Paper No.165, 1972.

Wasserman, M. J., International Money Management. American Management Association, New York, 1972.

Wells, Rosemary, International Trading. Edward Anorld, London, 1971.

Whiting, D. P., Finance of Foreign Trade. MacDonald and Evans Ltd., London, 1977 (4th Edition).

World Bank Reports, 1982 - 1985.

Zuwerkar, Clarance, Economic Development: an Introduction. MacMillan, London, 1976.