DEVELOPMENT BANKING IN KENYA:

A CASE STUDY OF INDUSTRIAL DEVELOPMENT BANK LIMITED.

by

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October, 1991

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DEDICATION

TO MY FAMILY, WITH LOVE.

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LIST OF ABBREVIATIONS

ADB	African Development Bank
AT&H	African Tours & Hotels
BADEA	Arab Bank for Economic Development in Africa
BOD	Board of Directors
DDC	District Development Committee
DEG	Deutsche Enwicklungs Gesellschaft (German Development Company)
DFCK	Development Finance Company of Kenya
DFI	Development Finance Institution
EADB	East African Development Bank
ECGD	Export Credits Guarantee Department
EIB	European Investment Bank
EXIM Bank	Export Import Bank of India
IBRD	International Bank for Reconstruction and Development
ICDC	Industrial and Commercial Development Corporation
IDB	Industrial Development Bank
IDBI	Industrial Development Bank of India
IDC	Industrial Development Corporation
KIE	Kenya Industrial Estates
KTDC	Kenya Tourist Development Corporation

ABSTRACT

The main objective of this study is to examine the determinants of the demand for development funds in Kenya. The study provides an overview of theories of development banking with respect to developing countries. It proceeds further to discuss the particular features of industrial development banking in Kenya and how such features affect the effectiveness of development banks in the economic development process. A detailed case study of Industrial Development Bank Limited provides an indication of the successes and failures of development banking in Kenya. The econometric results presented in this study indicate that the partial adjustment model is appropriate for the estimation of the specified demand function. The demand function is found to be structurally stable over time. Further, the results reveal that the determinants of demand for development funds are the level of income, the exchange rate and the degree of monetization. Nonetheless, this study recognizes that this conclusion must be treated with caution because of the limited sample period which was covered. Future research will continue to be appropriate, especially with the possible deregulation of interest rates by the government.

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INTRODUCTION

1. Preliminary Comments

A number of studies as well as various conferences on development banks indicate that these institutions are vital instruments of economic development. Theoretically, they provide the necessary ingredients for industrialization which is one of the most important paths to economic development. They provide medium and long-term funds for productive investments through the mobilization and reallocation of appropriate resources.

In this study, the analysis of Kenya's Industrial Development Bank (IDB) Limited will be used as a case study to analyze the general aspects of development banking in Kenya. The study is presented in five chapters. Chapter One will discuss the general concept of development banks with specific reference to their operations in developing countries. The historical development of development banks and their operations will be discussed in general. The purpose of this chapter is to provide a base for the subsequent analysis of evaluating development banking in Kenya. The chapter also provides a critique of these organizations, particularly with regard to their ability to promote development under excessive government control.

Chapter Two focusses on the general aspects of industrial development banking in Kenya. A discussion of their role in the country's economic development will be provided. Four industrial development bank institutions will be discussed. The chapter will analyze their problems and the role of government in their operations.

Chapter Three contains a detailed analysis of the Industrial Development Bank (IDB) as a case study. It will introduce the IDB by examining its origin, role, policies and how its policies have been implemented. The chapter will discuss some of the successes, inadequacies and laxities in its financing procedures with specific reference to its policies regarding its role in the country's industrialization process.

Chapter Four provides an econometric analysis of the demand for IDB's investment funds. Chapter Five deals with conclusions and policy recommendations. This chapter integrates IDB's operational experiences with the general aspect of development banking in Kenya.

2. Objectives of the Study

As a means of understanding the role and place of development banks in Kenya, this study seeks to answer the following questions:

(a) In what ways and to what extent has IDB contributed to Kenya's economic development in terms of resource mobilization and allocation?

(b) What are the main factors that determine the demand for investment funds of IDB and how do such factors affect its operations?

(c) What measures would be appropriate to strengthen IDB's operations?

The study covers the period 1973 to 1989. The principal findings and conclusions with regard to policy implications will provide a basis for understanding Kenya's development banking system. The hypothesis

that the objectives of the development banks in Kenya are constrained by their inability to mobilize appropriate resources is confirmed for the case of IDB.

3. Research Methodology

In this study we have utilized secondary data from various published reports. This is supplemented with our personal knowledge of development banking and discussions with colleagues at IDB and those at other development banks in Kenya. Views and experiences of the banks' clients have been taken note of in the study. There is heavy reliance on IDB's quarterly project reports, IDB's operational policies and other documents of the bank. Government of Kenya documents and International Monetary Fund (IMF) Statistics have also been used.

An econometric analysis is undertaken to analyze the demand for IDB funds. A single equation demand function for IDB's investment funds is specified. A partial adjustment of the Koyck transformation model is also estimated. A detailed model specification is provided in Chapter Four.

CHAPTER ONE

1. DEVELOPMENT BANKS IN DEVELOPING COUNTRIES

1.1 The Concept of a Development Bank

By definition, a development bank is a specialized institution that mobilizes resources for medium and long-term financing. It is "a chosen instrument for facilitating and stimulating economic growth".[1] Economic growth is a desirable process especially in developing countries. Economic growth refers to an increase in national income, and is a component of economic development which is a process that entails many changes in the basic characteristics and structures of the economy. The impact of growth is measured differently from country to country. For the purpose of this study, we will be concerned with how development banks relate to economic growth and the eventual process of economic development.

A development bank plays a major role in economic development through its ability to influence the capital formation process. This process involves, in part, the establishment of industrial enterprises, which in turn provides a basis for entrepreneurial development. In considering economic development, effective entrepreneurship is one of the most crucial elements of the overall investment process.

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[1]L.K. Bansal, Regional Development Banks and Industrialization, Deep & Deep Publications, New Delhi, 1988, p. 17.

Given that policies designed for economic development vary among countries, the objectives and functions of development banks will also differ in accordance with the environment they operate in. However, they do possess certain common characteristics with respect to their functions. The basic common characteristics are the need to mobilize foreign and domestic resources and financing of projects that are expected to contribute to a country's economic development.[2]

Harlander and Mezger[3] have rightly chosen not to provide any specific definition of development banks. They instead choose to describe and analyze the objectives, structures, policies and operations of development banks. Theirs is an examination of several development banks in Africa. The objectives behind the establishment of these institutions involve providing solutions to problems specific to individual countries. Effectively, the structures of these banks are determined by individual governments which predominantly decide on the ownership and management of these organizations. Further, governments provide policy guidelines upon which operations of development banks are based. Policies taken by these institutions determine their effectiveness in realizing their objectives and operations, and such operational policies ultimately define what a development bank is in a given economy.

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[2]John White, Regional Development Banks, Overseas Development Institute Ltd., London, 1970, p. 5.

[3]H. Harlander, and D. Mezger, Development Banking in Africa, Weltforum-Verlug, München, 1971, p. 17.

Generally, development banks are defined by the basic roles they play in any economy. There are two major roles for these banks. These are financial and developmental (promotional) roles.[4] The financial role involves the provision of medium and long-term finance to development projects. This may be in the form of equity participation, loan provision and loan guarantees. This role also relates to their ability to mobilize the financial resources required for such purposes.

The developmental role refers to the banks' capability to recognize the problems of, or bottlenecks to, economic development. The bottlenecks envisaged include the critical shortage of viable projects, lack of entrepreneurial skills, undeveloped or underdeveloped capital markets and difficulties in the implementation of development plans. In an attempt to solve these problems, development banks have to be involved in such activities as: identification of viable projects; development of entrepreneurial capabilities, which is done by identifying and motivating local entrepreneurs; assistance in the implementation of projects that are technically feasible, and economically and financially viable; development of a capital market and the subsequent broadening of project ownership; and provision of technical, managerial and administrative advice to clients so that implemented projects can prosper. Developmental objectives of these institutions are, therefore, achieved through these types of activities.

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[4]J.T.D. Houk, Financing and Problems of Development Banking, Frederick A. Praeger, Inc., New York, 1967, p. 11.

By carrying out their financial and developmental roles these institutions become involved in various activities that have an important developmental impact on the economy. Such activities, which may range from the improvement of investment proposals to the overall development of the business community, can ultimately help in the development of an efficient industrial structure. Therefore, with refinement of their skills and growth of experience, development banks can play a significant role in solving problems such as regional imbalances, international competitiveness and promotion of exports, and inequitable income distributions.[5]

These kinds of roles performed by development banks constitute a major difference between them and the commercial banks. Development banks assume greater risk through the promotion and financing of development projects whose financial viability may not be guaranteed in the long-run. Commercial banks rely largely on demand deposits as their source of loanable funds and hence their ability to assume the possible risks involved in the financing of development projects is quite minimal. They accept deposits and lend to credit-worthy borrowers against suitable collateral. Commercial banks usually lend short-term. This is because much of their liabilities (demand deposits) are short-term. They generally tend to operate in such a way so as to minimize the risk (liquidity problems) which would tend to arise if they were to

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[5]William Diamond, "The Impact of Development Banks on Their Environment" in Aspects of Development Bank Management, William Diamond and V.S. Raghavan (eds.), The John Hopkins University Press, Baltimore and London, 1982, p. 134.

lend long-term using short-term deposits. For development banks, the promotion of medium and large-scale enterprises (in the private or public sector) involves providing technical, financial and managerial assistance at all stages of a project. This implies that, not only do these institutions finance pure financially viable projects, but they also deal with a wide spectrum of economic activities that are not necessarily financially viable in both the private and public sectors. The possibility of conflict between requiring a project to be financially viable and to serve developmental goals at the same time may be inevitable. It is suggested, however, that development banks may fail to achieve their objectives if they confine their financing to bankable (profitable) projects only.[6] This may appear an inevitable dilemma for these institutions, which need to ascertain the financial viability of those enterprises they have to fund and still maintain their developmental role by promoting social projects. This situation necessitates a mix of banking and development policies and operations.

Development banks are not the only promoters of economic development. They co-exist with other institutions and individuals devoted to the same end, and hence there is a need to coordinate their activities by taking into account such co-existence. However, this should not make them passive instruments of economic activity; rather,

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[6]L.K. Bansal, op. cit., p. 20.

given an appropriate operating environment, they should be active agents of economic development.[7]

In summary the financial and developmental roles of development banks illustrate why these institutions are needed in developing economies. Available literature on these organizations points out that, fundamentally, development banks play a vital role in stimulating economic development.[8]

1.2. Historical Perspectives[9]

The evolution and growth of development banks in developing countries may be traced to the Latin American countries. Latin American development banks were established during the depression of the 1930s during the Second World War. These were the periods when Latin American countries were hard hit by deteriorating prices for their primary goods exports, shortages of consumer goods and lack of foreign exchange to promote private investment. The governments of these countries were

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[7]E.T. Kuiper, "The promotional role of a development finance company" in Development Finance Companies: Aspects of Policy and Operation, William Diamond (ed.), The Johns Hopkins Press, Baltimore, 1968, pp. 7-8.

[8]See, e.g. William Diamond and V.S. Raghavan: op. cit., p. 133; J.T.D. Houk: op. cit., p. 112; L.K. Bansal: op. cit., p. 43; J.K. Onoh, Money and Banking in Africa, Longman Group Ltd., Essex, U.K., 1982, p. 111; J.A. Kane, Development Banking, D.C. Heath and Company, Lexington, 1975, pp. 14-15.

[9]This section is based on G.F. Mbowe, "Government/development bank relationship in less industrialized countries" in Development Banking in the 1980s, UNIDO, United Nations, New York, 1980, pp. 47-52.

forced by such economic hardships to pursue a policy of aggressive industrialization through import substitution. The promotion of this policy was implemented parallel with the establishment of industrial development finance institutions which channelled funds to the private sector. The period therefore witnessed the establishment of the Nacíonal Financiera in Mexico which started business in 1934; Corporacíon de Fomento de la Producíon in Chile in 1939; Instituto de Fomento Industrial in Colombia in 1940; Banco Industrial de la República in Argentina in 1943; and Corporacíon Venezolana de Fomento in Venezuela in 1946.[10]

The emergence of development banks and their growth in Africa and Asian countries between 1950 and 1975 was associated with the political independence of these countries. These development banks were established on social, political and economic grounds. The main aim was to establish a sound financial infrastructure for mobilizing domestic and external resources in order to accelerate industrial development. The establishment of development banks in the Middle East over the same period was related to the exploitation of the natural resources of this region.

In general, the creation of development banks in developing countries was connected with the unfavourable circumstances that prevailed in these countries at the time. Some of these conditions include:

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[10] W. Adler Robert, and Raymond F. Mikesell, Public External Financing of Development Banks in Developing Countries, Bureau of Business and Economic Research, University of Oregon, 1966, p. 6.

(i) absence of private markets for raising equity and long-term capital;

(ii) unwillingness of existing commercial banks to provide financial assistance to local entrepreneurs, due to inadequate collateral securities;

(iii) relatively low savings, because of the low earning capacities;

(iv) unfavourable climate for foreign investment, which was a result of the policies that were pursued by governments whose objectives were to indigenize their economies;

(v) limited markets and high production costs as a consequence of a shortage of skilled labour technicians and managerial competence; and

(vi) the need for pre-investment surveys and adequate assessment of industrial ventures, which implies that these countries needed to ascertain possible areas in which they would industrialize.

It was then hoped that, by starting development banks, appropriate resources would be mobilized for the needed level of industrialization.

1.3. Development Banks and their Operations in Developing Countries

1.3.1 Nature of their operations:

Developing countries experience frequent external and internal economic changes. Such changes affect the operations of development

banks. By their nature, these institutions should be able to respond to the needs of their environment. Their effective operations depend greatly on how well they freely integrate themselves with governments, industry, agriculture and other sectors they serve. It is through this integration that they can participate in the economic development of these countries. The criterion for the success of these institutions is based on the extent to which they assist in the development of resources: human, material, and financial.

As already observed, countries define their priority areas differently. In such circumstances, development banks are supposed to operate within the framework of "a national development plan and policy."[11] This implies that development banks' activities should be tailored to the particular needs of each specific country. These activities can differ from one another. For example, some countries emphasize modernization and expansion of industries, others emphasize development of mining and agriculture, still others might emphasize rural development or housing development, among others. This suggests that development banks have a broad mandate laid down in their statutes aimed at stimulating the economic development of any given country.

Developing countries' desire to accelerate the pace of their economic development is tied up with an increasing emphasis on industrialization. Development banks then are expected under such guidelines to act as instruments of investment in this area. But structural constraints in developing countries make the process of

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[11]H. Harlander, and D. Mezger, op. cit., p. 33.

development uneven. It is also true that the role of industrial development banks is essentially a supplementary one. This is because the industrialization process, in the absence of other conditions favourable to the creation of productive private industrial enterprises, is such that these institutions by themselves cannot create such enterprises. As a result, on the development banks, which have to operate within government policy objectives, also experience various problems which eventually inhibit their ability to operate efficiently. One major problem facing these institutions is lack of sufficient resources. Their resources often do not permit them to provide the necessary finances for the promotion of industrial and other sectoral development.[12]

The ability to mobilize resources determines the ability of development banks to finance projects which are crucial to economic development. Financing of projects may be based on economic reasons, in which case projects with "high economic returns" will receive high priority.[13] On the other hand, the allocation of resources to various projects may be based on political and (or) social considerations, which predominantly argues in support of financing development projects which may not have high private rates of return. This form of financing is often directed to social projects. While the social responsibilities of development banks are important, it must be recognized that the banks'

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[12]Shirley Boskey, Problems and Practices of Development Banks, The Johns Hopkins Press, Baltimore, 1959, p. 5.

[13]Ibid., p. 26.

contribution to improving the quality of life of the people will also depend on the banks' overall performance including their financial viability. In spite of the fact that governments may dictate certain projects to be supported, development banks are in fact obliged to apply sound financial policies in their operations by both the governments who usually own them and the individuals and (or) institutions who may provide them with credit. In the long run, they must meet their agreed-upon profit objectives to survive.[14]

1.3.2 Resource mobilization

Resources of development banks include share capital, domestic or external borrowing, managed funds, which are usually provided by governments for concessional lending, and their internal cash generation.

By share capital is meant shareholders' funds. Development banks with the status of a limited liability company have their share capital subscribed either totally or in part by the local government along with any private shareholders.

The share capital is usually supplemented by loan capital. If the equity capital contributed by the shareholders is too small, then the possibility of obtaining loan capital will be prejudiced. With low

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[14]This very often refers to some specified level of positive net worth (for instance, 5 percent capital-asset ratio) that has to be maintained for a bank to remain in operation. For details see World Bank, World Development Report 1989, Oxford University Press, New York, p. 73.

equity levels, potential lenders will not be convinced that their interests will be protected. Given the risks involved in a development bank's operations and the likelihood of low earnings during the initial period, these institutions need as much equity as possible in relation to loan capital. At the same time, the scale and nature of the operations will determine the adequacy of equity capital.

As to what debt-equity ratio these banks should maintain in relation to their capitalization levels, no specific solution is offered. "A great deal will depend upon the types of assets accepted as security for their loans and upon their loan and investment policies, in other words, upon the risk of investment".[15] Also Boskey argues that "In determining the proportion of its resources which it can prudently employ to purchase equities, the bank must be mindful of the need to have sufficient funds in liquid or readily realizable form to meet its fixed obligations."[16]

The implication is that, if development banks are to invest in equity, then the shareholder capital should be sufficient to cover the equity investment or at least most of it. Regardless of the circumstances, adequate share capital is essential for successful operations. Most of the development banks have problems maintaining a sufficient level of share capital, particularly if they are wholly dependent on the government or government agents as the shareholders,

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[15]S.K. Basu, Theory and Practice of Development Banking, Bombay: Asian Publishing House, Bombay, 1965, p. 25.

[16]Shirley Boskey, op. cit., p. 24.

since such shareholders generally make insufficient contributions. And even if sufficient contributions were made, supporting projects with generally low financial rates of return erode the banks' capital base.

External borrowing by the development banks is done through government guarantees. This method of mobilizing external resources is on the basis of conditions laid down by the external lenders. For instance, the World Bank, as a rule, used to require an initial debt: equity ratio of 3:1 to be sustained by a development bank and all the borrowings to be backed by guarantees of the local government.[17] Given that such capital structure required by the multilateral agencies was not based on any analytical findings,[18] it has not gained any significant popularity in the developing countries. The condition of government guarantees is basically acceptable since this gives control to the government over the operations of the development banks. The debt-equity ratio requirement is no longer imposed by the external lenders; rather, other factors have been given preference. These include quality of management and professional skills, developmental objectives in line with what these external agencies consider appropriate, degree of autonomy from government interference, and aggressive portfolio supervision.

Development banks may also borrow from the government, or issue their own obligations in the money market. Portfolio sales provide a

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[17]H. Harlander, and D. Mezger, op. cit., pp. 26-27.

[18]William Diamond (ed.), Development Finance Companies: Aspects of Policy and Operations, The Johns Hopkins Press, Baltimore, 1968, p. 66.

means by which the banks gradually dispose of enterprises they themselves have established. They may sell their own shares to the public. More often, in developing countries, it is difficult to attract individual investors, who view these banks as institutions that may not make enough profits to warrant dividends due to their financing of developmental projects or lending in inflationary economies. But in some situations private capital may be responsive because the shares offered by development banks may be the only available low risk opportunities. This is particularly true in developing economies with relatively undeveloped securities markets.[19] The study by Harlander and Mezger illustrates that the power of domestic borrowing by development banks is often fixed in their statutes or by-laws.[20] Such limits may be expressed either in absolute amounts or in relation to the bank's paid-up share capital and part of the free reserves. Again the level of indebtedness depends on the nature of investment pursued; whether it is equity or loan, as already discussed.

Since part of the domestic borrowing may be done in a securities market, development banks can promote private capital formation which is an essential element of local investment capital. But the low level of domestic savings in developing countries often inhibits the efficient operation of capital markets.

Government allocations as a source of funds usually take the form of budgetary allocations which may be different from the normal share-

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[19] Shirley Boskey, op. cit., pp. 26-27.

[20] H. Harlander, and D. Mezger, op. cit., p. 25.

capital held by governments. Governments grant development banks a lump-sum amount which is supposed to be managed by these institutions on their behalf. The repayment of loans made out of these government allocations and the interest revenue are expected to provide fresh funds for other new investments. In most cases, such funds are usually intended for the financing of social projects, which are assumed to have the potential for improving the living standards of the people. Some governments have annual budgetary allocations while others just make occasional allocations to the banks. For example, governments may decide to start a special fund to be administered by these institutions for purposes of, say, assisting local entrepreneurs who may require small and medium-term loans and cannot obtain assistance from the commercial banks. Occasional allocations constitute the worst form of financing for development banks as they do not facilitate effective forward planning of investments.

The intensity of resource mobilization through this form of government participation depends on whether a development bank is fully government-owned or both public and private sector owned. Government savings are usually channelled to development banks on the basis of ownership, meaning that institutions with full government ownership are preferred over those with private ownership. There are also those with mixed ownership.[21] In such cases, government allocations or any other

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[21]V.R. Jayme, "Development banks and the mobilization of domestic financial resources", in Development Banking in the 1980s, UNIDO, United Nations, New York, 1980, p. 171.

form of government assistance are provided with the understanding that public shareholding is the controlling share in these institutions.

For the development banks, government participation is an essential means of mobilizing domestic savings. In cases where governments are not able to provide sufficient resources whenever required, these banks become ineffective in attaining their objectives. When this becomes a real problem, "government owned banks may seek government guarantees for the bonds and other debt instruments they may issue to mobilize domestic resources".[22] As already indicated, this assumes the existence of well-developed capital markets. This then requires that governments of developing countries make an effort to improve the overall financial infrastructure to allow for the existence of an efficient capital market.[23]

In summary, resource mobilization by the development banks is not easy under the circumstances prevailing in these countries. But it is possible for these institutions to collaborate with their governments, the rest of the financial sector and with external financial agencies to arrive at a consensus on how best to approach the problem of resource mobilization.

1.3.3 Resource allocation

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[22]Ibid., 172.

[23]David B. Gill, "Development banks and the mobilization of financial resources", in Aspects of development bank management, (ed), W. Diamond and V.S. Raghavan, (eds.) Johns Hopkins University Press, Baltimore, 1982, p. 219.

The criteria for allocating resources is determined by the bank's selection of development projects. Outside of developmental concerns, a project has to be financially viable. Development banks allocate resources to projects on the assumption that the private sector does not possess sufficient and effective initiatives to foster desired development projects.

In terms of policy, the necessity to earn a return on their investment implies that development banks have to operate in accordance with commercial principles, without at the same time forgetting their developmental role. Any development bank charter specifies how the process of resource allocation should be pursued. There are well laid down priorities that specify why resource allocation is undertaken in whichever form. Such charters can be revised from time to time in accordance with the economic environment in which the bank is operating. However, there are some basic factors, especially in developing countries, that determine the order of priority in resource allocation. These factors (without prioritizing them) include: profitability, capital intensity of projects, capacity to attract foreign and domestic capital, import substitution capability, implementation period, input-output ratio, optimum size, balanced regional development, capital-labour ratio and balance of payments position.[24]

Development banks in their allocative procedures are supposed to undertake financial and economic appraisals of projects they have to promote. The financial appraisal is designed to measure the viability

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[24]L.K. Bansal, op. cit., p. 34.

of a project in terms of its financial returns. Conventional financial ratios such as current ratio (calculated as current assets divided by current liabilities), return on assets, and financial rate of return are used to decide on the risks and expected returns. Similarly, the economic appraisal is designed to measure the contribution to national welfare. In other words, it is used to ascertain the overall developmental impact of a project on the community.

Economic appraisal may point to areas that may require changes in, say, capacity utilization or factor proportions with the purpose of improving the efficiency of a project. Or it may point to the inefficiencies resulting from government policies. When these are discovered, development banks need to persuade their governments to make appropriate policy changes. This implies that development banks ought to emphasize the need for successful projects operations to policymakers. Government policy instruments do change and can have far reaching implications on the operations of a project. Most project failures in developing countries are a result of low financial returns which are coupled with frequent policy changes introduced by governments with regard to developmental priorities. On the other hand, governments are usually inflexible with respect to changes that may be suggested by development banks, partly because of the diverse structural problems that these countries face. Generally the economic analysis undertaken in project appraisal shows the link between the financial viability of a project and government policies. These latter are the development priority issues expressed in most governments' development plans.

Development banks often pursue both economic and social objectives which are usually complex. Given that a benefit-cost analysis cannot capture all the indirect benefits of a project, it is not enough to judge a project on the basis of its effects on the income of the various social classes alone. Development banks' decisions may be based on other beneficial effects. These include focussing particular attention on bringing new persons to the entrepreneurial class, seeking to alleviate regional disparities or promoting small-scale industries. Such activities provide social benefits but they are not necessarily fully reflected or even reflected at all in a benefit-cost ratio.[25] Development banks in developing countries generally carry out a benefit-cost analysis on projects that utilize external resources. While this is a basic requirement for such external funds, it should be recognized by the multilateral and bilateral lending agencies that the local development banks have complex problems involving the treatment of social issues, usually not quantifiable. The general appraisal system then is not a straightforward process with specific rules but is quite complex.

The combination of banking and developmental criteria leads to a proposition that all "bankable projects are not necessarily economically important nor is every economically important project necessarily

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[25]V.V. Batt, "On a development bank's selection criteria for industrial projects", in Aspects of Development Bank Management W. Diamond and V.S. Raghavan (eds.), The Johns Hopkins University Press, 1982, Baltimore and London, pp. 60-74, passim.

bankable".[26] This implies that, even though sound and profitable projects are not denied financial assistance due to social considerations alone, it is true that some projects whose profitability prospects are rather low and would otherwise not be financed are financed. This is a common trend in developing countries where such projects are regarded as social projects in so far as they conform to a country's developmental objectives, such as the provision of employment. Experience has shown that such projects usually perform poorly financially. These qualifications notwithstanding, in practice, almost any soundly conceived project that is likely to be profitable, will have sufficiently high economic priority to warrant development bank financing.

The amount of resources available to development banks largely determines the project preference. The volume of resources limits the variety of projects to be financed. Development banks tend to have less preference for certain sectors which may expose them to greater risk. For instance some banks decline to commit funds to, say, services or hotel industries.

Ownership of projects is another significant factor that development banks consider in their allocation procedures. Some purely private projects may meet the financial appraisal conditions and hence tend to be preferred by any investor, development banks inclusive. But most of these enterprises are foreign-owned. The decision to assist local entrepreneurs may necessitate publicly-owned development banks to

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[26]Shirley Boskey, op. cit., p. 30.

shift resources towards the financing of these locally-owned projects. This aspect of development bank financing is illustrated by studies that have been made in the African continent which show that development banks with majority public ownership tend to promote local enterprises while those with private ownership tend to promote enterprises in which foreign capital is invested.[27] Some banks, especially those that are government-owned, decline to finance projects owned by individuals. Incorporated companies are usually preferred since they can pave the way for financial participation of other investors through the purchase of shares in the company at a later date. This tends to be encouraged by development banks.

Other equally important issues addressed by development banks in their allocative procedures include management capability; value and liquidity of assets available as security; the technology involved and whether it can readily be handled by the local entrepreneurs; and the location of a project, whether in a rural or urban area.

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[27]H. Harlander and D. Mezger op. cit., pp. 33 and 46.

1.4. Development Banks and Economic Development in Developing Countries

As already indicated, participation of development banks in the process of economic development involves promotion of developmental activities. These activities are usually provided for in many countries' periodical development plans. Execution of such plans is supposed to be carried out through specific development strategies. The objective of any development strategy is to optimize the use of a country's scarce resources. In the process, it is expected that long-term socio-economic objectives will be achieved. The main business of development banks is to mobilize and allocate financial resources to achieve these objectives.[28]

The role of development banks in the process of development occurs through the various investments they promote. Given that developing countries face a shortage of financial resources, the decision about which project to promote is based on the ability of any project to make the best use of the scarce resources and "benefit the greatest number of people".[29] The assumption is that such a project can actually take off and be managed efficiently. The productivity of such investments is improved through the provision of expertise by development banks such as information on technology, effective management and proper project

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[28] S.A. Dave, "Social Obligations of Development Banking", Development Banking in the 1980s, UNIDO, United Nations, New York, 1980, p. 159.

[29] S.A. Dave, op. cit., p. 160.

implementation.[30] These institutions thus are intended to act as instruments for accelerating growth and increasing per capita national income.

Participation of development banks in development involves an integration of their financing and developmental functions. They are supposed to suggest to governments projects that should be incorporated in national plans or propose a more effective orientation of investment policy. However, in most cases, it is the governments that identify priority areas of project funding. Development banks are then expected to participate in such areas, which may not necessarily be on the basis of effective economic consideration. Kuiper, in his analysis of the promotional role of development banks, argues that close cooperation between government officials and development banks provides a healthy environment of active participation of the banks in the development process.[31]

But such close association should not lead to unnecessary political interference, since development banks have to operate profitably in order to justify their existence. The extent of government interference in the operation of these institutions in developing countries varies from one country to another. The degree to which government influence can cripple the efforts and efficiency of development banks largely depends on the degree of cooperation and extent of linkages between these institutions and government ministries

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[30]L.K. Bansal op. cit., p. 28, 143.

[31]E.T. Kuiper, op. cit., pp. 7-21.

and how well they are maintained. This relationship, whether positive or negative, provides a measure of the developmental role played by the development banks in developing countries.

A serious shortcoming of these institutions is the inability to change their policy objectives in accordance with the changing economic conditions in the country. Most governments of these countries have not addressed this issue of evaluating the efficiency of their development banks. Regardless of this problem, the existence of development banks, in so far as they partake in the economic development process, is justified. These institutions have the capability to promote and develop the industrial base of developing nations. This is also possible with other sectors of the economy, given appropriate resources.

1.5. Government and Development Banks

A large number of development banks in developing countries are government controlled directly or indirectly through other government agencies. This means that these institutions continually experience political influence on their operations, especially with regard to the scope and direction of their activities. Usually the concern is whether such government influence has positive or negative impact on the development banks. At the initial stages of establishing these institutions, government support is necessary for resource mobilization and allocation, particularly when a country is experiencing very low levels of economic development. This perhaps may be conceived as

positive government participation in the operations of development banks. At what stage of a country's economic development should government control of these institutions cease is an issue widely debated among the politicians and the technocrats, with the former arguing for continued government control.

In general, continued government control over the activities of development banks has meant that these institutions are, in many cases, mere conduits of financial resources to projects that are largely unprofitable. When development banks are required to finance such projects, they themselves become unprofitable public corporations and hence public liabilities. Effectively this has a chain reaction in the sense that they cannot attract competent personnel and private investors and therefore overall resource mobilization is inhibited. These circumstances in which development banks find themselves often means that their intended functions are overshadowed by political dictates.

At some stage of a country's economic development, possibilities for the development of a dynamic financial system relying less on government control are inevitable. Diversified numbers and forms of private financial institutions are established. These institutions are likely to provide most, if not all, of the possible services provided by development banks. The private financial institutions can mobilize resources much easier than development banks with high government control. Domestic resource mobilization procedures of these institutions are often faster and less bureaucratic than those of development banks. The existence of, say, savings banks, long-term

credit unions, commercial banks with investment banking facilities, consultancy firms providing advisory services and other institutions dealing with aspects of the capital market, may render government-controlled development banks unnecessary. They cannot compete and hence cannot mobilize the appropriate resources for development financing. At this stage, development banks become financially and institutionally weak. Therefore, the appropriate action is either to close or restructure them. Restructuring these institutions requires professional boards of directors, trained management and competitive salaries.[32]

Development banks are only useful if they can successfully mobilize appropriate resources for long-term lending. Institutions that wholly depend on foreign resources will not achieve their developmental objectives in a financially competitive environment, especially when excessive government influence is experienced. This only makes these development banks inflexible with respect to desired changes. External lenders may not be keen at this point to lend to these banks. Such external lenders like the World Bank are left with no choice but to press for restructuring of these institutions to allow them to operate commercially. In other words, governments do not need development banks in order to accelerate their economic development process if such institutions cannot adjust to the changes in their operating environments.

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[32]World Bank, _op. cit._, p. 106.

CHAPTER TWO

2. DEVELOPMENT BANKING IN KENYA[33]

2.1 An overview

The first development finance institution (DFI) in Kenya was established in 1954 as a statutory body under the name of Industrial Development Corporation (IDC) and commenced operations on 15th February, 1955 with its offices in Nairobi.[34] The original purpose of IDC was to facilitate industrial and economic development of Kenya by initiation, assistance or expansion of industrial, commercial or other undertakings in Kenya. The functions and objectives were defined in general terms with no limitations as to the sectoral and regional scope of its operations or the size of its investments.

In the fiscal year 1963/64, another new company was formed, the Development Finance Company of Kenya (DFCK). This company was established to finance and promote large-scale projects. It was therefore formed with specified objectives. The founder shareholders of this company were IDC, which represented the Kenya government;

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[33]In this section the terms 'Development Bank' and 'Development Finance Institution (DFI)" should be understood to be synonymous.

[34]H. Harlander and D. Mezger, Development Banking in Africa, Weltforum-Verlag, München, 1971, pp. 148-183 passim.

Commonwealth Development Corporation (CDC); and Deutsche Enwicklungsgesellschaft (DEG). In 1967 Nederlandse Overseas se Financierings-Maatschappij, N.V. (NOFM) joined as the fourth partner.

The creation of DFCK did not limit IDC's operations. The nature and scope of IDC's operations necessitated a change of name to reflect the corporation's wide range of operations, however. Therefore the Industrial Development (Amendment) Act of 1967 changed the corporation's name to Industrial and Commercial Development Corporation (ICDC), the name still in use. In June 1967, it was decided that a specific company be formed to manage the Kenya industrial estates which were previously under ICDC's area of operations.[35] This separate company was called Kenya Industrial Estates Limited (KIE) and was incorporated as a wholly-owned ICDC subsidiary.

Although ICDC had shares in DFCK, the latter was predominantly a private institution. It has retained this status through the present time. Thus, ICDC and its subsidiary KIE were the first wholly government-sponsored development finance institutions. The ICDC was charged with the provision of finance to enterprises which were of long-term value to the country, regardless of their profitability. In fact the 1966-1970 development plan spelled out that one of the corporation's objectives was "to make marginal projects economic".[36] Instead of

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[35]An industrial estate according to the 1966-1970 development plan was defined as an integrated organization of individual enterprises under its own manager with common infrastructural and advisory services. The purpose of such an organization is to assist small entrepreneurs.

[36]Government of Kenya: Development Plan 1966-1970, Government Printer, Nairobi, p. 242.

financing and promoting projects based on thorough feasibility and market studies, ICDC was required to undertake projects that were given to it. Consequently the operations of the corporation during that plan period were not based on any systematic development policy based on adequate research.[37] However, due to continued government support at the time and later diversification of its operations in a number of subsidiary companies, ICDC survived to continue with its main objective of industrial promotion and enhancement of Africanization of industry and trade.

Tourism has always been a major foreign exchange earner for Kenya. This is clearly demonstrated by the existence of Kenya Tourist Development Corporation (KTDC). The KTDC was created by an Act of Parliament towards the end of 1965. Its main objective was to provide comprehensive planning of tourist activities and subsequent investment in tourism. The corporation was expected to provide financial and technical assistance to the sector, especially in the development of facilities such as hotels, lodges and beaches. Government investment and foreign resources were expected to be channelled to this sector through the KTDC. This corporation, with its subsidiary company, African Tours and Hotels Limited (AT&H) has continued to develop tourist facilities on the basis of its initial objectives. It has so far succeeded in promoting tourism in all distinct centres in the country. This has been possible through two programmes; the Commercial Loan Programe, which has been used to extend credit to commercially viable

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[37]H. Harlander and D. Mezger, op. cit., p. 163.

projects and the Revolving Fund Programme (RFP), which is mainly used to provide credit to indigenous Kenyans to enable them to set up catering and hotel facilities in various distinct centres, who would not otherwise get financial assistance from commercial banks.

January 1973 saw the establishment of another development finance institution, the Industrial Development Bank (IDB) Limited. This is a government-owned bank through direct share-holding and also through the share-holding of other government parastatals, which include ICDC, Kenya National Assurance (KNA), Kenya Reinsurance Corporation (KRE) and National Bank of Kenya (NBK).[38] The original shareholders of IDB were the ICDC and the Kenya government. The basic purpose of this institution was to support Kenya's industrialization through the mobilization of resources to finance the establishment of medium and large scale industrial enterprises.

The other development bank that operates in Kenya is the East African Development Bank (EADB) which was formed in 1967 through the East African Cooperation Treaty. Its purpose was to assist in the economic and social development of Kenya, Uganda and Tanzania. After the break-up of the East African community in 1977, it still remained to carry on with its established objectives. In Kenya, the bank has participated in co-financing of projects with other development finance institutions.

The foregoing overview indicates that four of the six development finance institutions are owned by the Kenya government. These are ICDC,

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[38]IDB, The IDB Corporate Plan, unpublished, Annex 1, page 3.

KIE, IDB and KTDC. The government has also minority interests in the other two, the DFCK and EADB. In Kenya, development finance institutions take the form of parastatal corporations and semi-commercial companies, as in the case of ICDC, whose operations spread to ownership of departmental stores, taxi services, insurance brokerage and cinema theatres.

2.2. Role of Development Banks in Kenya's Development Policy Objectives

In Kenya, the operations of development banks are closely tied up with government policy guidelines. Their impact in the economic development process may be assessed by examining the successes or failures of the developmental projects that have been financed by them. The success of such projects in promoting economic development is a function of their ability to produce benefits to the economy; in particular, employment opportunities, domestic income, or foreign exchange earnings.[39] Development banks have a role to play in promoting local enterprises and industry. These institutions supplement the gap in Kenya's financial system, which commercial banks have been unable or are unwilling to fill.

As a government policy, capital formation has been a key concern for the DFIs. They have consistently participated in this area by

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[39]Details of this aspect of financing are explicitly dealt with in Shirley Boskey's Problems and practices of development banks. The Johns Hopkins Press, Baltimore, 1959, pp. 50-56.

investing in new investments. Development of industrial and commercial sectors have been accorded high priority by the government. These sectors, which then form the priority areas for development bank lending, have witnessed rapid growth with their share in the overall gross domestic product (GDP) increasing from 8 percent in 1963 to over 26 percent in 1987.[40]

Industrial and commercial development has been instrumental for Kenya's various policy objectives which include (i) increasing employment opportunities, (ii) diversification in the country's earnings through increased export potential, (iii) rural-urban balance development strategy, (iv) technological development through developing indigenous talents and technologies and also assisting in the acquisition, adoption and assimilation of foreign technologies.[41]

Real gross domestic product from the manufacturing sector has been increasing over recent years in absolute terms, ranging from K£370.47 million in 1983 to K£736.44 in 1988 at 1985 prices, as seen in Table 1 below. On average, the real GDP growth rate was 14.9 percent during 1983-88 period. This impressive growth rate may generally be attributed to liberal allocation of foreign exchange for raw material imports and adequate supplies of local raw materials, especially for the agro-based industries. During the same period, real gross capital formation grew at an average of 18.2 percent. The fact that this growth rate was

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[40]Government of Kenya, Development Plan 1988-93, Government Printer, Nairobi, p. 139.

[41]Ibid., Chapter 7, Passim.

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higher than the GDP growth rate, implies that capacity utilization has decreased in recent years, notwithstanding the absence of time series data on industrial capacity utilization. Given that during 1983-1988, the incremental capital to output ratio (ICOR) from the manufacturing sector showed an increasing trend, it implies there was a decrease in efficiency of investment in the sector. However, the future growth of the manufacturing sector depends on higher investment levels coupled with optimal capacity utilization.

In 1988, the manufacturing sector employed a total of 170,300 people which was about 13.5 percent of the total wage employment in the country (Table II below). Over the 1983-88 period, manufacturing sector employment grew at about 2.8 percent amounting to 4,300 new employees per year. The ratio of output growth to employment growth showed an increasing trend such that, on average, it was 3.24. This may have been the case due to some relatively rapid growth of capital intensive industries.

The development and growth of the industrial sector depends, in part, on the creation of new projects. In other words, the speed with which new industrial enterprises are setup will indicate the industrial growth potential. However, effective industrial development depends on the financial viability of any such new and existing projects. Appropriate financiang and effective management of projects are key elements to successful project operations. The operations of development banks in promoting such investments are therefore vital in so far as the industrial growth process is concerned. While the DFIs

have continued to pursue their policy objectives in promoting the industrial sector, an equally significant level of commercial lending has been and continues to be an alternative source of funds, especially where short-term financing is required. Not only do the DFIs finance new projects but also those that are already established. The kind of funding that may be given to such enterprises may be for expansion programmes or any other related area aimed at efficient production of the industry.

Table I

Manufacturing Sector: Real Gross Domestic Product and Real Gross Capital Formation, (1985 Prices)

K£Millions

Year	Gross Domestic Product	Gross Capital Formation
1983	370.47	99.99
1984	418.29	91.08
1985	458.36	89.97
1986	585.36	155.28
1987	656.03	168.34
1988*	736.44	201.98

*Provisional

Source: Economic Survey: various issues and the author's calculations.

Table II

Employment in Manufacturing ('000)

1983	1984	1985	1986	1987	1988
148.8	153.1	159.8	164.8	169.7	170.3

Table III

Average Earnings Per Employee (1985 Prices), K£

1983	1984	1985	1986	1987	1988
926.19	1,007.89	1,030.86	1222.81	1,350.67	1,497.88

Source: Economic Survey: Various issues and author's calculations.

The changes in project approvals and expenditures by the four development banks charged by the government to foster industrial expansion between 1983 and 1988 are shown in below in Table IV.

Table IV

Industrial Projects Approved by Selected Government or Quasi-Government Institutions, 1983-1988

Institution	Number of Projects					
	1983	1984	1985	1986	1987	1988
IDB	2	6	6	10	18	15
DFCK	22	12	13	10	12	4
KIE	139	114	229	411	164	205
ICDC	7	8	9	12	15	14
TOTAL	170	140	257	443	209	238

Institution	Approval Expenditure 1985 prices (K£Million)*[42]					
	1983	1984	1985	1986	1987	1988*
IDB	2.38	2.23	2.94	5.44	10.74	6.02
DFCK	2.33	3.38	5.83	4.07	5.82	0.64
KIE	2.16	1.89	1.83	4.17	2.32	3.06
ICDC	1.19	3.23	1.64	5.83	7.25	2.83
TOTAL	8.06	10.73	12.24	19.51	26.13	12.55

*Provisional

Source: Calculated from figures in various Economic Surveys.

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[42]Approval expenditure does not necessarily imply amount of funds disbursed to projects. It is possible that the funds approved in a given year may not have been fully disbursed in that year, or alternatively, funds disbursed in a given year may have been approved in the previous year.

On average KIE approved more projects than any of the other institutions, but didn't necessarily spend more. KIE, which lends the bulk of its resources to small enterprises (Ksh 20,000-200,000) in local funds, has continued to attract many local entrepreneurs. In 1986 for instance, KIE approved 411 projects with a high amount of local currency funds committed compared to other years of its funding performance. The good performance by KIE can be attributed to the good improvement in Kenya's economic performance during the year. Low prices of oil and an adequate supply of agro-based raw materials were crucial factors to the establishment of small scale processing industries.[43] Most of KIE's projects were grain mills in various rural areas, while others included wood, furniture and bakery products industries. All these projects are easy to establish given the readily available raw materials. Such circumstances, in part, illustrate why this institution showed a remarkable performance, in terms of projects approved, in 1986. However, KIE has also experienced serious problems in recycling its loans primarily due to the arrears which sometimes leads to a higher number of write-offs than the other institutions.

In terms of the average figures for projects approved over the period 1983-1988, KIE ranks first due to the reasons already discussed. This is followed by DFCK, ICDC and IDB in that order. However, in terms of the average amount of funds committed, IDB leads, followed by DFCK, ICDC and KIE. Even though institutions like IDB, DFCK and ICDC record

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[43]Size is here measured by the number of workers. In Kenya, 'small' will generally be taken to mean 1-49 workers. Size is also sometimes measured by capital employed.

relatively low project approvals, it is also true that they are involved in the financing of large capital-intensive investments which require great amounts of financial resources. This is as opposed to KIE whose investment portfolio involves small and largely labour-intensive enterprises. While the changes in the DFIs operations for each particular year are not so drastic, other than for the already discussed case of KIE in 1986, DFCK's operations were particularly affected in 1988. This company's 1988 operations were adversely affected by the 1988 devaluation of the Kenya shilling against the major world currencies. This adverse effect was also felt by the IDB and ICDC.

Foreign exchange risk is a major factor inhibiting the successful operation of development banks in Kenya. For those institutions whose loans are denominated in foreign currency, project approvals have been dictated by external conditions such as the weakening of the Kenya shilling against the major world currencies. The 1988 devaluation of the Kenya shilling made development banks' funds unattractive to investors; hence, there was a fall in the number of projects approved by IDB, DFCK and ICDC. Even though IDB and ICDC do not show as drastic declines in approvals as did DFCK in 1988, they also did not approve many new projects. Most of their investment approvals were for expansion of existing projects and assisting those that were experiencing serious liquidity problems due to poor management.

Each of these institutions emphasises particular areas of the industrial sector at any given time, depending on their sectoral exposures. For instance, in 1988 IDB concentrated in chemical, food,

textile industries as well as imported spare parts and raw materials for industry. DFCK concentrated its activities in clothing, bakery and water drilling. KIE's operations were widely spread into food, textiles, clothing and leather, wood and furniture, metal products, printing and publishing industries. ICDC's emphasis was on the rehabilitation of its existing projects or strengthening the equity base of those projects that required such assistance.

In terms of real capital formation, the DFIs' total investment during the 1983-88 period was 11.1 percent of the gross fixed capital formation in the manufacturing sector (see tables I and V). Capital formation in the manufacturing sector, where the DFIs are involved, was 13.8 percent of the total gross investment in the economy (see tables I and VI). Hence, overall, the DFIs contributed 1.5 percent of the country's total fixed investment. The DFIs contribution to capital formation in the manufacturing sector is generally significant, given the size of this sector. But this has not been easy and it is not anticipated to be any easier, under the present circumstances in which the DFIs are operating. These institutions have had serious portfolio problems attributable to weak accountability, poor financial practices and huge foreign exchange losses. In fact the DFIs have been incapable of providing the required level of domestic long-term finance to support long-term projects in the industrial sector. The great growth potential of the sector has required a lot of financial assistance from all sources. The long-term lending conditions associated with the DFIs' finances are usually appropriate for this kind of long-term industrial

financing. Since the manufacturing sector incomes grew by 5.3 percent during the 1983-1988 period and are projected to grow at 6.4 percent during 1989-1993, there is significant growth potential in this sector.

Table V

Total Investment of the DFIs in the Manufacturing Sector 1983-88 (1985 prices) K£million (cumulative)

IDB	29.75
DFCK	22.07
KIE	15.43
ICDC	21.97
Total	89.22

Source: Calculated from figures in various Economic Surveys.

Table VI

Gross Capital Formation: All Sectors (1985 prices) K£million

1983	1984	1985	1986	1987	1988*
646.54	694.56	778.42	1109.93	1223.14	1377.30

*Provisional

Source: Calculated from figures in various Economic Surveys.

Table VII

Actual Inflation Rates

1983	1984	1985	1986	1987	1988
11.5	10.2	13.1	3.9	5.2	8.3

Sources: Calculated from the consumer prices at 1985 prices.

In addition to the contribution of these institutions towards capital formation, creation of employment is another important feature. These development banks have assisted in the creation of direct jobs in the enterprises they have financed, and also indirectly through the linkage effects of these industries. Employment projections may be realized only if industries operate with more labour-intensive technologies and at relatively full capacity utilization. However, more labour intensive technology is not necessarily an advantage regarding long-term competitiveness of industries. Labour-intensive industries could generate more employment at the expense of either modernization or at the expense of rising productivity and efficiency. This might be a serious short-coming of industrial development in the long-run. The Kenyan experience of labour-intensive industries is that they are small-scale and geographically dispersed. The success rate of these enterprises has usually been low due to inadequate management and inappropriate funding. This implies that, even though there is the potential for increased employment, there is a need for increased soft

lending terms by the development banks and intensive supervision both during and after implementation of the project.[44]

Most, if not all, of the small-scale projects do not benefit from the bulk of the foreign resources that may be available due to foreign exchange risks and the nature of their operations. The major problem with these projects, even with local currency funding, is inadequate management. There is lack of basic skills in accounting and marketing. These projects often operate as family enterprises and hence cannot hire qualified managers. While promotion of local entrepreneurs has been the main emphasis of Kenya's economic development policies, difficulty in identifying viable projects has been a major setback. Local enterprises to be promoted are usually small or medium-scale which pose significant problems to the DFIs since they are difficult to supervise and their default rate is high. Not only are these projects a burden in the DFIs' investment portfolios, but they are equally problematic to the country. Thus, there are problems to overcome, especially with regard to realizing specific policy objectives; for instance, development of local entrepreneurial skills, industrial expansion or employment creation. But with the provision of relevant information services to these enterprises, the ability to reduce losses incurred by the small businesses and the development of the wage sector in Kenya could be greatly enhanced. This promotional role by development banks has not been given particular attention in Kenya. There has been very little commitment by these banks in the education of local entrepreneurs for

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[44]IDB, Historical background, achievements, problems and future prospects, February 1989, (unpublished), p. 4.

effective management. This kind of inadequacy on the part of development banks may be attributed to lack of resources to effect such training programmes and the general laxity of the bank manangement.

In terms of industrial diversification, in line with Kenya's policy of district focus for rural development strategy that came into force in 1983, there has been some emphasis to promote projects away from major cities. However, this is not to suggest that there has been great success in locating industrial projects in the rural areas of Kenya. Even though many of the financed projects were initially located away from the major cities, the observation is that such projects are now found in towns which have developed into relatively large urban centres in recent years. As for large industrial projects, mostly promoted by IDB, DFCK and ICDC, the possibility of being located in very small town centres in quite minimal. This is due to the nature of industrial infrastructure that the large projects require, such as telephone services, electricity and better roads. Therefore, with the recent rapid development of Kenya's urbanisation, development banks have not been successful in promoting rural-based industries. In fact Kenya's pattern of industrial location has, in part, continued to encourage large rural-urban migration, which has serious economic implications in the urban centres.

For an effective reduction of rural-urban imbalance, it is the responsibility of the policymakers to provide development strategies aimed at providing the basic necessary infrastructure in the rural areas, such as roads, electricity and telephone services. This will encourage the investors to locate their industries in the rural areas,

especially the agro-based industries. It is under such comprehensive policies that development banks can be successful in their participation in rural industrialization.

2.3. Operations of Development Banks in Kenya

Operations of development banks in Kenya are largely a function of the kind of financial resources available to them. The source and adequacy of their financial resources are the key elements of their operational processes. Such resources determine the extent of their success in the realization of their objectives as set out in their operational policies. In other words, adequate and appropriate resources will assist more projects than in a situation of limited resources. Appropriateness of resources imply that both small and large scale enterprises can easily utilize them without undue constraints such as foreign exchange risk.

Development banks are financed through domestic and foreign borrowing in addition to share capital. The three forms of financing of these institutions are basically the forms by which they mobilize their financial resources. Domestic mobilization of resources involves: a) cash generation out of operations, b) share capital and c) domestic borrowing by public bond flotation process.

The extent to which development banks utilize their internal cash generation as a source of funds for new investments is very crucial. The term loans are expected to be repaid with interest such that a revolving process of funds into new investments can be maintained. This

is also true for equity investments from which dividends are earned. In Kenya the success of this process has not been fully realized. This has been due to the DFIs' poor portfolio investments. Poor portfolio investments, in part, relate to the source of funds. Projects that are largely financed through foreign lines of credit are likely to experience more difficulties than those which utilize local currency funds, due to possible foreign currency fluctuations as already indicated. But again, the key element of success for any project depends largely on its internal management. Therefore, even with unprofitable investments, there are viable projects, meaning that companies that have been financed by the DFIs and are not in arrears in their loan repayments. For a project to be classified as being without problems, it must not be in arrears in its financial obligations with its lenders. It should also be capable of meeting such obligations in the future. In the Kenyan experience, not many such projects are held in the DFIs' portfolio investments.[45] Experience shows that the viable projects are mainly private with local or foreign ownership. The isolated cases of public projects that have recorded acceptable returns in their operations are usually those that produce for the domestic market under protective policies put in place by the government.

There are then those projects that are classified as problem projects.[46] These range from those with what are considered to be

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[45]Deloitte Haskins and Sells Management Consultants Ltd., DFIs Study in Kenya (1989), vol. 1, (unpublished), passim.

[46]We are using IDB's reports for classification of projects which are not significantly different from the other DFIs classifications.

moderate problems to those with serious problems. Projects may be seen to be repaying well but their ability to sustain such repayments in the future is not feasible. There are others that do not make regular loan repayments and in fact others simply do not pay at all. This category of projects apparently form the greatest portion of the DFIs' investments.[47] They all have working capital problems, management inadequacies, capacity under-utilization, poor marketing and technical problems with machinery and equipment.[48] Whenever it is necessary for the DFIs to liquidate such projects, losses are usually incurred since the assets of such projects cannot cover the loan amounts in arrears. This is a major problem for the DFIs, given that such assets offered as security may be functionally obsolete with a short economic life due to physical deterioration. This implies that at the time of liquidation, a low value is received for them compared to the total indebtedness of the project under liquidation.

The Kenyan DFIs generally invest in new and expanding companies which do not have access to a stock market as a possible source of finance. This implies that it is not possible to assess the market value of equity investments which are held by the DFIs in the various projects. The Kenyan stock market is not developed enough to allow these institutions to participate effectively in market operations for purposes of mobilizing domestic resources. Dividend earnings for the

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[47]Deloitte Haskins and Sells Management Consultants Ltd., DFIs Study in Kenya (1989), (unpublished), vol. 1, Sec. II & III, Passim.

[48]IDB Quarterly Reports various issues (in-house reports - not published).

DFIs from their investments are generally low given that most companies make losses. These kinds of equity investments held by the DFIs are not attractive to alternative investors and hence, if ever they were to be sold, ready buyers would not be available. Shares held in the various projects are not tradeable. This explains why Kenyan DFIs concentrate on making loans rather than equity investments. Pure equity investments form a very small proportion of their total exposure to projects. But still the loan investments are not good enough in the sense that most of the enterprises financed by the DFIs are loss-making entities as already discussed. Loan and interest repayments by these enterprises cannot generate an efficient source of funds for further investment in new projects. In general what is clear is that Kenya's DFIs' largely depend on the external resources for their term lending rather than the local resources, which is typical of a developing country.

Allocation of funds by the DFIs' is predominantly determined by government policies. Being development-oriented institutions, they are continually guided by government policies as emphasized in the development plans. However, as financial institutions they are supposed to take a keen interest in their investment procedures. They all carry out project appraisals before deciding on loan or equity approvals. However, it should be noted that appraisal procedures vary in intensity from one institution to another. Not all appraisal procedures may be carried out by some development banks. This is evidenced in the often very large debt-equity ratios in financed projects which ultimately close down due to heavy financial debts. Whenever a detailed project appraisal is undertaken, the key factors examined are location of

project, ownership, capital cost, owners' equity, management, technical, financial, economic and environmental aspects of the proposed project. Usually feasibility studies are presented to the management of the DFIs who are in turn supposed to make detailed analyses of such documents in accordance with the stipulated policy regulations concerning the lending process.

Due to government control over the operations of the DFIs, some projects presented for funding may be classified as developmental in which case a strict financial analysis may not be undertaken. Some of these projects end up being non-starters or loss making entities. This is evidenced from the Minister for Finance's statement in the Sessional Paper Number 5 of 1986 which states that "... the government in its endeavours to promote development in the country had given these projects financial support in persuading local banks to participate in raising the capital the projects required, ..., unfortunately, these projects began experiencing financial problems soon after inception for various reasons, such as poor marketing, poor management, and under-utilization of capacities".[49] This implies that although there is need for development projects to be viable, on the contrary a great number of them are not. Nevertheless, these projects are promoted on the assumption that they play strategic roles in the country's economic development process.

Viability of projects is an essential factor by itself to determine the allocation procedures among the development banks in

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[49]Quoted in the Weekly Review, November 21, 1986, p. 21.

Kenya. The major point is that these institutions operate within an environment that has a number of structural problems such that, although effective conventional project appraisals are done and viability ascertained, other microeconomic and macroeconomic changes affect the projects' profitability. Kenya, like any other developing country, is vulnerable to external economic changes and has to adjust her economic policies regularly to reflect such changes. These adjustments have to be absorbed by the country's financial system, of which development banks are hardest hit, since profitability of projects originally conceived as viable becomes difficult to achieve.

In summary, the general observation on Kenya's development banks is that, due to the nature of projects in which they are involved (ones where generally the private sector is not involved, or which are designed to create employment or fill gaps in production chains), the risk is often higher than in comparable projects where private interests are prevalent. The main risk involves low rate of return from such projects vis-a-vis the cost of capital, which consequently leads to cash shortfalls and foreclosures. Another relatively serious problem with the allocation of funds by the development banks relates to the debt/equity ratio. Whereas this is often stressed as an essential element for their participation in projects, many of these projects have been funded with low equity and high debt levels. The consequences are usually disastrous since such projects will never attract other prospective investors and will continue to accumulate arrears in their interest and principal loan repayments. Such a phenomenon implies that the vicious cycle of inadequate domestic resources for Kenya's DFIs will

continue to persist. The eventual result is the overall poor performance of these institutions which are expected to stimulate economic development.

This brief analysis of Kenya's development banks shows their general background and operations. The main common feature with them is the nature of their portfolio investments of which a large percentage constitutes poorly performing projects. The poor performance of these investments affects the viability of the development banks. Local resource mobilization is then not feasible because of such poor performing projects. But even though failures of the projects funded by the DFIs are evident, overall, their participation in Kenya's economic development, especially the industrial sector, ought not to be underestimated. Directed credit programmes to industry, state-owned enterprises, small and medium firms and underdeveloped regions have been undertaken through the development banks. In fact, the growth rate of the manufacturing sector in recent years (6.0 percent in 1988) may justify the need for continued existence of these banks to provide long-term financing. However, this may not necessarily be the case under the present operation of these institutions but rather with specific restructuring of their policies.

Government policies affect them all insofar as their developmental roles are concerned. Government policy objectives in place during any development plan period have a specific impact on the type and nature of projects financed and promoted. Such policies affect the country's investment infrastructure through some of the legislation that may be imposed. The kind of infrastructure that may result from government

policy will naturally have an impact on the type of projects in the DFIs' portfolios and also on their capacity to mobilize appropriate resources. This is a key role of the government in the operations of Kenya's DFIs. For those wholly government owned institutions (IDB, ICDC and KIE), the government has the sole discretion in appointing the chief executives and members to their boards. Managers appointed for political reasons are not usually qualified and are generally susceptible to unnecessary external pressures in making loans. The Kenyan DFIs will only perform their well intended functions and compete effectively within the country's financial system if professional boards of directors, trained management and competitive staff are maintained.

CHAPTER THREE

3.0 THE INDUSTRIAL DEVELOPMENT BANK LIMITED (IDB)[50]

3.1 Origin

The IDB was incorporated in January 1973 to promote Kenya's industrial development through the mobilization of suitable resources. Its purpose was to assist the establishment and growth of medium and large scale industrial enterprises.[51] The bank was expected to become a major channel for the inflow of institutional foreign capital and technology and a vehicle for accelerated local participation in the Kenyan industrial sector. The initial shareholders of the bank were the Kenya government and the Industrial and Commercial Development Corporation (ICDC). The IDB started with an authorized share capital of Ksh 40 million and by the end of 1973, the paid-up capital was Ksh 17.5 million. ICDC held 51 percent of the shares while the government held 49 percent. This was in accordance with an earlier promotional agreement signed by the two partners in 18 December 1972.[52] The bank commenced operations towards the end of 1973.

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[50]The analysis is based on the bank's annual reports, unpublished management papers and our knowledge of the institution.

[51]Medium scale industries are those with total capital costs, including permanent working capital, of between Ksh 1 million and Ksh 10 million. Large scale industries have corresponding costs that are above Ksh 10 million.

[52]IDB, Annual Report and Accounts 1974, p. 6, published in Nairobi.

At the time of inception, Kenya's industrial base was relatively small. The industrial sector was dominated by non-indigenous and foreign firms with the manufacturing sector contributing about 12 percent of the gross domestic product (GDP).[53] The early phase of Kenya's industrialization process laid emphasis on indigenization[54] and promotion of import substitution industries since most capital, consumer and agricultural inputs were imported at the time. The financing and promotion of such industries were considered crucial in Kenya's industrial development. Whereas the existing development finance institutions at the time provided term loans to the industrial sector, IDB became a major source of long term financing with the bulk of its funds denominated in hard currencies. By end of its first year of operations, IDB had negotiated DM 4 million (Ksh 12 million equivalent) from the German Development Company (DEG), £1 million (Ksh 17.3 million equivalent) from Morgan Grenfell and Co. Ltd. of London and 10 million Finnish marks (Ksh 20 million equivalent) from the Government of Finland. These sources of foreign funds were in addition to a major World Bank line of credit extended to the bank in 1973 (US$ 5 million). These initial negotiations by IDB were perhaps good signs of the bank's vital role in mobilizing foreign resources for industrial development.

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[53]Government of Kenya, Economic Survey, 1975, Government Printer, Table 2.4, p. 10.

[54]Indigenization refers to a policy aimed at encouraging indigenous Kenyans to participate in the ownership and management of industrial enterprises. It is synonymous with the Africanization policy mentioned in the preceding chapter.

The very first investments of the bank were in projects that heavily utilized locally available raw materials as inputs. This move was in line with the government policy objective that required a substantial reduction in imports and a subsequent improvement of the balance of payments position. Creation of employment was an equally important consideration in the promotion of projects. Therefore, projects which initially received IDB's financial assistance were appraised on the basis of such existing policy objectives. Effectively, government policy guidelines were crucial to the bank's operations at the time and have continued to remain so until the present time.

3.2. Organization and Objectives

The IDB has four departments, namely establishment, operations, finance and accounting, and legal. Each department is under a head of department with a number of divisional managers and officers. The day-to-day running of the bank is done by a Board of Directors (BOD) with a full-time managing and deputy managing director. The directors are appointed by the government for a term of three years. The BOD is the policy-making body of the bank. The managing director is the administrative head of the bank. He exercises the overall supervisory control and is therefore charged with the responsibility of effective management of the institution. The bank falls under the Ministry of Industry but also, as a financial institution, it derives some of its financial policy guidelines from the Ministry of Finance.

IDB's Statement of Policy and Regulations, as formulated in 1973, outlines the operational policies and procedures designed to achieve the bank's objectives. Broadly the bank is expected to mobilize both local and foreign resources to finance the establishment of medium and large-scale manufacturing projects in mining, agro-industries, engineering, tourism, transport and shipping. Each investment should normally have a total project cost of over Ksh 1 million with the bank not participating in more than 50 percent or less than Ksh 400,000 of this cost, except for special considerations given to expansion programmes of existing industries. The bank's participation can either be through one or more forms: medium or long-term finance, direct equity investment, provision of guarantees for funds from other sources, or underwriting of security issues and other similar obligations. The bank will not engage in purely commercial and farming operations, real estate, refinancing or transfer of existing assets.[55]

These policy objectives were and are supposed to promote the industrialization process in Kenya. The initial government strategy for industrialization, as already mentioned, was geared towards the promotion of import-substitution industries. This later changed to the promotion of production for export with minimal protection of the local industries. These strategies have always been integrated into the bank's operational policies regarding its investments. Given that IDB was intended to mobilize external resources, it meant that it was to act as a medium between the government and the multilateral or bilateral

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[55]Details of policy and regulation of the bank are found in pages 4-5 of most Annual Reports published by IDB, Nairobi, Kenya.

financial institutions. Through the necessary government guarantees, the bank was expected to acquire foreign resources and channel them to the industrial sector in line with its policy objectives, implying that IDB was administering such funds on behalf of the government.

As a development finance institution, IDB has regarded its role as being primarily developmental thus providing concessionary or soft long-term financing. Such a role has been predominantly a function of the sources of its financial resources. The source of the bank's investment funds is highly correlated with the nature and type of projects promoted. This again refers to our earlier discussion in the previous chapter on the appropriateness of the available financial resources as they relate to the operations of the funded projects.

3.3. Mobilization of Resources

The possible sources of IDB's funds are government allocations, the bank's share capital, foreign currency, local loans and internal cash generation. The bank has not been involved in active open market operations as there has not been any well-developed stock market in Kenya for a long time. However, now that the government has encouraged one through the "capital markets development authority",[56] it is not clear how IDB will practically pursue its objectives to exploit it. It

[56]This is a government parastatal formed by an Act of Parliament in 1989 to start and coordinate an active stock market. It is expected that the organization will widen the scope of activities for the stock market which has for long been monopolized by the Nairobi Stock Exchange. The Nairobi stock exchange has been dealing only with limited securities for selected companies.

is expected that IDB, along with other financial institutions, will take advantage of its existence, to participate and develop it since it will form a significant source of local currency resources.

Kenya, like many other developing countries, has a number of internal and external imbalances that necessitate various changes in government priorities over time in the overall economic development process of the country. Government priorities and budgetary constraints make it difficult for the Treasury to make frequent allocations of funds to IDB. This implies that this is not (and has not been) a reliable source of investment funds for the bank. With regard to the bank's share capital, paid-up share capital has always been below the authorized share capital. It has always been in arrears. The share holders, which are other government parastatals, expect the bank to be self-sufficient by way of revolving the loans advanced, and above all, these shareholders themselves lack the resources to meet their share capital obligations. At its 17th anniversary IDB's paid up capital was 64.4 percent of the authorized amount. Even though the bank may not be under-capitalized, its share capital is an inadequate source of funds for effective investment.

Local currency resources are the most appropriate form of development funds. Such funds are ideal for financing medium-scale indigenously-owned projects. These kinds of projects very often require local currency loan and equity funds. The IDB has not been successful in mobilizing local resources for long-term financing. As a development bank it cannot effectively particpate in the creation of deposits and credit as the commerical banks. Deposit creation is a method by which

banks can finance their portfolio earning assets by issuing their own liabilities. Such liabilities must be offered at some sufficiently attractive yield that asset holders will be willing to take into their portfolios. In essence when banks create deposits, they simultaneiously create credit. Therefore, the difference between the lending rate (an element of credit creation) and the deposit rate forms the revenue for the banks. As a development bank, IDB cannot borrow short-term and lend long-term. Short-term borrowing by IDB implies issuing its liabilities at a rate high enough to attract private domestic savers in the short-run. However, the bank is not able to offer such a rate given that it lends long-term at lower interest rates than the short-term deposit rate. The problem of mobilizing local currency resources is further aggravated by the fact that a number of IDB funded projects have performed poorly. Loan repayment and interest income from such projects are not a reliable source of funds for further investments in new projects. Where the bank participates in equity financing of projects, expected returns in the form of dividends are also not any better. This means that IDB cannot recycle funds from its investments to new undertakings, which further restricts its abilities to fund projects.

The generally poor portfolio investment of the bank has a serious negative effect on its reserves and retained earnings. The inability of the projects to service their loans means that IDB has to use its own resources (reserves and retained earnings) to pay and avoid default to its principal lenders. Such action severely strains the bank's cashflow and its eventual liquidity position.

In terms of resource mobilization, IDB has been relatively successful in mobilizing external resources for its foreign currency lending requirements. For instance, between 1980 and 1985, it mobilized an equivalent of US$65 million from the World Bank, BADEA, Swiss mixed credit and ADB.[57] There are a number of external sources of funds that the bank has utilized since its inception and continues to do so since foreign currency has remained a substantial source of its development funds. Some of these external sources include ADB, IBRD, EIB, BADEA, IDBI, ECGD, DEG, EXIM bank and Swiss credit. However, given the nature of these funds, the bank views that "foreign currency funds are not ideally suited for development financing,"[58] for a number of reasons. First, foreign funds have a foreign exchange risk inherent in them which means that possible foreign currency fluctuations against the Kenya shilling makes them very expensive. Second, some of these funds are in tied lines of credit which further makes them inappropriate to prospective borrowers because it requires them to acquire machinery and equipment from sources which may not be subject to competitive bidding. Despite these short-comings, the bank has continued to make use of this source to promote industrial development in the country. This is basically the only major source of funds available.

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[57]World Bank, Project Completion Report, March 7, 1988, p. 14.

[58]IDB, Towards Improved Performance, (unpublished), June 1987, p. 15.

3.4. Resource allocation

Over the period of IDB's existence, the government has produced four five-year development plans: 1974-79, 1979-83, 1983-88 and 1988-93. While the first dealt with imported inflation and import substitution, the 1979-83 plan emphasized structural adjustments, resource utilization, efficiency and export production. The 1983-88 plan emphasized mobilization of domestic resources, decentralization of development to rural and semi-urban areas, and it further emphasized the critical level reached in the country's debt servicing, meaning that there was great concern over the country's foreign earnings capacity. Emphasis was on less imports of consumer goods and more production for export. The current 1988-93 plan re-emphasizes export production and employment creation. Each of these strategies constitutes IDB's policy framework and the changes in policy emphasis have various implications for the bank's operations and allocation of resources.

The IDB has predominantly been guided by its set objectives in its equity and loan investment allocations. Such objectives have generally been pursued in accordance with specific government policies. The bank usually undertakes a detailed project appraisal with a view to determine the viability of the project to be financed. Areas usually covered in the appraisal process include economic and financial viability, management capabilities and technical feasibility.

By economic appraisal is meant the ability of the project to contribute to the creation of employment, its effectiveness in local resource utilization, its export potential and hence its ability to earn

the country needed foreign exchange. The economic aspects further include the question of industrial diversification. The bank usually seeks to diversify its investments both geographically and by industrial sectors, the reason is that it is required to participate in the promotion of overall industrial development in the country without undue sacrifice of any particular region or sector. This is basically a government policy objective which, for all practical purposes, is not largely achieved, due to relatively poor infrastructural development.

Economic appraisal is tied up with technological appraisal. The link is through the appropriateness of the technology as it relates to the local entrepreneur's ability to handle it and hence participate effectively in the industrial promotion process. Imported technology should be adaptable easily without long training programmes for local entrepreneurs. Machinery and equipment that is imported is supposed to conform to the expected plant capacity utilization. The IDB takes a keen interest in this aspect since there are usually discrepancies between the overall installed plant capacity[59] and the actual plant capacity utilization. Such discrepancies may be due to some defects or inappropriateness of the installed equipment with different processing capabilities. Effectively, projects may end up operating at excess plant capacity. Any such irregular operations often have adverse effects on the profitability of the project.

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[59]This refers to the processing capability of the machinery which may be measured in units of quantity (Kgs, tons, mts. etc.) per some time period i.e., minute, hour, day, etc.

Financial appraisal is essential since it is by this means that IDB determines the viability of the project. The success of projects funded by the bank in turn determines the viability of IDB itself. Here, traditional financial ratios are used. The financial rate of return of a project is calculated and compared to the cost of capital.[80] Debt-equity ratios are analyzed to determine the level of capitalization of a project. Although this is quite crucial, what has happened over the years with some of IDB's medium and large scale projects is that they are under-capitalized. The main reason for this phenomenon has been that the percentage of the shareholders' own funds to the total project cost is often very small due to misinformation by the project sponsors during the initial appraisal stages. This means that these projects depend heavily on borrowed capital for start-up and operations. The inevitable financial burden on such debt-financed projects results from shareholders not having the necessary resources to eject into the projects for efficient operations. While IDB approves projects partly because a specific debt/equity ratio is satisfied (promised), for all practical purposes, such a ratio does not necessarily hold in reality. The bank cannot effectively assess the actual cash held by the project sponsors since no cash deposit accounts are maintained with IDB.

Other ratios examined include current ratio, debt coverage, return on assets, fixed asset cover and return on equity. One point to note is that, being a development bank, some of these ratios are not strictly

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[80]The financial rate of return in Kenya is usually based on the current yield on Government Treasury Bonds.

adhered to, particularly when it involves a social project.[61] Another essential consideration in the appraisal procedure involves the ratio of value-added to gross sales. A project will be considered as an effective user of local raw materials if the ratio of net value-added to gross sales is less than the ratio of domestic value-added to gross sales. The trend has been for the bank to regard 30 percent as the minimum that can be acceptable for a project in the manufacturing sector.

All the financial analyses are carried out along with a market appraisal. This is carried out to determine the extent of the available market that the project intends to serve. The long-term success of a project depends upon the profits it can earn out of its operations. Availability of an effective market for what is to be produced is crucial if profits are to be realized. IDB considers a detailed market appraisal to be an important aspect of the overall project appraisal.

Management appraisal is yet another of the criteria used when deciding whether to fund a project. Adequate management is the key to the successful implementation and operation of projects. What the IDB usually requires is that the project sponsors possess relevant experience in the area they are interested to promote. In particular, it is essential for the project to be managed by competent personnel in key areas of operations, finance and administration. Under normal circumstances, the bank does not manage enterprises; however it

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[61]Social projects are ideally government-sponsored based on specific priority objectives. A classification of these projects is given in "Reconstruction of IDB, Appendix 1 on Classification of Projects in IDB Portfolio", (unpublished report).

endeavours to ensure the acquisition of competent management.[62] Even though this aspect of appraisal is carefully examined, experience has shown that management problems have continued to plague projects during and after the implementation period. Deficiencies in management are also found in such areas as technical, marketing, financial, planning and project design. These are problems frequently observed and noted in the quarterly project reports of the bank.

The bank approves its funds to individuals who may be indigenous Kenyans, foreigners with Kenyan registration or a combination of Kenyans and foreigners. Any of these groups of individuals have to apply for funding as an incorporated company. This is basically for the same reason given earlier, that the bank prefers a situation where the possibilities of future participation by other investors in the company exist. For the foreign or jointly-owned firms, the local shareholding usually must be the controlling share in the company. This condition is given a lot of weight, especially when the bank is utilizing an ADB line of credit. This line of credit specifies that beneficiaries should be Kenyans, which precludes any kind of foreign ownership.

The appraisal process may take a long time depending on the feasibility studies presented. Some prospective investors feel that the time lag between the submission of the application and approval is unnecessarily long. However, this is an area that requires careful examination by both the bank and the clients. It is possible that the bank is faced with no choice but to take a long time in the appraisal

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[62]IDB, "Statement of Policy and Regulations, No. 9", <u>IDB Annual Reports</u>, p. 4, IDB Publication, Nairobi.

and the approval processes. There are issues that the client usually has to settle before any steps towards approval are taken. More often there is deficient information with regard to the clients' share of the project's cost. The ability of the sponsors to implement a project depends on their own equity and this has to be ascertained.

Given complete and correct information, IDB has the capability to appraise a feasibility study report within three weeks by the use of relevant computer programmes that are available at the bank. Occasionally, delays do arise as a result of a shortage of appraisal officers. The bank has a problem keeping its personnel, as other organizations may offer better terms. Thus, there can be a heavy workload for the appraisal division to handle, given that the whole appraisal process does not end at the bank offices but involves site visiting. Approval of a project report is done at three levels of meetings. From the appraisal officer, the report is presented at the management and investment committees for discussion and approval. The final approval at the bank level is given by the Board which sits once a month or at such times as necessary. Overall, the bank's clients feel that delays in approvals and disbursements are the main cause of capital-cost escalations.

Regardless of such detailed appraisal, there is evidence of project failures. This does not necessarily imply poor project appraisal but rather, a number of other problems beyond the bank's control do affect project operations. Some of these problems include; foreign exchange risks, deficient project management and government regulations, especially for certain product prices. There are, also,

some inadequacies with the bank's monitoring procedures. What may be considered as a serious shortcoming of the appraisal techniques of the bank involves inadequate evaluation of the assumptions and information provided by project promoters. Project appraisal officers are usually inclined to rely on information provided by the promoters. Due to the bank's resource constraint, no frequent sectoral studies are carried out by the bank independently to assess the possibilities of effective investment in any one sector.

Monitoring and control of the borrowers has posed particular problems to IDB. The bank does not have the same day-to-day contact with its clients as the commercial banks; and hence, no current financial information on most projects is available. This deficient project information further complicates loan recovery. Moreover, in some instances where the bank has been encouraged by the government to assist particular projects, such projects may willingly default because of the belief that the bank cannot easily liquidate them, since they are assumed to be priority projects. Although these types of projects may not be many, the amount of money usually involved is quite huge.

Since IDB depends heavily on external funding sources, there is also external approval to be sought by the bank in order to draw an equivalent amount in foreign currency from a specific line of credit with respect to the project approved by the Board.[63] Depending on which line of credit is proposed, the bank sends a copy of the Board-

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[63]The bulk of IDB's funds have always been foreign currency denominated and hence the borrowers have to repay their loans in foreign currency equivalent at the time of making payments.

approved report to the external lender. Occasionally, some questions may be raised about the project by the external lender. Whenever such questions arise, the IDB management provide answers to whatever may be queried through the telex system to cut down any possible delays.

On average, it takes between 4 to 6 months from initial application to first disbursement. This period may vary depending on the number of questions raised during the appraisal process and how fast they are resolved.

After the necessary approvals have been granted, legal documentation starts and a large amount of time may pass at this stage. The delays usually experienced are due to the processing and registration of the documents offered as security with the relevant government ministries. The inevitable delays are caused by the government bureaucratic processes involved in these ministries.

The interest rate charged by IDB on the approved loan amount depends on the cost of the funds from the external lender. Thus, the interest rate is determined on the basis of the borrowing rate the bank pays for the foreign funds. A higher lending rate is always charged so that it may be possible for IDB to meet its financial obligations to the external lender and at the same time be able to meet its operational costs without requiring government budgetary allocations. However, it should be noted that such loan interest incomes are not generally sufficient to produce consistent profits for the bank. Other charges that may be paid by the bank to external lenders are ultimately passed

on to its clients.[64] For long-term financing the interest rate charged has been between 11 and 14½ percent. However, whenever local currency is used to provide financial assistance, a 19 percent rate is charged which is comparable to the commercial interest rate charged by financial institutions not dealing with exclusively long-term financing. The higher rate usually applies to short-term financial assistance, such as raw material financing.

3.5. IDB's role in Kenya's Economic Development Process

3.5.1 Sectoral Overview

The Kenyan economy has experienced a growing modern sector[65] since its independence in 1963. This growth has presented different problems and indeed new challenges and opportunities. The modern sector is expected to provide employment opportunities to the Kenyan population. Over 80 percent of Kenya's population live in the rural areas.[66] The urban-skewed development, coupled with a pyramidal

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[64]These charges/commission include commitment fees and rescheduling fees where applicable.

[65]Kenya is basically a mixed economy with the coexistence of the public and private sectors. The elements of the private sector are 1) small farmers and livestock herders, 2) the informal sector, which comprises of small-scale firms and the self-employed and 3) the modern large-scale farms and firms. It is this third element which we are referring to in this study; in particular, the industries. The public sector is essentially the government.

[66]Government of Kenya, Development Plan 1989-1993, Government Printer, Nairobi, Table 9.1, p. 198.

distribution of both demographic age and incomes, implies that the bulk of the population continues to suffer unemployment and low incomes with a high dependency ratio. However, government development policy objectives are now geared towards rural development for the purpose of increasing the earning capacities of the vast number of the rural population. The creation of employment opportunities is a major issue addressed by the policymakers. Each sector of the economy is expected to possess the potential to create jobs.

The manufacturing sector, which is of interest in this study, underwent tremendous expansion during the 1970s. This expansion was facilitated by the industrial development strategy which emphasized the promotion of import-substitution industries. As it continued to grow, it remained highly capital-intensive, import-dependent and highly protected. But the government changed its policy when it was realized that industries that were protected were operating inefficiently. In its fourth (1979-83), fifth (1983-88), and sixth (1988-93) development plans, the industrial development strategy adopted has emphasized export promotion, import liberalization, private sector development and job creation. Import liberalization has had an impact on the manufacturing sector in terms of efficiency. In other words, the open competition which is encouraged in the process necessitates the industrial enterprises to produce and distribute with some level of efficiency which would not be the case if they were protected. Liberal allocation of foreign exchange for raw material imports has in recent times contributed to positive increases in volume of output.

The growth rates from this sector, as shown in Table VIII below, indicate that there are wide variations in the annual growth rates. This is characteristic of any country that depends on a few products for export earnings. Such earnings usually have a strong influence on domestic incomes. The high growth rates in GDP recorded in 1976 through 1978 were basically due to the establishment of a vehicle assembly plant in 1976 and the high coffee prices of 1977/78. The vehicle assembly plant alone contributed about 40 percent of the sector's growth in terms of value added during the 1976/77 fiscal year. Gross domestic incomes improved significantly due to the high coffee prices while at the same time the terms of trade improved by about 32 percent in 1977. Although the world-wide recession of the early 1980's is reflected in the slow growth of the manufacturing sector, the 1982 political disturbances greatly contributed to the lowest growth rate ever recorded in the sector. The 1984 severe drought kept domestic incomes very low. This is clearly reflected in negative growth rate in the agricultural sector.

The "import-substitution" strategy stressed by the government during the 1970s contributed to the rapid growth rates over the period 1973-78. The manufacturing sector grew at an average of 11.1 percent per annum during this period. As already mentioned, this strategy resulted in the promotion of inefficient enterprises which could not compete externally and hence this necessitated a change of policy.

Since 1979, the adoption of import-liberalization, with the aim of promoting export-led industries, has significantly affected the growth rates of this sector downwards, as seen in Table VIII. The sector grew at an average of 4.8 percent per annum during 1979-1987. This was

TABLE VIII

Growth Rates of Real Gross Domestic Product

(GDP) 1972-1987 (1982 prices)

	Agriculture	Manufacturing	Government Services	Others	Total GDP
1972	7.6	7.3	12.8	3.6	6.8
1973	4.4	14.4	6.3	1.0	4.1
1974	-0.2	5.9	6.8	4.0	3.1
1975	4.6	4.0	8.5	-0.01	3.1
1976	3.7	14.0	5.1	2.0	4.2
1977	9.5	16.0	5.1	6.1	8.2
1978	8.9	12.5	6.4	8.4	7.9
1979	-0.3	7.6	7.1	7.7	5.0
1980	0.9	5.2	5.6	5.2	3.9
1981	6.1	3.6	5.3	6.9	6.0
1982	11.2	2.2	3.8	1.4	4.8
1983	1.6	4.5	4.2	1.5	2.3
1984	-3.9	4.3	2.9	2.7	0.8
1985	3.7	4.5	4.2	1.5	4.8
1986	4.9	5.8	6.3	5.4	5.5
1987	3.8	5.7	5.7	4.9	4.8

Source: Development Plan, 1989-1993, p. 5.

basically because of the removal of some level of protection. However, since 1985, the sector seems to have adjusted to the policy in place. For instance, the sector recorded an overall growth rate of 6.0 percent in volume of output in 1988 compared to a 5.7 percent in 1987.[67] Although such increased growth may be attributable to rising domestic demand for manufactured products, the export market, especially the Preferential Trade Area (PTA)[68], has also some significant impact on Kenya's manufacturing sector. In this case, the Kenyan exporters have a possiblity of a wider market given that a common duty applies to specific commodities in all the PTA member countries.

3.5.2 IDB's role in promoting the manufacturing sector

The bank's role in this sector may be examined on the basis of its loan and equity investments in the sector. By its policy objectives, IDB has pursued and continues to pursue the same objectives as specified in government development plans with regard to the manufacturing sector. This implies that active consultations with the relevant government departments have been key to its operations in promoting the industrialization process in Kenya. The bank has been affected by each and every change introduced into the manufacturing sector. Table IX

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[67]Government of Kenya, Economic Survey, 1989, Government Printer, Nairobi, p. 118.

[68]PTA comprises 14 Eastern, Central and Southern African states who have signed a trade agreement to fix a common duty on specific manufactured products originating from member countries.

TABLE IX

Loan and Equity, 1974-1989, (Ksh '000)

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Loan	8000	29068	82613	124046	151486	1896212	237994	330152	468058	464576	508254	648785	701169	632015	750948	574873
Equity	4393	13825	28239	52073	78346	86525	94110	62148	57125	50622	54879	50326	47694	46430	47230	42301
Total	12393	42893	110852	176119	229832	276137	332104	392300	525183	515198	563133	699110	748863	678445	800178	617174
Growth		246%	158%	58%	30%	20.1%	20.2%	18.1%	33.9%	-1.9%	9.3%	24.1%	7.1%	-0.9%	17.9%	-22.9%

Source: IDB's Annual Report and the author's calculations.

below shows loan and equity approvals to manufacturing and related activities over the 1974-89 period.

From the table, it is clear that there was tremendous growth between 1974 and 1976, even after allowing for inflation. This was mainly because IDB had just started its operations and most enterprises were encouraged to approach the bank for long-term financing. This was also the time when government policy encouraged import-substitution industries, as already indicated. Although there has been a decline since 1977, this decline has not been far below the overall growth rates for the manufacturing sector as shown in Table VIII. Although, on average, IDB's investment portfolio grew at 41.1 percent per annum during 1974-1989, it should be noted that this figure hides considerable variation in annual growth rates which ranged from as high as 240.6 percent in 1975 to as low as -22.9 percent in 1989. However, using Tables I and V, cumulatively, IDB's contribution to gross capital formation in the manufacturing sector in recent years (1983-1988) is about 4.0 percent. While this rate is less than the 5.3 percent average growth rate of the manufacturing sector during the same period, the bank's potential to finance capital formation in the sector is great. The negative growth of IDB's investment in 1983, as shown in Table IX, was due to the large devaluation of the Kenya shilling in 1982. This action made IDB's funds quite expensive and unattractive to investors. This was also the case in 1987 and 1989.

The relatively high negative growth rate in 1989 also reflects, other than the 1988 devaluation, the difficult economic conditions the economy was facing with its external balance; this necessitated a number

of macroeconomic adjustments, such as a credit freeze and a reduction in government expenditure. Further, due to the foreign exchange risks, the Bank made a lot of loan cancellations. Also, investors were able to get favourable financing elsewhere.[69] While the bank continues to invest in the manufacturing sector, its overall profitability has continued to decline due to the relatively large stock of unprofitable investments in place.

3.5.2.1. Import Substitution and Imported Inflation (1974-1979)

The 1970's was the period when the manufacturing sector, as indicated, was built under a highly protective incentive system. The three central elements of this system were a) licensing very limited importation of goods competing with domestic manufacturers, b) high duties on competing imports and c) relatively low duties on industrial inputs.[70] What this meant for IDB was that a number of projects were promoted without due consideration of the appropriateness of the technology. That is, the projects were largely capital-intensive. Projects funded during this period utilized largely imported raw materials. They also became the early victims of import restrictions necessitated by the foreign exchange restrictions arising from the oil price rises of the 1970s and the decline in Kenya's terms of trade. As a result, during the 1970s IDB experienced poor portfolio performance

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[69]IDB, 1988/89 Annual Report, IDB Publication, Nairobi, p. 8.

[70]Government of Kenya, Sessional Paper No. 1, 1986, Government Printer, Nairobi, p. 95.

with high default rates. For instance, between 1975 and 1979, total arrears to the bank represented 20 percent of the total loans which is a relatively significant figure.[71]

3.5.2.2 Efficiency, local resource use, export promotion and decentralization (1979-1983 and 1983-1988)

The type of industrial sector that emerged during the early phase of industrialization did not perform as well as expected, hence the 1979-83 development plan provided a shift from restrictive import licensing as a means of protecting local industry.[72] The IDB then shifted its funding to new investments that had the capacity to produce for export. This implied that such projects had to be evaluated in terms of the efficiency of their production processes. Also use of available local raw materials was given some priority in the appraisal process of new projects. Generally, utilization of local resources requires the establishment of small and medium-scale industries. These industrial enterprises require local currency financial assistance. Given that during this plan period the bank did not succeed in mobilizing adequate local resources, promotion of such enterprises was greatly constrained. But even with those projects which received foreign currency funding, the foreign exchange fluctuations were

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[71]This estimate is calculated using figures of the audited accounts of the banks between 1975 and 1979. Any loan portfolio that was rescheduled during this period has not been taken into account.

[72]Ibid., pp. 95-97.

inhibitive to their operations. For instance, the devaluation of the Kenya shilling in 1981/82 had a major negative effect on the operations of IDB-funded projects. The devaluation increased the bank's foreign currency-denominated debt. Ultimately, the financed projects experienced a heavy arrears burden. This problem, among others, is reflected in the growth rates of the manufacturing sector which slowed over the 1980s as shown in Table VIII. While there was need to increase exports of manufactured products, the industrial sector did not perform well enough to warrant significant growth in exports from the sector. Hence its contribution to solving the country's external debt was insignificant.

The 1979-83 development plan also provided a shift of developemnt emphasis from urban to rural areas. This was a vital policy objective that ultimately aimed at controlling the rural-urban migration. Decentralization of industries away from the major cities and towns was expected to provide employment for rural dwellers. Decentralization of industry was among the aspects of the "District Focus for Rural Development" Strategy.[73] This is a developemnt strategy that focuses on individual districts as the basis of the overall economic development of the country.

As a development bank, IDB was expected to participate in the promotion of industries that were rural-based and favourably recommended by District Development Committees (DDCs), normally chaired by respective District Commissioners. Such committees are charged with the

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[73]Government of Kenya: District Focus for Rural Development, 1984, Government Printer, Nairobi, pp. 1-17, Passim.

responsibility of comprehensive planning of development projects in the various districts. While IDB has continued to encourage decentralization of industries, its successful participation in the process has been greatly constrained. The constraints have been: the nature of the financial resources available to the bank; the generally poor performance of projects; and, to some extent, the operational policies of the bank.

Ideally, the bulk of IDB's funds are foreign currency denominated. These are not attractive investment funds, especially to the medium and small-scale projects, due to the inherent foreign exchange risk. The majority of rural-based projects are medium and small-scale and largely labour intensive. They therefore require local currency loans with concessional lending terms, since most of their machinery and equipment can be purchased locally. IDB, which exclusively finances the foreign component of machinery and equipment, cannot provide the local currency requirement due to its inability to mobilize such local resources. However, experience has shown that even with concessional local funding of these projects, the major problem that inhibits their success is deficient management, as already discussed. This implies that their problems are compounded whenever foreign currency denominated loans are provided since it is very often difficult for them to bear the additional foreign exchange risk. The exchange risk also has some adverse effects on the operations of even the very large projects.

The IDB's operational policies are such that great emphasis is placed on the promotion and establishment of large industrial projects which are mainly capital intensive. These projects import a large

portion of their machinery and equipment while some even import their input requirements, for instance the chemical industries. They therefore find it easier to approach IDB to finance the imported machinery and equipment, which the bank does by making direct payment to the foreign supplier. Large enterprises are usually not the type of projects that can easily conform to the policy of decentralization due to the strong desire of the project sponsors to locate them in the major urban centres. Basically, the urban centres have well developed infrastructure and other benefits due to agglomeration, and hence are more suitable for the establishment of large-scale industries.

As may be inferred, IDB's policy on diversification of industry has actually been reduced to sectoral diversification rather than geographical diversification. Over 67 percent of IDB financed projects are located in the major cities and their environs.[74] However, while IDB has not been successful in diversifying on a geographical basis, it has succeeded in diversifying its portfolio investment within various sectors of the economy. It maintains a 20 percent limit of its total approved investment in any one sector. It spreads its projects largely to safeguard itself from possible adverse effects of poor performance in any one sector, and in fulfilling the government objectives, tends to promote a balanced industrial base across sectors. This balance then does not strictly refer to rural-urban balance with regards to IDB's operations. Table X below shows the sectoral distribution of the bank's investments as of 30 June 1989.

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[74]This is based on a survey of 125 IDB assisted projects as at June 1989.

Since its inception, IDB has helped finance a total of over 120 projects, with a total investment of Ksh 1.8 billion equivalent in loans and equity. With the bank's assistance small establishments have grown into large industrial enterprises. This is particularly the case in textile, fabrics and garment manufacturing, basic metal industries, food processing, and chemical and pharmaceutical firms. As a result of this growth in industry, complementarity between industries has increased with considerable forward and backward linkages.[75] Given the number of large industrial enterprises financed through IDB's loans, equity participation or co-financing, the share of the bank in the promotion of industrialization is remarkable. This observation disregards the fact that some of the projects have not performed well in terms of profit margins. The bank has helped to create 60,000 new jobs directly through the financed projects, which is about 4 percent of the national wage employment.[76] There are also indirect jobs in the linked industries and activities. This is in line with the government policy objective of job creation. The creation of jobs is most pronounced in the current development plan (1988-93) with particular emphasis on self-employment through the small-scale industries' programme.

However, under this strategy, the bank's full participation in the promotion of small enterprises cannot be realized given its present operational policy and regulations, which emphasize the promotion of

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[75]Coughlin, Peter, Towards a new industrialization strategy in Kenya, (unpublished), p. 2.

[76]IDB, Quarterly Project Progress Reports, (unpublished), various issues.

TABLE X

Approved Industrial Sector Investments* (Ksh. million)

Industrial Sector	Loan	%	Equity	%	Total	%
Hotel & Tourism	312,320	18	7,682	11.2	320,000	17.8
Basic metal industries	308,060	17.8	5,000	7.3	313,060	17.4
Textile & Fabrics	250,066	14.4	7,245	10.6	257,311	14.2
Food & Beverages	172,700	10	16,510	24.1	189,210	10.5
Chemical & Pharmaceuticals	177,365	10.2	4,198	6.1	181,563	10.1
Engineering & Metal Products	108,691	6.3	2,233	3.3	110,924	6.2
Mining & Minerals	97,197	5.6	3,300	4.8	100,497	5.5
Rubber & Plastics	78,061	4.5	6,137	9.0	84,198	4.7
Paper, Pulp, Wood & Printing	77,494	4.5	1,900	2.8	79,394	4.4
Fibre & Cordage	70,974	4.1	6,279	9.2	77,253	4.2
Transport, Communication & Power	47,751	2.8	-	-	47,751	2.7
Motor Vehicle Assembly	32,682	1.9	2,700	3.9	35,382	2.0
Shipping & Marine	-	-	5,250	7.7	5,250	0.3
TOTAL	1,733,361		68,434		1,801,795	100.0

*The figures shown are cumulative figures showing totals as of June 30, 1989.

Source: IDB Annual Report 1988/89 and the author's calculations.

medium and large-scale industries. In principle IDB does not provide any financial assistance to small-scale informal projects such as the ones suggested in the national development plan. The premise of the national development plan is that, by encouraging very small-scale projects, a significant level of entrepreneurial development will be achieved. The achievement of local entrepreneurial skills eventually provides a firm basis for local participation in the ownership of the industrial enterprises. Development of the industrial sector from a rather informal sector level does not involve importation of heavy machinery and equipment as it is the case for large manufacturing concerns. Instead the basic requirement is the provision of simple machine tools and implements which may be fabricated locally. Given that IDB does not provide such assistance, as already indicated, it means that the bank is inefficient in facilitating this specific government policy objective.

Despite this deficiency, IDB's developmental role has continued to be an important stimulus to Kenya's economic growth. As already illustrated, promotion of the medium and large scale industries has continued with successful mobilization of foreign funds. However, IDB can perform its role better with changes in its operating policies.

CHAPTER FOUR

4.0 DEMAND FOR DEVELOPMENT FUNDS: AN ECONOMETRIC ANALYSIS

This chapter examines the empirical evidence of the demand for IDB's investment funds since its inception in 1973. The preceding chapter provided a detailed analysis of the bank's role and operations in Kenya's economic development process. Its operational successes and inadequacies were indicated with particular reference to resource mobilization. The following sections estimate a demand function for the bank's development funds.

4.1 Theoretical Aspects of the Model

We specify a single equation linear demand function for development funds. The equation specifies the demand for IDB's development funds by Kenya's manufacturing sector. Although a simple functional form is used, we expect that the results of our model will provide us with an indication of what determines the demand for funds from a DFI with IDB's operating features.

The demand function for development funds can be thought of as a special case of a demand for money function. Studies of the demand for money[77] indicate there are two main factors determining the demand for

[77]For details see, D.E.W. Laidler, The Demand for Money: Theories and Evidence, Harper and Row Publishers, Inc., 1977, p. 65; J. Tobin, "Liquidity Preference as Behaviour Towards Risk", Review of Economic Studies, 25 (February 1958), pp. 65-86; M. Friedman, "The Quantity

money: opportunity cost factors and scale factors. The former refers to the cost of holding money in terms of lost earnings on other assets. The latter refers to income or wealth, which is used as a proxy for the volume of transactions in the economy.

There is disagreement with respect to the appropriate opportunity cost variable to use in the empirical estimation of a money demand function. In particular, there are arguments as to whether long-term or short-term interest rates represent a better measure of opportunity cost. Long-term interest rates are usually measured by the yield on 20-year bonds whereas short-term interest rates are measured by use of a 3-month treasury bill rate or 4 to 6 month commercial paper rate.[78] Use of any one particular rate depends on the state of the financial system being considered. For instance, in more developed countries there may be no problem with using either long-term or short-term interest rates. However, in developing countries, where the financial systems may not be well-developed, use of either long-term or short-term interest rates may not be an appropriate measure of the opportunity cost of holding money.

There are also differences of opinion concerning the appropriateness of various scale variables in the demand for money function. But income, non-human wealth and permanent income are the

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Theory of Money. A Restatement" in M. Friedman (ed.), Studies in the Quantity Theory of Money, Chicago University Press, Chicago University Press, Chciago, 1956, p. 1-21; and J.T. Boorman, and T.M. Havrilesky, Money Supply, Money Demand and Macroeconomic Models, Allyn and Bacon, Inc., Boston, p. 174.

[78] D.E.W. Laidler, pp. 108-109.

commonly accepted variables.[79] Like the opportunity cost variables, use of a particular scale variable depends on the economic conditions prevailing in any one particular country. For instance, in developing countries most studies use current income as measured by GNP or GDP, or permanent income.[80] However, use of permanent income is most appropriate in more developed countries than the less developed countries. This is because of the high ratio of consumption to income in many of the low income countries; this makes current income the most appropriate variable to use. Due to problems of data, non-human wealth as a variable is rarely used in empirical work for most countries, developed or developing. Some studies argue that use of current income is the appropriate scale variable when a narrow definition of money is emphasized, while others discount this argument.[81]

In this study we use real gross domestic product from the manufacturing (industry) sector as a proxy for the volume of transactions in that sector. This is an appropriate scale variable given that IDB lends predominantly to the manufacturing sector. In Kenya, like any other developing country, sectoral income figures do not represent the true output levels. This is because of the existence of a large informal sector whose output is not effectively measured.

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[79]For details see R.L. Thomas, op. cit., pp. 297-298, and A.H. Meltzer, "The Demand for Money: The Evidence from the Time Series", Journal of Political Economy, 71 (June 1963), pp. 219-246.

[80]Ambaye Kidane, Demand for Money in Developing Countries, Dalhousie University, Halifax, M.A. thesis, 1986, p. 42.

[81]J.P. Judd, et. al., "The Search for a Stable Money Demand Function: A Survey of Post-1973 Literature", Journal of Economic Literature, 20(3), 1982, p. 1009.

However, since our estimation is confined to the modern industrial sector, the assumption is that the figures used are quite representative.

Nominal income is transformed to real income using the consumer price index as a deflator. Changes in the consumer price index reflect changes in the cost of acquiring fixed capital goods and consumer items by the middle income consumer.

Having specified a scale variable in the model, we need to choose an opportunity cost variable. There are a number of possibilities. One is the interest rate on financial assets. In more developed countries, the use of interest rates as an opportunity cost variable in estimating any demand for money function is a common and appropriate phenomenon. However, in most developing countries, interest rates are not an effective determinant of the demand for money due to underdeveloped financial markets and greater government control in determining their levels.[82] As a result, interest rates often remain unchanged over a long period of time. Such prices are basically influenced by the government, whose securities normally constitute most of the market assets.

In Kenya, interest rates are determined by the Central Bank of Kenya and not by any free market operations. The interest rates tend to fluctuate with the central bank discount rate (bank rate), which does not fluctuate often. Nevertheless, we try a specification of the model

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[82]A.F. Darrat, "The Money Demand Relationship in Saudi Arabia: An Empirical Investigation", Journal of Economic Studies, 11(3), 1984, pp. 43-50.

using an interest rate variable. Due to high inflation rates, the real interest rate on medium-term and long-term lending by IDB is used. In addition to interest rates, there is a second opportunity cost variable to be included. This is the foreign exchange rate. Given the sources of IDB's funds (see Chapter 3), the foreign exchange rate is expected to be an important determinant of the demand for funds. The exchange rate represents the foreign exchange risks associated with foreign financial resources. Foreign exchange rate changes are defined such that an increase in the rate implies a depreciation of the Kenya shilling against the U.S. dollar. Other models which have specified the foreign exchange rate as a determinant of the demand for money indicate that a depreciation of the domestic currency usually leads to a decrease in the demand for money.[83] It is postulated here that a rise in the exchange rate (i.e., depreciation of the Kenyan shilling) should have a negative effect on the demand for IDB's funds because of the foreign exchange risk which can be a disincentive to investors.

The growth of financial intermediation in Kenya is also an important factor to consider in our model. The level of financial intermediation reflects the degree of monetization of the economy.[84] The degree of monetization, on the other hand, indicates the size of the

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[83] Ibid., p. 45.

[84] B.B. Bhattacharya, "Demand and Supply of Money in a Developing Economy: A Structural Analysis for India", Review of Economics and Statistics, 56(4), 1974, p. 502.

financial sector of a growing economy.[85] During the period of our study (1973-1989), a number of developments in Kenya's financial system have taken place. The degree of monetization has increased tremendously.[86] This development has led to increased competition for IDB and hence should have a negative impact on the demand for the bank's funds as investors have a wider choice of sources from which they can borrow. The degree of monetization is therefore used as another scale variable. It is calculated as a ratio of M_2 to nominal Gross National Product, where M_2 refers to currency in banks and circulation plus demand and time deposits.

Having briefly outlined our theoretical model, we now proceed to develop the empirical model.

4.2 Empirical Model

For this model, we use annual data for the sample period 1973 to 1989 inclusive, giving 17 observations. The choice of the sample period is dictated by the availability of data, since the IDB was established only in 1973. The nature and sources of data are set out in the appendix. We acknowledge the fact that our study is constrained by the

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[85]W.S. Jung, "Financial Development and Economic Growth: International Evidence", Economic Development and Cultural Change, 34(2), 1986, pp. 336.

[86]Central Bank of Kenya, Its Evolution, Responsibilities and Organization (1986), p. 17 and Government of Kenya Economic Survey, 1987, p. 64, Government Printer, Nairobi.

small sample problem. However, this does not significantly affect our empirical analysis of IDB. The available data still serve our purpose.

One issue in the literature on the demand for money concerns the stability of the demand for money function.[87] Two fundamental conditions are vital for the stability of the estimation function. First, the model should have a good fit. In other words, the coefficient of determination (R^2) should be reasonably high. In our case we choose to accept $R^2 \geq 0.8$. Second, coefficients estimated over different time periods should not be significantly different from one period to another.[88] Stability of the model is important for policy purposes.

Our single demand function is of the form:

$$BL_t = a_0 \, rY_{mt}^{a_1} \, rInt_t^{a_2} \, RE_t^{a_3} IR_t^{a_4} e^{u_t} \tag{1}$$

where;

BL_t	=	Bank loan and equity investments (approvals) in real terms
rY_{mt}	=	Real Gross Domestic Product from manufacturing

[87]D.E.W. Laidler, op. cit., pp. 119-152, Passim.

[88]This is a discussion based on a Chow-test with an F-statistic as a test parameter. See Gregory C. Chow, "Tests of Equality Between Two Sets of Coefficients in Two Linear Regressions", Econometrica, 28 (July 1960), pp. 591-695.

IR_t = Degree of monetization

$rInt_t$ = real interest rate

RE_t = foreign exchange rate (Ksh. per $US)

U_t = Disturbance term

Taking the logarithm of equation (1) we derive our estimating equation:

$$\ln BL_t = \ln \alpha_0 + \alpha_1 \ln rY_{mt} + \alpha_2 \ln rInt_t + \alpha_3 RE_t + \alpha_4 IR_t + U_t \qquad (2)$$

Since IDB's investment approvals do not necessarily reflect the desired loan and equity approvals by borrowers, we also apply a partial adjustment model which is the Koyck transformation of the distributed lag model. The benefit of using this transformation is that the disturbance term is not correlated "with its own previous values".[89] This model assumes that IDB's actual loan and equity approvals are a fraction of the desired approvals. This specification reflects two aspects of IDB's situation. First, inadequate financial resources limit its lending capability and second, there is a lack of profitable projects. The desired level of approvals (which are assumed to be the optimal level of approvals for effective investment) are not observable. The partial adjustment model measures these influences.[90]

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[89]A. Koutsoyianis, Theory of Econometrics, MacMillan, London, 1973, p. 10.

[90]Ibid., p. 10.

On this basis, desired approvals are incorporated into the model as follows:

$$\text{let } lnBL_t^* = \ln \beta_0 + \beta_1 \, lnrY_{mt} + \beta_2 \, rInt_t + \beta_3 \, RE_t + \beta_4 \, IR_t + u_t \quad (3)$$

where $lnBL_t^*$ = desired real bank loans and equity investments (approvals).

Assuming actual approvals are a fraction of the desired level, we specify

$$(\ln BL_t - \ln BL_{t-1}) = \lambda(lnBL_t^* - lnBL_{t-1}) + v_t \quad (4)$$

where:

λ = coefficient of adjustment, $0 < \lambda \leq 1$

$lnBL_t - lnBL_{t-1}$ = change in logarithm of actual approvals

$lnBL_t^* - lnBL_{t-1}$ = change in logarithm of desired approvals

Substituting equation (3) into (4) we get:

$$lnBL_t = \lambda \, ln\beta_0 + \lambda \, \beta_1 \ln r \, Y_{mt} + \lambda\beta_2 \, rInt_t + \lambda\beta_3 \, RE_t \, \lambda\beta_4 \, IR_t + (1-\lambda) \ln BL_t + w_t \quad (5)$$

where $w_t = (\lambda u_t + v_t)$

4.2.1. Prior Expectations

The real interest rate is expected to influence the demand for development funds negatively. When the interest rate is high it increases the cost of borrowing from IDB and therefore demand will decline. The real gross domestic product from manufacturing (rY_{mt}) is expected to influence the demand for development funds positively. In other words, an increase in income motivates investors to start new industrial enterprises and also to expand existing ones. Such actions will lead to an increased demand for bank credit. A rise in the price of foreign exchange leads to high prices for imported products. Imports of such machinery and equipment will decline since it is more expensive to purchase them from abroad. For IDB, whose funds are predominantly used to finance imports of machinery and equipment, a rise in the exchange rate will thus influence the demand for its funds negatively. The degree of monetization (IR_t) is expected to influence the demand for IDB's development funds negatively for the reasons discussed above (section 4.1).

We test four different specifications of our model. These are:

$$BL_t = f(rY_{mt}, rInt_t, RE_t, IR_t) \quad (6)$$

$$BL_t = f(rY_{mt}, RE_t, IR_t) \quad (7)$$

$$BL_t = f(BL_{t-1}, rY_{mt}, rInt_t, RE_t, IR_t) \quad (8)$$

$$BL_t = f(BL_{t-1}, rY_{mt}, RE_t, IR_t) \qquad (9)$$

Note that in equations (7) and (9), the real interest rate is dropped. The argument that interest rates are not appropriate opportunity cost variables was borne out by the estimation of equations (6) and (8). In both cases, the coefficient on the real interest rate was not significantly different from zero.

4.3 Empirical Results

The estimated coefficients of the four equations are given in Table XI. The results for equation (6) show that the coefficient of the real interest rate ($rInt_t$) has the wrong sign and is statistically insignificant. Initial estimates indicated the presence of positive autocorrelation. Even after correcting for it, there is still evidence of autocorrelation, implying that the usual t and F tests of significance will not be valid. Further, the coefficient estimates will no longer be minimum variance estimates.

Estimation equation (7) also indicated the presence of autocorrelation. Even after correction for autocorrelation in equation (7), the Durbin-Watson statistic falls within the inconclusive range. However, results of these equations show that, apart from the coefficient of the real interest rate, the coefficients of real income (rY_{mt}), the exchange rate (RE_t) and the degree of monetization (IR_t) are all statisticallly different from zero, and have the expected signs.

This implies that the demand for development funds is influenced by changes in all three of these variables.

Equations (8) and (9), the partial adjustment models, have better results suggesting that they are the most appropriate for our estimation. There is no evidence of autocorrelation. All the estimated coefficients have the correct signs and the R^2s are above 0.85. The results of the two equations are not significantly different from one another. The results of equation (8) show that the coefficient on interest rates is again statistically insignificant. The statistical insignificance of the interest rate in our model confirms what has been written concerning the influence of interest rates in explaining the demand for money in developing countries.[91] Often interest rates in developing countries are not determined by market forces. Wide interest rate variations rarely occur. The generally inflexible nature of interest rates in these countries implies that the demand for money is not interest elastic. For the case of demand for development funds in Kenya, the results confirm the effect of the government policy of institutional interest rate ceilings.

The partial adjustment model represented by equation (9) gives the best results for the Kenyan case. This specification suggests that when

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[91]For details see A.F. Darrat, op. cit., pp. 45-48 and J.K. Onoh, Money and Banking in Africa, Longman Inc., New York, 1982, pp. 151-152.

Table XI: OLS Results

Equation	Constant	$\ln BL_{t-1}$	$\ln rY_{mt}$	$\ln rInt_t$	$\ln RE_t$	$\ln IR_t$	R^2	D-W(D-H*)
6.**	7.596		2.866	0.034	-5.600	-5.153	0.8063	1.53
	(0.953)		(5.468)	(0.194)	(-5.059)	(2.605)		
7.**	4.894		2.783		-5.085	-4.380	0.8207	1.590
	(0.781)		(5.057)		(-4.470)	(-2.703)		
8.	7.377	0.345	1.696	-0.053	-3.638	-3.657	0.8682	0.052*
	(1.074)	(2.273)	(-2.476)	(-1.338)	(-2.828)	(-2.002)		
9.	8.341	0.333	1.680		-3.764	-3.835	0.8668	0.317*
	(1.387)	(2.347)	(2.554)		(-3.179)	(-2.276)		

* The Durbin-H statistic is used to test for autocorrelation in the lagged dependent variable equations.

** Corrected for autocorrelation.

- The figures in parentheses below the estimated coefficients are t-ratios.

- Results are tested at 95 percent level of confidence (two-tailed test).

changes in exchange rate, incomes and monetization levels occur, thethe demand for development funds adjusts with a lag.[92] The results of equation (9) show that the coefficient of the foreign exchange rate (RE_t) is negative and highly significant. A one percent increase in the foreign exchange rate leads to a 3.8 percent decrease in the demand for IDB's funds, suggesting that demand is highly sensitive to changes in the exchange rate. Also the coefficient of the degree of monetization (IR_t), which represents the existence of possible alternative sources of funds, is significant and has the expected sign. A one percent increase in the level of monetization leads to a 3.835 percent decrease in demand for the bank's funds. These results support our earlier claim that changes in the foreign exchange rate and the level of monetization significantly affect the bank's investment portfolio negatively. The decline in the demand for development funds as a result of changes in these two variables is quite large considering the fact that we are dealing with an individual bank. The monetization and exchange rate effects suggest that in the long-run IDB will be unprofitable unless it ventures into other activities aimed at mobilizing sufficient domestic resources.

The decline in the demand for IDB's funds as a result of an increase in IR_t is tied up with the effects of foreign exchange risks inherent in the bank's funds as already discussed. The bank's foreign denominated funds are generally more expensive than local currency

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[92]For the details see C.A.E. Goodhard, Monetary Theory and Practice: The U.K. Experience, MacMillan Press Ltd., London, 1984, p. 58.

funds. Therefore, it makes sense for the investors to apply for local currency funds available in the financial market rather than the IDB's expensive funds. The increase in availability of funds from a number of different sources, as reflected by IR_t, implies investors can easily shift to other sources of local funds.

Real income from the manufacturing sector (rY_{mt}) has a positive impact on the demand for the bank's funds as expected. A one percentage increase in rY_{mt} leads to a 1.7 percentage increase in the demand for IDB's funds. The coefficient of the lagged dependent variable is significant, implying that last period's loan and equity approvals have a positive influence on the current period's lending of the bank. The results show that the adjustment coefficient (λ) is 0.667, implying that about 66.7 percentage of the discrepancy between the desired and actual approvals is eliminated in a year.

The long-run elasticities can be calculated as the relevant short-run elasticity divided by the partial adjustment coefficient.[93] From these calculations, the long-run income elasticity of demand for development funds is 2.519 while the corresponding figures for foreign exchange and degree of monetization are 5.643 and 5.750, respectively. These are substantially greater than the corresponding short-run elasticities of 1.680, 3.764 and 3.835, respectively, as would be expected. However, the elasticities are all elastic which implies that the demand for development funds is relatively sensitive to small

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[93]D.N. Gujarati, Basic Econometrics, McGraw Hill, Inc., New York, 1988, p. 529.

changes in income, exchange rate and the country's degree of monetization.

To test for stability, we divided the data into two sub-periods. The first period is 1973-1979 inclusive, the other, 1980-1989 inclusive. The first sub-period was chosen on the basis that, during that period, Kenya continued to encourage the promotion of import-substitution industries. Also the oil crisis of the 1970's had a tremendous negative impact on Kenya's growth rate. The problem was compounded with prolonged drought conditions in 1974 which worsened the country's balance of payments and foreign reserve position.[94] In the second sub-period, government policy objectives for industrial development shifted from an import substitution strategy to an export-led industrial development strategy, as discussed in the preceding chapters. The 1980's were no better years for Kenya's economic growth, however, as the huge external debt and the devaluation of the Kenya shilling against major world currencies had adverse effects on the growth of the economy. The severe drought conditions of 1984 also had tremendous negative effects on the economy, especially in the agricultural sector, which recorded a negative growth rate (Table VIII, Chapter Three).

Separate estimates were made for each of the sub-periods and a Chow-test was used to determine if the coefficients for each period were significantly different. The results of the Chow-test are as shown below, where the critical F-value is at the 95 percent level of confidence:

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[94]Government of Kenya, Economic Surveys, various issues, Government printer, Nairobi.

F-Calculated	F-Critical	Degrees of Freedom
1.59	5.79	F(2,5)

Since $F_{calculated} < F_{cr}$, we cannot reject the null hypothesis that there is no difference in coefficients obtained in the two sample periods. This implies that the demand function coefficients were stable during the two sub-periods.

4.4 Conclusions

The estimated demand function for IDB's development funds leads to the following conclusions:

(a) Interest rates have an insignificant influence on changes in the demand for IDB funds. This is largely because Kenya's interest rates are institutionally determined and hence do not vary in response to changing market conditions. They are not competitive free-market rates. This conclusion is similar to that of other studies on the operation of interest rates in developing countries.[95]

(b) Foreign exchange rates and the degree of monetization have a significant negative influence on the demand for the bank's funds.

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[95]For example, A.I. Abdi, Commercial Banks and Economic Development: The Experience of Eastern Africa, Praeger Publishers, New York, 1977, pp. 10-34; S. Ghatak, "Rural Interest Rates in the Indian Economy", The Journal of Development Studies, 11(3), 1976, pp. 190-201 and J.K. Onoh, op. cit., p. 151.

This result is supported by evidence on the demand for money in general in Kenya[96] and evidence for other developing countries.[97] There are great contraints to the bank's operations with regard to policy implicatons which are discussed in the next chapter.

(c) The real gross income from the manufacturing sector is a significant variable in the demand function, influencing the demand for development funds positively. The long-run income is greater than unity implying demand is income-elastic in the long run.

The above observations have clear-cut implications for IDB's long-term lending policies. Problems with domestic resource mobilization have serious consequences for IDB's effective operations, expecially under conditions of controlled interest rates. It is difficult for the bank to accept deposits that command higher rates than what it charges on its long-term loans. In the next chapter, policy implications and appropriate recommendations will be suggested with a view to strengthening the bank's operations as it continues to participate in long-term financing.

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[96] J. Kulola Mayunga, "Demand for Money in Kenya: An Econometric Analysis", Dalhousie University, Halifax, M.A. thesis, 1987, p. 92.

[97] A.F. Darrat, op. cit., pp. 43-50.

CHAPTER FIVE

5.0 POLICY IMPLICATIONS AND CONCLUSIONS

5.1 Policy Implications

In general, development banks have played an important role in the development process of developing countries. Given a rudimentary commercial banking system, development banks have served as a source of funds that would otherwise not be available to finance investments, especially those which may be considered as developmental. This is particularly the case for Kenya. Industrial development banks in Kenya have provided a means for mobilizing financial resources, especially foreign resources, for industrial projects. While their operations have been constrained by a number of factors, they have played a significant role in the financing of capital formation in the manufacturing sector. They have further contributed to the creation of jobs and an increase in income.

The constraints on development banks' operations in Kenya include excessive government intervention, which limits their ability to compete with the commercial banks; excessive dependence on foreign funds, which leaves them vulnerable to foreign exchange risk; a predominantly unprofitable investment portfolio, which in turn affects the banks' overall profitability; and a relatively high staff turnover due to generally low salaries.

Nonetheless, despite these difficulties, development banks continue to be important to the Kenyan economy. There are certain features of the economy that necessitate the existence of these institutions. While Kenya's financial system has been expanding rapidly in recent years, it has not been stable enough to sustain an increasing demand for bank credit. This is evidenced by the number of recent bank failures and mergers among a number of commercial banks and non-bank financial institutions, due to liquidity and insolvency problems. Further, commercial lending institutions, as a whole, tend to provide minimal financial assistance to projects with low expected rates of return. Long-term financing provided by these institutions tends to be directed to more established projects. The continued existence of development banks will play an essential role in providing financial assistance to projects that are considered high risk projects by the commercial lending institutions for the forseeable future. Further, given that the government still controls and owns some projects regarded as vital for economic development, and also given that the process of privatization of public enterprises has been quite slow, development banks will continue to be needed to provide long and medium-term financial assistance to government or public sector projects.

In Kenya, like many other developing countries, domestic savings are generally low and hence do not provide a sufficient source of loanable funds for financing projects. Neither do retained earnings. Therefore, the demand for development bank loans to finance the majority of investment can be expected to remain high until these problems are

overcome. The domestic equity capital market (stock market) is not yet developed enough, having been established only in 1989, to fill this gap. Since commercial lending institutions largely provide short-term working capital and trade finance, appropriate long-term financing of most Kenyan investments will continue to be provided by the development banks.

Finally, the current government policy of encouraging and promoting small-scale industries requires the services of development banks. Emphasis on the establishment of small-scale enterprises is mainly based on the notion of employment creation for the majority of Kenyans, especially when such enterprises are rural-based. However, due to the potential high risk associated with small firms, commercial lending institutions will generally be unwilling to assist most of them financially.

In the current stage of Kenya's economic development, development banks are vital agents of economic development. However, they can only perform this role well if they have sufficient financial resources and an appropriate restructuring of their policies that reflects each stage of the country's development. Development banks need to mobilize sufficient domestic currency resources to supplement the foreign resources despite the problems they encounter in this area.

With regard to the particular case of IDB, it too, has faced a number of constraints on its operations. The most important of these are institutionally controlled interest rates and the fact that most of its funds are foreign resources.

IDB cannot compete with the commercial banks, especially in the process of deposit creation because it is not possible for it to use short-term deposits to make medium and long-term loans, given the current financial system. The commercial banks have an advantage over IDB in the deposit creation process because they can offer higher rates to depositors while charging rates higher than the deposit rate on their loans, even with controlled interest rates. Therefore, the generally low savings in the country are taken by the commercial banks. Thus, it will be necessary for IDB to revise its operational policies so as to enable it to approach the financial market with more commercially oriented policies. Further, appropriate interest deregulation policies should be encouraged so that, among other things, the bank can effectively participate in the deposit creation process. The policy implication is that economic growth can be encouraged by abolishing institutional interest rate ceilings and by ensuring that the financial system in general operates competitively. It is possible that IDB and other development banks will face serious competition from the commercial lending institutions given that the latter have been involved in the deposit creation process longer. But with appropriate policy and administrative changes, IDB in the long-run has the potential to play a leading role in the development process. Given the possibility that commercial banks would be involved in long-term financing, IDB may have the option of lending to projects that cannot find assistance from commercial banks. That is, IDB would act as a "lender of last resort" to high risk projects.

The second constraint facing IDB is its continued dependence on foreign funds for lending. This implies the bank will continue to be subjected to adverse effects of competition from other financial institutions not operating under the same constraints. This is because foreign funds are more expensive than the local currency denominated funds due to the inherent foreign exchange risk. The existence of these constraints is supported by the econometric results, which show that interest rates have an insignificant influence on the demand for the bank's funds while the exchange rate and degree of monetization have a large negative influence. Further, the significant influence of the degree of monetization implies that there is a high level of substitution among the domestic credit sources which are available. These circumstances may mean that, in the long-run, development banks will no longer be necessary as the commercial sector takes over. However, it should be noted that under the current conditions, it will take many years for commercial banks to get to such a point.

On the other hand, since demand for development funds was found to be income elastic, it implies that demand grows at a rate higher than income growth in the manufacturing sector, all other things equal. This further means that as the Kenyan manufacturing sector grows, there will be a continuing large demand for funds, ceteris paribus. Unless there is an increase in funds available for investment, it implies there will be even greater credit constraints than there are now. This inevitably requires IDB and other development banks to be more aggressive in

domestic savings mobilization especially by actively participating in the capital market which has been recently established.

The IDB can and should play a major role to encourage the development of the capital market. The bank's role as an underwriter and investor in stocks and bonds will be vital to this resource mobilization process. Since IDB can operate within the terms provided for by the Companies Act, it is possible that it can easily and quickly transfer the necessary documents regarding ownership and/or debt, unlike most development banks. It is, however, necessary that appropriate financial instruments be available.

For IDB to fulfil an active role in the capital market, it has to induce domestic investors to buy its own shares. This will ensure that the bank's operations are conducted as profitably and with as little risk as possible. IDB's readiness to sell, from its portfolio, securities of enterprises that are profitable is an area worth pursuing as a means of promoting the capital market. Not only does this encourage broader ownership of industrial shares, and increase the supply of marketable securities, but it also replenishes the bank's resources from domestic sources and enables it to continue lending and expand its new investment activities.

One other area that is readily available for the bank to enter is to undertake the underwriting of public issues of shares (and other securities) of the companies it finances. The appraisal of the company conducted by IDB and its willingness to invest some of its own funds will help create in the investing public the confidence that the company

being assisted is financially sound. Where the underwriting of a public issue is not possible, IDB might still persuade other investors to participate with it in a financing operation, mostly through equity participation.

In this way, IDB could encourage the flow of private savings into productive investments. For such effective operations to yield tangible results within the Kenyan industrial sector, the government needs to accept suggestions regarding project operations from the bank which are based on practical experience. For instance, the bank can advise the government on matters affecting the attractiveness of investments in productive companies in both the private and the public sectors.

To improve on the performance of IDB's portfolio investment, appropriate development of entrepreneurial capabilities is essential, among other factors. This could be undertaken through workshops and seminars organized by the bank in conjunction with other financial institutions. Minimum fees could be charged for such services to meet the expenses of organising the relevant workshops and seminars. The services of successful business executives of various local firms or retired managers in the business sector would be useful in running these workshops. In this way, the bank need not necessarily involve its own staff members as the resource persons. This is an important area that the monitoring division of the bank could endeavour to implement. This area, which has not been effectively explored up to now, may prove a useful process of continuous counselling and maintaining a close relationship with the bank's clients.

Finally, with respect to the quality and competency of the bank's officers and administration personnel, it is recommended that appropriate salaries and benefits be paid so as to retain qualified professional staff of the bank in all departments. This is vital if the bank is to operate profitably in a increasingly competitive environment. Such reforms would strongly enhance the bank's ability to mobilize resources and contribute to Kenya's economic development.

5.2. Conclusion

This thesis has examined the extent to which IDB has contributed to Kenya's economic development in terms of resource mobilization and allocation. We have looked at factors influencing the demand for development funds, how such factors affect the operations of the bank, and appropriate measures that might be taken to strengthen the bank's operations.

The thesis started with an examination of the theoretical aspects of development banking. Problems which affect development banks with regard to their operations were examined. It was established that these institutions do experience excessive government influence with regard to their operational policies. The consequences of this have not been good for them especially with regard to their resource mobilization and allocation procedures.

Structural problems that exist in developing countries have adverse effects on the general operations of development banks. While

they still have the potential to contribute to economic development, they have been constrained by various problems such as inflexible policies and institutional rigidities in most of the developing countries. It was suggested that, for development banks to be efficient agents of development, there is a need to restructure them in accordance with the changes in their operating environments.

Chapter Two of this thesis examined the process of development banking in Kenya. The focus was on industrial development banks and their contribution to the process of industrialization. Potential successes and failures were indicated. Inadequate domestic resources; unprofitable investments due to poor management, inadequate working capital, foreign exchange risk, and excess capacity; and government interference are some of the problems which face development banks. Some development banks have problems with their appraisal and monitoring procedures. Most of these institutions have funded projects with very low equity levels and hence remain undercapitalized and unable to breakeven. Delays in the necessary approvals and subsequent disbursements by the development banks very often contribute to project cost escalations.

Kenyan development banks do not have an effective means of providing entrepreneurial training programmes. Their monitoring and recovery procedures lack some effectiveness. These institutions do not possess up-to-date financial and operational information on their investments. Although this may be circumstantial given that development banks have no control over the projects' daily banking activities, part

of it, at least, reflects a certain laxity by bank officers. Very few projects receive the personal attention of bank officers other than occasional telephone contacts.

This thesis recognized the fact that despite the difficulties facing them, Kenya's development banks have a great potential to contribute to the country's economic development. However, their role would be enhanced if there were changes in their operational policies. Such changes are necessary as the financial market becomes relatively more competitive.

A detailed analysis of the Industrial Development Bank in Chapter Three revealed specific features of one of Kenya's industrial development banks. Organizational and operational policies of the bank were analyzed. Results of the analysis confirmed the various problems that were generally indicated concerning aspects of development banking in Kenya. This thesis outlined the problems that the IDB faces and the consequences of continued operation of the bank with these same problems. The seriousness of the bank's inflexible policies towards domestic resource mobilization and the inevitable competition from the commercial banks was indicated. The IDB will require an increase in the local currency financial resources if it is to continue to offer long-term finance to the industrial sector.

In Chapter Four, a demand function for IDB funds was estimated. It was found that manufacturing sector income, the exchange rate and the degree of monetization are the main determinants of demand for the bank's funds; but not interest rates. Policy implications and

recommendations were suggested. Finally, it was indicated that IDB has to revise its policies and increase its capacity to retain competent personnel if it has to operate efficiently. Meaningful restructuring of the bank requires necessary and appropriate government policy changes towards the financial sector. Policy recommendations, such as we have suggested in this thesis, can provide the basis for an evolution of the structure for IDB and other development banks so as to meet the challenges of an ever-changing economy.

APPENDIX: DATA

BL ('000)	Y_{mt} ('000)	I	RE	IR	IFL
8000.000	1956.000	9.000	7.143	20.600	1.089
12394.000	2381.400	9.500	7.343	18.500	1.179
30000.000	2547.800	10.000	8.367	17.400	1.193
78000.000	2883.600	10.000	8.277	17.600	1.113
100000.000	3598.800	10.000	7.729	19.700	1.148
119800.000	4386.400	10.000	7.455	19.100	1.169
134200.000	4996.800	10.000	7.420	20.200	1.080
214200.000	5902.800	10.600	9.048	16.000	1.138
271000.000	6848.800	12.400	10.922	15.600	1.118
89300.000	7446.400	14.500	13.312	15.600	1.204
66000.000	8165.200	15.800	14.414	15.000	1.115
49200.000	9219.200	14.400	16.432	14.900	1.102
132200.000	10368.000	14.000	16.226	13.100	1.130
113000.000	11527.000	14.000	16.455	15.000	1.039
226000.000	13111.200	14.000	17.747	14.400	1.052
130000.000	15951.200	15.000	20.572	12.500	1.083
66000.000	17546.400	17.300	21.633	15.00	1.100

NOTE: 1. BL - Bank Loan and Equity Approvals

Y_{mt} - Manufacturing Sector Incomes

I - Interest Rates

RE - Exchange Rates

IR - Degree of monetization

IFL - Inflation

2. For estimation of the demand function real figures were used by taking note of the inflation levels.

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