Experiences with financial sector reforms and trade liberalization in Kenya

By

Maureen Were
The Kenya Institute of Public Policy Research and Analysis (KIPPRA)
Bishops Garden Towers, Bishops Road
P.O. Box 56445, Nairobi, Kenya
Tel: 254 2 719933/4, Fax 254 2 719951
Email: mwere@kippra.or.ke
Website: http://www.kippra.org

Rose Ngugi
University of Nairobi and KIPPRA
Email: rngugi@kippra.or.ke

Phyllis Makau
Ministry of Finance and Planning
pmakau@hotmail.com

1. Introduction

Although the need to liberalize the Kenyan economy was realized in early 1970s following external shocks that resulted into macroeconomic instability, a comprehensive reform program was only implemented in 1990s. To facilitate in the liberalization process, Kenya received structural adjustment lending from the World Bank and also Enhanced Structural Adjustment Facility (ESAF) loan from the IMF (O'Brien and Ryan, 1999). It was expected that the reforms would restore macroeconomic stability with greater reliance on market forces and enhanced private sector participation in the development process.

The reform programs indicate three phases in the implementation process that are distinguished by the approach used, level of government commitment, donor-government relationship and political reforms. In the first phase, 1980-84, an ambitious broad approach was adopted taking upon trade reforms, grain marketing, interest rates, energy and family planning. However, little was achieved especially with reversals trade reforms and lack of adequate government commitment to the reform process. The latter dissatisfied the donors and the reform process characterized by stop-go pattern in adjustment lending (Swamy, 1994). In the second phase, 1985-91, government commitment was described as patchy (Swamy 1994) and it saw the donors suspend their support in 1991 to pressurize for political reforms and government commitment. During the period, there was a shift to sectoral approach to implementation process and reforms were initiated in agriculture, industry, financial sector, export development and social sectors. The third phase started with the resumption of aid in 1993, characterized by comprehensive reforms. However, the donors dissatisfied with the pace, suspended aid in July 1997.

Haggard and Webb (1993) while recognizing that structural reforms are triggered by economic crises, indicate that governments respond differently to the crises. It is noted that governments do not always take remedial actions following crises and in some cases actions taken are not sustainable or institutionalized. As a result, a cycle of policy deterioration may be witnessed as the urgency of reform lessens with the easing of crisis. The success of reforms is attributed to various factors including sequencing and comprehensiveness of the reforms (Bhattacharya and Patel, 2003; Mirakhor and Villanueva, 1993; Montiel, 1995; Agenor and Montiel, 1996). It is also influenced by pressure from interest groups and stakeholders (Nelson, 1984; Fidrmuc and Noury, 2003; Haggard and Webb, 1993) where for example, Haggard and Webb (1993) observe that non-tradable goods sector may oppose devaluation while firms in the import substitution could shy away from trade liberalization. Interest groups may show resistance to the reform process at the initial stage especially if there is

uncertainty about the outcome and if the losses are too high and the compensation scheme is not adequate. Haggard and Webb (1993) also note that policy reforms depend on the discipline and competence of bureaucracy, costs of reforms, political scenarios and level of information asymmetry between the government and the public. For example, it is argued that reforms are more difficult to initiate before an election than immediately after. In addition, the commitment of the government and donors has a significant impact on the speed at which the reforms are implemented.

Several questions may be raised in an attempt to understand the reform process in Kenya. For example, what motivated the mounting of the reform process? How has the government implemented these reforms? Does the implementation process indicate an optimal sequencing, adequate support from masses including the interest groups and stakeholders? Is the capacity of the government adequate enough to see through a successful implementation of the reforms? How are the losers compensated in the process? This study attempts to document an in-depth analysis of the reform process in Kenya with emphasis on the financial and trade reforms. The study seeks to understand the initial conditions and the motivation factors in the reform process, government and donor commitment, mobilization of mass support and compensation schemes, the sequencing and timing of the reforms, the coherence of the reforms and the constraints faced in the implementation process.

2. The path to the reform process

Like in some other countries, thirst for liberalization policy in Kenya was preceded by economic crises. However, the government showed some reluctance in implementing the reform even where the need for it was very obvious, while at the same time it took measures that did not necessarily remedy the situation. For example, after a remarkable economic performance witnessed in late 1960s, in 1971, the government witnessed a balance of payment deficit problem following an expansionary fiscal budget in 1970 and 1971. Instead of liberalizing the economic, policymakers imposed policy controls that were characterized by controls on domestic prices, foreign exchange transactions, interest rates and importation licensing. There was also mounting pressure from the urban elite group who were thought to be a political threat; this group consisted of urban salary and wage earners mainly employed by the government parastatals (Nelson, 1984). Further, the bank ceilings made it impossible for the government to draw the funds to implement proposed changes, while the government was put under pressure with conditionality in receiving the financial support.

The oil crises of 1973/74 saw the economy experience macroeconomic instability with escalating balance of payment problems and doubling of the current account deficit. This seemed to signal the government that controlled policy approach to macroeconomic management was inadequate to tackle the external shocks effects. Consequently, Sessional Paper No. 4 1975 *On Economic prospects and policies* was prepared aimed at revitalizing economic performance. The government sought IMF assistance in 1975 and in July 1975, an agreement was arrived at with IMF on an extended facility to support programme set in the sessional paper. In October, the shilling was devalued by 12.5% against the SDR and import control system made progressively more restrictive. In May 1978 the central bank introduced administrative restraints on the approval of import licenses which were further tightened in August. While this reduced imports, it did not stop the decline of foreign reserves. In 1979, the government arranged balance of payment support from IMF through the first and automatic credit tranche and standby agreement was agreed upon in August 1979. The World Bank also moved in to medium term balance of payment support to help the country adjust to oil price shock and in November 1979, import deposit scheme was relaxed. However, the ceiling on bank credit to government proposed by IMF was greatly exceeded and when the bank credit fell within the ceiling in the middle of 1980, the government tried to draw its fund credit but was refused so that the credit negotiated in 1979 was never used.

Following the oil crises in 1979, it was time again for the government to come up with further policy measures to deal with the escalating economic crises. The government presented a structural adjustment programme in Sessional paper No. 4 1980 on *Economic prospects and policies* similar to the 1975 Sessional paper No. 4. Emphasis was made on fiscal stabilization and balance of payments problem. It suggested the need to eliminate quantitative restrictions on imports to replace the equivalent tariff and relax industrial protection under the import substitution strategy and a higher interest rate structure. And in the 1980/81, budget import controls were liberalized and interest rates increased. A new credit was negotiated with IMF in October 1980 with less stringent policy conditions except that import policy was to change from quantitative to tariffs. However, there seemed to be no full commitment on the government on the need to use the resources to achieve long-term adjustment. And the agreement fell part as the government expenditures increased more rapidly than budgeted. By the second half of 1981, the government conceded a measure of liberalization under pressure from IMF and World Bank and this saw devaluation of the shilling in 1982. There was also outright ban in selected imports and abolition of No-Objection certificates procedures. New system of licensing was put n place in November

1981. In January 1982 a third standby agreement was reached with IMF but with tough conditions but again the agreement was suspended as by middle of 1982 bank credit to the government had broken the agreed ceiling. The government prepared Sessional paper No. 4 1982 spelling out further attempts to reform import controls where items could be removed from the quota-based schedules to quota-free ones, at a rate to be determined by the availability of foreign exchange. Although export compensation scheme was abolished in middle 1982, little was achieved on the imports. For example, in April 1983, a new mechanism for the shifting of items was established but its implementation was delayed. At this stage minimal achievements with policy reversals were witnessed mainly because of what was described as lack of government commitment to reform process. The government showed commitment to the reform process in *Sessional Paper No.1 of 1986 on Economic Management for Renewed Growth*, in which it adopted an outward-looking development strategy and proposed the liberalization strategies. However, it was not until the 1990s that a greater degree of liberalization was witnessed, both in the financial and goods markets.

3. Trade and Financial reforms

Financial and trade liberalization were undertaken simultaneously (Appendix Table 1 summarizes some of the key events or reforms since 1989). For successful reform process, Mirakhor and Villanueva (1993), Edwards (1983) and Montiel (1995) observe that an optimal sequencing of the reforms should be adopted. For example, financial reforms should be preceded by macroeconomic and financial stability, otherwise this may result to high interest rates, bankruptcy and loss of monetary control. Relaxation of capital controls should be done after the financial reforms and trade liberalization. If capital account is opened before the financial reform, then capital outflows and balance of payments crises would characterize the administratively set low interest rates where the later acts as the push factors. Further, without macroeconomic stability currency-substitution increases in favor of foreign currency while fiscal rigidities prevent adjustment of primary fiscal deficit necessitating borrowing that may be inflationary at domestic level or increase the current account deficit with the increased external borrowing. Opening of the capital account after the trade liberalization is desirable to avoid contractionary effects.

Sequencing of the reforms in Kenya, show some consistency with what is proposed in the literature where financial liberalization preceded trade reforms and opening of capital account. Interest rates were liberalized in 1991. The government embarked on a phased tariff

reductions and rationalization of the tariff bands in 1990[1]. By 1991, quantitative restrictions affected only 5% of imports compared with 12% in 1987 (Swamy 1994). Simultaneously, foreign exchange controls were gradually relaxed, starting with the introduction of Foreign Exchange Bearer Certificates (Forex-Cs), which could be used for automatic import licensing in 1991 (see Were, et al., 2001). During the same year, currency declaration forms were abolished. In 1992, foreign exchange retention accounts were introduced 100% for non-traditional exporters and 50% for traditional exports. Further secondary market for fore-C's was established. Significant changes were witnessed in 1993 following the resumption of aid after two years suspension. The government adopted a tight monetary and fiscal policy and also made significant steps in liberalizing the external sector. For example, in March 1993, Forex-Cs were made redeemable at market rate instead of official exchange. However, in the same month, all the retention accounts were revoked and import licensing and exchange controls reinstated. In May, import licensing was abolished and retention accounts reintroduced, while in October, the official exchange rate was abolished, paving way for freely floating exchange rate. With the trade liberalization having moved a substantial step, capital controls were relaxed for offshore borrowing in February 1994 subject to quantitative limits. Complete liberalization of offshore borrowing was implemented in May 1994, while some restrictions on inward portfolio investment were lifted in January 1995. By 1995, virtually all the foreign exchange restrictions had been eliminated; foreign exchange bureaus were permitted and the exchange control Act was repealed.

While the sequencing the reforms seems to portray the proposed framework, either some gaps in the sequencing or other factors indicated in Section 1 to influence the reform process, could explain the experience with the implemented reforms. For example, the preconditions of macroeconomic and financial stability for successfully financial reform were not met, generating a feel that things were done in hasty (Ngugi, 2000). The experience with high interest rates, banking crises and the recently proposed Donde bill[2] are a good testimony of the fact something was not right in the reform process. It is therefore important to carry out an in-depth analysis of the reform processes in order to understand factors that may explain the outcomes.

[1] There were initial attempts to liberalize imports during 1980-84 and 1988-91 but these, particularly the first attempt was less successful (Swamy 1994).
[2] The bill proposed controlling of interest rates

4. Objectives of the study

The main objective of this study is to document the trade liberalization and financial reforms processes and draw policy implications for future reform efforts. The specific objectives are:

- To analyze the motivation for and timing of the reforms, including both external and internal factors.
- To evaluate the implementation process including the scope, sequencing, speed and meeting of prerequisites for successful reform.
- To assess the adequacy of government capacity in the design, implementation and monitoring of the reforms.
- To examine the role played by the stakeholders and interest groups in the design and implementation of the reform programs including methods used to mobilize the interest groups and the masses and the compensation schemes.
- To assess the interaction between politics, donor community, and the reform processes.

5. Tasks

The specific tasks for each major period of reforms (in accordance with the project objectives) are to:

- Describe the initial conditions with the reforms.
- Describe the macroeconomic policies and institutional infrastructure during the reform process.
- Study the framework of the reform program including the set goals and objectives, activities proposed, the timing and the indicators for evaluation purposes.
- Find out preparations made for the proposed reforms including any efforts made to enhance the government capacity, information channels to the masses and compensations schemes or coping strategies to mitigate adverse effects of the reforms on the losers.
- Identify interest groups stakeholders their interests in the reforms and whether they portrayed a political threat. Also find out their abilities for and avenues of participation, reactions to the reforms and dynamism in their behavior in the course of the reforms.

- Study the dynamics in the implementation process with regard to government commitment to the reforms, the donor-government relationship, economic reforms-political cycle relationship and the government-masses relationship.
- Compare the proposed framework with the actual implementation so as to capture the lags and assess the comprehensiveness of the reforms.

6. Hypotheses

- Adoption of reforms and the speed of adjustment are determined by the level of economic crises, external pressure, government commitment, and the influence of the interest groups.
- Gradual implementation reduces coordination failures in the reform process.
- Proper sequencing of the reform processes enhances their complementarities and success.
- Comprehensive as compared to piecemeal reforms gain more public support and are more successful.
- Both the government and donor commitment are important for the momentum and sustainability of the reform process.

7. Methodology

Analytical framework

To fully address the issues raised, the study will mainly rely on documentary analysis and analytical narratives. To understand the reform process, analyzing the various stages of the reform is critical. These stages can be conceptualized into three basic questions—*why* the reform? *What* kind of the reform and *how well* the reform performed (Fanelli and Popov 2003). In the context of this study, some of the issues to addressed are highlighted below.

Why were the reforms undertaken? This will involve analyzing the initiation of the reforms including identifying the motivations for the reform—external vis-à-vis internal factors, mobilization of the public and the stakeholders to the proposed reforms, framework for the program including the set goals and objectives, activities proposed, the timing and the indicators for evaluation purposes.

What kind of reforms? This will involve analyzing factors shaping the design and implementation of the reforms. At this stage, the study will look at the scope and sequencing of the reforms, find out whether the perquisites were met, the speed of implementation, nature of consultations, constraint in meeting the set targets, the role of different stakeholders including the donor community and the compensation mechanism or coping strategies to mitigate the adverse effects of the reforms for the losers. A detailed description of the policy indicators for the trade and financial reforms will be undertaken.

How well did the reforms perform? To measure the success or failure of the reform, this will entail analyzing outcomes indicators—specific outcomes of the policy measures, as well as broader outcomes—comparison of the targets or the intended objectives and the accomplishments in order to assess the performance and comprehensiveness of the reform programme. Other issues of importance include coherence, consistency and coordination of the reform process.

Data

To comprehensively meet the set objectives, the study will utilize government policy documents such as Economic Surveys, Development Plans, budget speeches, Sessional Papers, minutes of meetings on key decision-making, IMF and World Bank country reports, Central Bank of Kenya publications. The study will mainly rely on secondary data, but in limited cases where gaps in the information flow are realized, interviews with key informants such as former Permanent Secretaries may be conducted.

8. Research output and dissemination

The following are some of the expected output and forms of dissemination:

- Research Report: The main output will be a detailed research paper on the identified reforms.
- Discussion papers: The work will be organized in the format that meets the standards set for KIPPRA Discussion Papers for publication and circulation to ensure that the research findings reach a wider audience
- Policy Briefs: These will follow the KIPPRA and will mainly target policy makers and planners in government , and pertinent stakeholders such as donor agencies.

- Dissemination workshop-this will be half-day workshop to disseminate the research findings

9. The Research Team

i) Maureen Were: Principal Researcher

Assistant Policy Analyst at Macroeconomic Division, Kenya Institute for Public Policy Research and Analysis (KIPPRA)

ii) Dr. Rose Ngugi: Principal Researcher

Lecturer, Economics Department, University of Nairobi and Policy Analyst at KIPPRA.

iii) Phyllis Makau: Co-assistant Researcher

Senior Economist at the Ministry of Finance and Planning, Republic of Kenya

Maureen and Rose are both macroeconomists. Maureen's research activities have so far focused on issues related to trade liberalization as exemplified by some of her research papers e.g. exchange rate liberalization, exports and aid flows. Rose's research activities have mainly focused on issues related to financial sector reforms such as interest rate liberalization, reforms in the banking sector and capital markets and the operation of the sector following liberalization. Phyllis, who is also an economist, augments the team based on her experience of working within government and she is also involved in the decision-making, execution and monitoring of some of the donor-funded projects for Kenya government. She has been involved in financial projects and she also conversant with sectoral issues. Thus, the composition of the research team is such that they augment each other in terms of achieving the intended objectives.

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Table 1: Trade and Financial Reforms: Chronology of key Events/Reform

Period	Reform/Key Events
1989	*June*— VAT remission for exporters & Exchange Risk Assumption fund *November*--Minimum saving rate raised by 0.5% and maximum lending rate raised to 15.5% *December*-Seven NBFIs and banks closed in a banking crisis
1990	*June*--Export processing zone bill, EPPO *November*-TBR liberalized
1991	*June*-Foreign Exchange Bearer Certificates (Forex-Cs) introduced *July*-interest rate liberalized *Octobe*r-Forex-Cs used for automatic import licensing *November*-Currency Declaration Forms abolished *November*—Donor Freeze on quick disbursing aid
1992	*January*- increase in minimum capital/assets ratio from 5.5% - 7.5% & guidelines to encourage self-regulation *April*-secondary market for Forex-Cs established *August*—100% retention accounts for non-traditional exports, authorization for interbank foreign exchange market. Export Promotion Council established *November*--50% retention accounts for traditional exports *December*-stop trading in forex-Cs. First defaulting on foreign debt service
1993	*February*—Retention scheme extended to service sector at 50%, foreign exchange allocation by CBK abolished *March*—Forex-Cs made redeemable at market rate instead of official exchange rate. Devaluation of 25% of official exchange rate *March*—Revoke all retention accounts, reinstate import licensing and exchange controls, ESAF cancelled. *April*—Devaluation by 33%. Resume reforms *May*—again abolish import licensing. Reintroduce retention accounts at 50% for all exporters. Devaluation 6% *June*—Max import tariff reduced from 60% -50%. Introduction of one way foreign exchange auction system. *August*—two way(to buy and sell) forex auction system introduced *September*—export compensation abolished *October*-freely floating exchange rate—abolish official exchange rate *November*—CBK started daily trading in forex with commercial banks. ------ --Restrictions on remittance of profits removed. --residents allowed to borrow abroad up to US$ 1m --30, 60, & 180 days Treasury bills introduced in addition to 90 days bills
1994	*February*—Current account liberalized. 100% retention accounts for all. *March*—capital account liberalized. Exchange controls abolished. *June*—NBFIs permitted to trade in forex. Abolish all export taxes. Accept obligations of articles of agreement of IMF *September*-Kenyan nationals could invest abroad

1995	*January*-Forex bureaus permitted. Portfolio investment by foreigners in stock exchange up to 20% equity permitted *June*-firms listed by NSE to issue commercial paper *July*—NBFIs subjected to mandatory cash ratios *October*-banking act amended *December*-Repeal of Exchange Control Act
1996	*May*—Treasury bills for 30, 90, 180 days replaced by 18, 91, 182 days; 60 and 270 days discontinued
2000	IMF froze funds Donde bill on control of interest rates
2001	

Source: Ngugi (2003), O'Brien and Ryan (1999), Ryan (2002)

Research Institution

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