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Development Finance in Kenya’s Industrial Sector: A Political Economy Approach

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ABSTRACT

For many years under colonial rule, Kenya was a 'plantation economy' dependant on exports of coffee, tea and sisal. It had a small industrial base dominated by and tailored to the needs and tastes of two major immigrant groups - the Europeans and Asians.

Upon attaining independence, Kenyan nationalists felt a need to encourage the participation of indigenous Kenyans in all sectors of the economy, including industry. To further this goal, development finance institutions were formed.

The study proposed herein undertakes to investigate the impact of four major development finance institutions, namely the ICDC, DFCK, IDB and KIE, upon the industrialization and indigenization processes in Kenya.
INTRODUCTION

What is industrialization? Industrialization is defined as "the organization of production in business enterprise, characterised by specialisation and the division of labour, and involving the application of technology and mechanical and electrical power to supplement and replace human labour. Conceived of in this way, all sectors of the economy, i.e. agriculture, services, producer and consumer goods can be industrialised."

The proposed research, however, will be concerned with a much narrower concept of industrialization - the development of manufacturing enterprises producing consumer, intermediate, and capital goods. Research indicates that manufacturing industry plays a leading role in economic development in the specific sense that a 1% increase in gross domestic product is normally associated with a more than 1% increase in value added in manufacturing. Further, there is evidence that the growth elasticity of manufacturing is greater, the lower the level of a country's per capita income. It has also been observed that the income elasticity of demand for manufactured goods is generally greater than that for food and agricultural products.

Due to the favourable demand, elasticities and economies of scale, manufacturing industry not only grows more quickly than other sectors, but its growth is also normally associated with increased employment. In agriculture on the other hand, where there is usually considerable disguised unemployment, expansion of productivity and output is usually connected with a reduction in the labour force employed. The expansion of manufacturing industry thus helps in three ways:

i) By absorbing redundant labour (this is especially true if labour-intensive techniques are adopted in lieu of capital-intensive techniques),

ii) By providing modern industrial inputs which raise both land and labour productivity,

iii) Expansion of manufacturing industry also increases the pace of technical change and helps raise productivity growth in
sectors other than agriculture.

It should also be noted that manufacturing capital goods industries need to grow at a faster rate than consumer goods industries. Studies indicate that the growth elasticity for consumer products - food, drinks, tobacco - are lower than those for producer goods such as transport equipment and iron and steel; therefore suggesting the importance of developing capital goods industries for a country to achieve fast economic growth.

Kenya's Industrial Strategy

When most Sub-Saharan countries attained independence in the early 1960's, they saw industrial development as the way to move from the colonial pattern of heavy dependence on imported manufactures and primary exports and to achieve rapid growth and modernization. In line with these objectives, the basic strategies for African industrialization during the 1960s and 1970s were to give incentives to import-substitution industries. Kenya was no exception. During this period, she offered various incentives to import-substitution industries.

Unfortunately, due to internal as well as external factors, import-substitution-industrialization (or ISI) resulted in serious distortions to the economy. Exports fell and imported inputs became scarce, and this engendered the shift towards export promotion, a policy Kenya adopted in 1980 and pursues until the present.

However, despite her attempts at industrialization, Kenya remains a largely agrarian economy and apart from tourism, coffee and horticultural crops are the major exchange earners. Unfortunately, the income elasticity of demand for primary goods is low (while that for manufactured goods is high, a phenomenon described as Engel's Law).

Another disadvantage with primary goods, especially crops as in Kenya's case, is that they are prone to disease, bad weather, and pests. Kenya has been lucky. She has not suffered pastilence on a devastating scale, or faced unfavourable weather conditions such as those that halved Brazil's coffee output in 1977-78.

Nevertheless, such pre-independence type reliance on a few
primary exports is clearly dangerous. Diversification of exports including intermediate and capital goods is therefore eminently desirable. For this to happen rapid industrialization must become a priority. The government has always acknowledged this and has made efforts to promote industrialization from the early post-independence years. However, it is arguable whether much change has been wrought in the colonial pattern of industrialization, which was characterised by Ann Seidman as being,

i) Concentrated in the urban areas,

ii) As consisting largely of first stage processing of agricultural products and last stage industries dealing in the production of luxury and semi-luxury items; and

iii) As being highly dependent on imported outputs.

Nonetheless, the Kenyan government continues to profess support for industry and has over the years made efforts to create a favourable climate for investment by offering such fillips as an improved basic infrastructure and medium and long term credit for investors via specially created development finance institutions.

The proposed study will deal with these development finance institutions (or DFIs) and the role they play in the industrial manufacturing sector.

The Development Finance Institutions

Political Motivation

Prior to independence, Kenya had an industrial structure producing a limited range of products that were exchanged for imported manufactures. This structure was controlled by European and Asian firms and subsidiaries of international companies.

Banks that had been established were foreign-owned and concerned with the finance of overseas trade and the provision of services for the non-African entrepreneurs. There was little credit provision for indigenous Africans because they lacked the necessary collateral and also because legal constraints had been imposed on lending to Africans by the colonial government (The Credit to Natives Ordinance).

After independence, the new leadership became increasingly
aware of the urgent need for economic growth and the widespread poverty and low productivity that inhibited the emergence of indigenous productive enterprise that could facilitate such growth. This awareness resulted in the formation of special financial institutions known as development finance institutions.

In addition, due to the lopsided ownership of industry by Europeans and Asians, Africanization of the economy became one of the major objectives of the new government and consequent to the Sessional Paper No. 10 of 1965 titled 'African Socialism and its Application to Planning in Kenya', and the First National Development Plan, 1964-70, the government set into motion a program for indigenization which included setting up of parastatals that would 'make capital available to Africans at reasonable terms to establish business'. Political objectives therefore also had a role to play in the formation of development finance institutions.

The Theoretical raison d'être

For investments to be carried out, there must be savings. Savings can be divided into potential savings and real savings. Potential savings form that part of income that is not consumed but has not been made available for investment. Often there is a gap between savings and investment with real savings lower than investment needs, and this is reflected in high market rates of interest for lending. Some governments imposed ceilings on interest rates at sub-market levels (Kenya for example maintained control of interest rates through the Central Bank until July 1991 when these rates were liberalized as part of the economic restructuring and liberalization programme).

Though there are obviously various reasons for investments surpassing savings, it can be surmised that one of the main reasons is a substantial amount of potential savings not being converted into real savings.

Without adequate real savings, the rate at which productive capacity and hence income can grow is curtailed. On average, the more rapidly growing developing countries have had higher saving rates than the slower growing countries. These countries have probably been more successful at converting potential savings into
real savings by making financial services universally available by reducing the costs and risks involved in saving, and by offering reasonably attractive returns on customers' deposits.

But savings by themselves are not much use. They have to be directed towards those who are in need of them and can put them to productive uses. Financial systems therefore play a dual role of accepting savings and activating them. In the absence of an efficient financial system, avenues for saving and borrowing are restricted and economic growth is curtailed.

Self-financed investments may provide a way to overcome the resulting difficulties, and indeed in the early stages of development, relatives, friends and money lenders may be the only source of external finance, but the needs of profitable investment opportunities may exceed the resources made available through this method and this could result in stagnation.

Financial systems in African countries at independence were not well developed and it was therefore necessary to augment and improve them and familiarize the public with financial institutions and their facilities. These financial institutions would have to work in consonance with the development plans of their respective governments since effective demand for credit and saving facilities could only come with growth in general productivity and living standards.

Though savers and borrowers were both equally important, borrowers were seen as potential investors and therefore, to paraphrase Eric L. Furness', the financial institutions would have to be prepared to help directly in the fostering of productivity by offering borrowers technical services such as assistance with formulation of loan proposals and help in the supply of equipment. The institutions would also have to reduce their collateral requirements because indigenous borrowers seldom possessed the type or amount of collateral acceptable to banks in the advanced countries.

However, commercial banks are known to operate on the principal that transaction costs, i.e., administrative costs plus default risk on loans, must be made good by the borrower who must pay some interest. To put it another way, returns must exceed
costs, as depicted below (also see Appendix I)

\[ r > \frac{(i + a + p)}{(1-p)} \]

where, 

- \( r \) is returns (represented by interest due to financial institution per unit of principal)
- \( i \) is cost of interest to the financial institution of raising resources, per unit of principal
- \( p \) is expected value of financial loss per unit of principal due to non-repayment of principal and interest,
- \( a \) is the cost of administering and supervising loans per unit of principal.

This understandably profit-oriented attitude towards lending places a high premium on collateral and loans that are self-liquidating i.e., where the completion of the project for which the loan is required automatically provides the funds for repayments. Not many potential investors in search of loan finance in the past could satisfy these conditions either due to lack of collateral or due to the inability to formulate convincing loan proposals. Also, commercial banks, fearful of losing their financial liquidity, chose to offer loans of a short-term nature, which was quite suitable for financing of trade and inventories, but not for financing industrial investments which require medium and long-term credit. Agriculture also experienced a shortage of credit due to lack of credit worthiness among the borrowers.1

A solution to the low availability of credit to industry seemed to lie in the creation of financial intermediaries devoted to making medium and long-term credit available to industry at low interest rates with low collateral requirements and easy terms of repayment (similarly special banks and co-operatives were formed to assist those willing to invest in agriculture).

The easy lending terms were likely to result in costs exceeding returns in defiance of the commercial bank credo (where returns must exceed costs), and strong government support was
therefore necessary to help these intermediaries overcome losses, at least in the short and medium term, before local industrialists could gain experience and start to earn profits on their investments, where-upon stricter loan conditions could be introduced.

Financial assistance from foreign sources was instrumental in the setting up of these institutions, known as development finance institutions, and it was hoped that the credit needs of investors could now be fulfilled. These institutions were also expected to initiate projects of their own as part of their mandate.

Having discussed the economic motives for the formation of development finance institutions, I will now discuss separately the four main development finance institutions dealing with the manufacturing sector in Kenya.

i). Development Finance Company of Kenya (DFCK)

The DFCK was incorporated as an investment company in 1963 to complement the already existing IDC (later ICDICO), while the latter concentrated on small projects. The Kenya government through the IDCICO is the largest shareholder in the DFCK. Other shareholders are the Netherlands Overseas Finance Company (ONO), CICO, the German Development Bank (KfW), and the International Finance Corporation (IFC). DFCK provides medium-term local and foreign currency financing for projects in the industrial, agro-processing and tourism sectors.

In 1978, the DFCK established the small-scale industries program in order to reach small Kenyan entrepreneurs who had been largely by-passed by other large and medium-scale programmes. In the first five years of its operation, 60 small projects received a total of Ksh.35.2 million in financial assistance. In 1983, small-scale industries was changed and incorporated into Small Enterprises Finance Company (SEFCO).
ii). Industrial and Commercial Development Corporation (ICDC)

The ICDC was originally formed in 1954 but under the name Industrial Development Corporation (IDC), which it changed in 1964 to ICDC. The ICDC is a statutory corporation established to facilitate the industrial and economic development of Kenya by initiation, assistance or expansion of industrial, commercial or other undertakings or enterprises in Kenya. It provides loans, both medium and long-term, to industrial ventures, offers management guidance and purchase shares in enterprises through its associate company, ICDC Investment Company Limited.

iii). Kenya Industrial Estates Limited (KIE)

KIE was established in 1967 as a subsidiary of ICDC, but was reconstituted in 1978 as an independent financial institution and principal government agency for promoting small scale industries throughout the country.

In 1971, the Rural Industrial Development Programme (RIDP) was formed under the aegis of the KIE. The RIDP operates independently outside the main towns. The programme benefitted principally from Danish technical and financial assistance (the KIE program itself has received financial and technical assistance from both multilateral and bilateral donor agencies. Funds have been passed on to the KIE through the government as loans). The purpose of the RIDP is to establish Rural Industrial Development centres in smaller townships located in the centre of agricultural areas comprising central workshops, offices and classrooms, to serve as bases for extension efforts to scattered local artisans.

iv). Industrial Development Bank (IDB)

IDB is a government funded financial institution. The IDB was established by the Kenya government in 1973 to facilitate industrial development in the country. Its main focus was to be on promotion, establishment, expansion and modernization of medium and
large-scale industrial enterprises. It participates in these enterprises through equity and loan.

Like the KIF, the IDR has received external assistance, mainly financial, from the World Bank, the German Development Corporation and Morgan Freretl and Co. in association with the Export Guarantees Development of the U.K.

In 1980, the IDR launched its Medium-Scale Enterprises Scheme to cater for the African entrepreneur.

LITERATURE REVIEW

In order to achieve a three-dimensional outlook on development finance institutions in Kenya's industrial sector, we must perform a look at the factors that have influenced their creation and the formulation of their objectives.

In this section we shall explore existing literature in an historical, political and economic mould and attempt to establish a broader-based conceptual framework in which to tackle the subject.

A 'Hospitable Investment Climate'\[^{11}\]

Under British rule, Kenya was for many years an 'export enclave' and the main interest of the British was to develop the colony into a supplier of raw materials, mainly agricultural, for British industries as well as a market for these industries. 14 Locally based industrialisation was actively discouraged, as was the case in other sub-Saharan colonies until the 1950s when the large dollar deficits accumulated by the colonial powers after the Second World War prompted them to promote the export of raw materials to the United States from their colonies, and to encourage import-substituting industrialisation by metropolitan (foreign) firms behind high tariff walls.\[^{15}\]

In 1954, the Industrial Development Corporation was established in Kenya "to facilitate the industrial and economic development of the colony".\[^{16}\]

Those likely to benefit from IDC assistance were Europeans,
Asians and multi-national companies. The Europeans were mostly involved in large scale processing of agricultural produce while Asians concentrated their capital in printing, engineering, soap fabrication, furniture, clothing and apparel, mostly in small and medium scale enterprises. Multi-national companies (such as the ubiquitous Coca Cola) undertook last stage fabrication of mostly consumer goods.

The part played by Africans, except as wage earners, was of little importance. The few African craftsmen running their own business were blacksmiths, carpenters and tailors operating in rural markets. Restrictions imposed on African entrepreneurship by the colonial power, such as the Credit to Native Ordinance which imposed limits on the amount of credit Africans could receive from non-Africans, effectively blocked the growth of African enterprises. The alienation of Africans from their own resources is illustrated by Odel's assertion that in 1958, Africans possessed only 3% of all physical assets in the country.

It seemed inevitable that as independence dawned, a transfer of resources to the Africans would be a major imperative of the new government. In the few years preceding independence in 1963, there was a sharp downturn in construction, a decline in employment and an outflow of capital, signs that the non-African population was apprehensive of the future. But this fear was exaggerated for Jomo Kenyatta had already declared that the British were not to be succeeded by a 'gangster government' that would nationalize the assets of foreign investors but one that would instead encourage investors .... to come to Kenya', and in 1964, the Foreign Investment Protection Act, entitling holders of 'Approved Enterprise Certificates' to transfer profits and capital out of the country, was added to already existing safeguards for private property under Article 19 of the Constitution of Kenya.

The 'hospitable investment climate' strategy appeared to be popular in many underdeveloped, late-starting countries which
recognised the dearth of indigenous entrepreneurship and capital as critical impediments to industrial development. By making conditions favourable to foreign investors, they hoped that their inflow would stimulate capital deepening and foster the 'migration of technology'.

This strategy probably owes a large debt to an American professor, Albert Hirschman, a leading advocate of balanced growth and an economic adviser in the 1950s to many Latin American countries. Hirschman argued that initial assistance by a government in an underdeveloped country should be on providing a certain minimum amount of 'social overhead capital', which includes transportation, communications and investments in electricity and irrigation, that could sustain 'directly productive activities' which are, basically, industrial activities. Hirschman was of the view that the economy should be unbundled with social overhead capital so that subsequently investors in directly productive activities are stimulated. The professor advocated for last industries first, believing those would create backward linkages and he also gave prominence to the role of foreign direct investment and imported foreign capital and loans which his some of his critics to call him "a contact man for the big multinational interests of the United States".

Anyway, so confident was the Kenyan government in the attractions of its 'hospitable investment climate' that in the 1966-70 Development Plan, some 86% of investment in manufacturing was expected to come from the private sector in which foreign participation was most likely expected to dominate, while the public sector was to continue providing investment in the fields of transport and communication.

DETs and Industrial Policy

Given the absence of technical and managerial know-how, the lack of financial resources, and the lack of an indigenous industrial class, the government of Kenya thus continued with the
colonial 'open door policy' towards foreign investment, with the long term goal of 'localization of capitalism'.

Before we continue, something needs to be said about the lack of an indigenous industrial class. In Kenya, the Asian minority already constituted "a merchant capitalist class which was poised to become an indigenous industrial bourgeoisie of the classical type", but the prospect of replacing European political dominance with Asian economic dominance hardly appealed to the new government. Policies were introduced which discouraged the Asian community from making long term investments in Kenya; citizenship became difficult to obtain, and special regulations denying Asians the opportunity for legal exportation of assets or profits, were introduced. In 1967, the Trade Licensing Act was passed, barring non-citizens from trading in rural areas and the non-central areas of the town, and from handling a progressively lengthened list of specific goods.

The displaced Asians were forced to experiment in other commercial and industrial undertakings and as a result, many ventured into manufacturing, tourism, construction, insurance, transport and automotive trade.

<table>
<thead>
<tr>
<th>APPROXIMATE DISTRIBUTION OF PRIVATE NON-FARM ASSETS 1971</th>
<th>KF MILLION</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASIANS</td>
<td>NON-ASIANS</td>
</tr>
<tr>
<td>INDUSTRY</td>
<td>70</td>
</tr>
<tr>
<td>SHARE IN PUBLIC COMPANIES</td>
<td>20</td>
</tr>
<tr>
<td>REAL ESTATE</td>
<td>200</td>
</tr>
<tr>
<td>TRADE</td>
<td>100</td>
</tr>
<tr>
<td>CASH</td>
<td>35</td>
</tr>
<tr>
<td>TOTAL</td>
<td>£425M</td>
</tr>
</tbody>
</table>

Source: Colin Leys
According to Table 1, by 1971 Asians owned 35% of the private non-agricultural assets of the country. But barely concealed political hostility still made them feel insecure and hesitant about investing locally and they therefore took every opportunity for sending assets abroad by unofficial means. 6

The goal of "localization of capital" was therefore to be achieved by discouraging these investments, the potential to form a local industrial class, and by investing directly in foreign firms with the aim of exerting control over them to privatize their management and also make their shares available to Africans without having to resort to nationalization which, Jomo Kenyatta deemed unsuitable in serving "to advance the cause of African socialism." 7

The instruments for carrying out investments in foreign firms were parastatal and state corporations, notably ICMC (which took over from the IDO in 1964) as well as the NPCA (formed in 1963) were among the former. The ICNC and the DECK both had dual roles for they were also expected to provide loans and extension services to Africans who were interested in establishing private enterprises in the manufacturing and commercial sectors. Within a few years the two institutions had excelled in forming joint ventures with foreign companies at the expense of initiating local businesses, and by the end of the 1960s the alliance between the government and foreign capital was such an extremely close one that for many years
...afterwards foreign industrial capital remained largely uninvolved. 22

One of the major reasons why the SADC and ECCO became so
attracted towards foreign companies is that their conditions for
landing effectively excluded the few emerging African enterprises.
Another reason is that though foreign firms had been assured that
their property would not be expropriated, they still sought an
"insurance policy" against political hazards and thus they thought
would be achieved by ensuring the participation of government
institutions such as the SINC and EOIC (and later on the KIE, formed

In recent years, the role of these institutions as agents of
industrialization has come into sharper focus. Existing literature
on their performance paints a less-than-compelling picture with their
defects seemingly outweighing their achievements.

...
Nairobi with only limited branch outlets in the larger towns and this encourages a pattern of skewed industrial development in favour of the immediate locale of the headquarters.

i) The institutions show an inclination to invest in large firms (East African Industries, Uchumi Supermarkets Ltd., Kimoi, Associated Vehicle Assemblers) rather than small enterprises. They therefore end up helping already successful businesses rather than initiating and supporting new ones. Thus, they no longer act as catalysts for local industrial development and the goal of nurturing indigenous entrepreneurship falls by the wayside.

ii) The proliferation of institutions has led to some unproductive competition by the financing of enterprises in the same lines of production even when market conditions do not warrant it. This has led to excess capacity in certain industries while others are complaining of lack of capital. The lack of investment coordination between the institutions is a waste of scarce resources.

iv) There is a lack of consistent supervision of clients which encourages a tendency towards financial indiscipline among the clients resulting in loan defaults. Since the machinery to conduct supervision exists in all the institutions, poor supervision can only be blamed on wilful negligence.

v) Clients complain that development finance institutions show a
preference for providing fixed capital loans, whereas the grantor need is often for working capital. These institutions seem to be out of touch with client needs.

vi) Finally, borrowers complain of complicated procedures and long delays that can result in borrowers having to seek assistance elsewhere especially if their requirements are for working capital.

DFIs have earned criticism not only as agents for industrialization, but also as financial intermediaries. As financial intermediaries, these institutions have displayed consistently unsatisfactory portfolio performances. The poor performances are generally the result of:-

i) Deficiencies in management, supervision and repayment collection processes on the part of the DFIs; and

ii) Poor management and financial controls of the client firms in which the DFIs have invested equity or debt financing.

In 1991, two DFIs, the ICDC and IDS were targeted for major restructuring as part of the Public Sector Reform Programme. The restructuring programme for the DFIs was financed by the World Bank and was termed the Financial Para-statal Technical Assistance Project.

Under the project the two DFIs were to undergo institutional and portfolio re-organization over a period of twenty four months. The objectives of the exercise was to improve the institutional capabilities of the ICDC and IDS to make them more commercially
oriented with an emphasis on profitability and financial sustainability.

However, the two-year period estimated for the restructuring proved inadequate as the time frame was extended and has currently exceeded the originally estimated period by one year which could be construed as evidence of the actual and unexpected amount of restructuring that was required.

A. Summing Up

Commentators generally tend to dwell on the negative aspects of DFIs but over the years these institutions have played a positive role in assisting both new and existing enterprises in the manufacturing and commercial sectors thus creating employment opportunities and fostering local entrepreneurship.

A major feather in the cap for DFIs is the KIE Industrial Estates program in which industrial estates for small manufacturers have been established in eight major towns. On the estates factory buildings are available for renting and there are associated administrative and technical services. Machinery and equipment are provided with one hundred percent credit, with technical and managerial assistance.

In addition to Industrial Estates in the major towns, KIE has established Rural Industrial Centres in ten secondary towns spread over the Western, Eastern and Coast Provinces, contributing to wider geographical distribution of industrial activity. In these
Kits, simple buildings and technical services are made available to very small scale producers. Despite criticism regarding the low occupancy rates in estates and centres in some towns, and the "coercion" of occupants by providing them with subsidized services and facilities and shielding them from competition and risks, it is generally conceded that a significant number of enterprises have been established over the years.

Hardly any mention is made of the fact that UFEs have eschewed corrupt practices: Frank Child, however, does remark on cases of kickbacks to loan officers in two of the institutions, but it is not likely that the problem is of serious magnitude since no other commentator discusses it.

Surprisingly, little is said about how factors beyond the control of UFEs have contributed to an unimpressive performance. For instance, no mention is made of the fact that in the early years, following independence, mistakes were almost inevitable due to the political climate existing at the time. There was a racialistic zeal, compounded by the massive success of the land settlement scheme which involved the transfer of land from Europeans to Africans to indigenise industry. Additional factors such as the need to create employment, the government's wish to attract foreign investors, the political desire to put people in key decision-making positions, and the overall policy to quicken the pace of industrialization all led to an emphasis on the number of projects promoted at the expense of quality backed by detailed...
millions of shillings in the form of equity and loans were utilized to prop up unviable companies (Yiken Textiles, Uchumi Supermarkets, Salt Manufacturers Kenya Limited) even as new projects were being initiated. This approach inevitably resulted in excess capacity in some industries and since not all the salvage operations were successful, valuable resources were wasted and this was manifest in weakening financial reports for the DFIs.

An issue of particular significance is that DFIs appear to have little influence within the government. Without gaining access to high level decision-makers in the government, DFIs cannot exercise any control on the formulation of industrial development plans. One economist has observed that Kenya’s industrialization plans are not consistently supportive of industry and this is mainly because the bulk of the nation’s politicians and senior bureaucrats do not have major economic interests in manufacturing. Their investments are in farming, transport, services, small trading, and real estate. Due to the nation’s racist colonial
The sense of priority (or lack of) that the government actually attaches to industrial development can be gauged from the suspicion that the old argument that agriculture and industry are antagonistically involved in a zero-sum game appears to still lurk in the minds of policy-makers. This is despite evidence that the fortunes of agriculture and industry are closely interwoven in that improvements in agricultural productivity depend on adequate supplies of industrial inputs (agricultural implements, chemical fertilizers) and that the expansion of industry depends to a large extent on improvements in agricultural productivity.13

Finally, the high rate of importation of consumer goods as well as factory inputs has affected enterprises assisted by DFIs. This ‘import-culture’ is, ironically, the result of two and a half decades of policies favouring import-substitution industries. Measures to step up local production of import-replacing inputs and consumer-goods has been opposed by powerful political forces with vested interests in the import business.4

Since many of the projects assisted by the DFIs are of an
import-substitution nature the institutions end up with deteriorating portfolios.

DFIs do not exist in a social and political vacuum. Indeed, it can be said that the primary brief of DFIs was Kenyanization (also termed Africanization or indigenization) a policy that was obviously motivated by social and political considerations. Kenyanization in regard to DFIs included equity investment in foreign firms and local entrepreneurship development, as we have previously seen, but small industrial development and rural industrialization were later added to the list of objectives. Kenyanization and the country’s industrial policy (we shall observe briefly the industrial policy in the next section) are virtually indistinguishable and they both also translate easily into the government’s broader social, political and economic objectives.

However, it does seem evident from the available literature that DFIs have failed in their attempts to fulfill the closely intertwined objectives of Kenyanization and industrial policy. On a broader canvas this failure could be seen as a betrayal of the government’s social and political agenda and also a setback to the socio-political and economic progress of the country.

Bearing this in mind it becomes vital to understand how the activities of DFIs can be reconciled with the national interests of the government. To be able to do this we must first establish whether empirical investigation actually validated the observations
made by commentators regarding DFIs and their pursuit of the goals of Kenyanization and industrial policy. If the observations are shown to be valid, we can then proceed to search for methods of improving the situation at both the institutional level (DFIs) and the policy-making level.

RESEARCH HYPOTHESIS

Kenya does not have what could typically be described as an industrial plan. Instead, the government follows a series of policy pronouncements formulated within the framework of the principles and objectives embodied in the Sessional Paper No.10, which Kenyatta once dubbed Kenya's economic 'bible', and the constitution of Kenya. These statements can be listed as follows:

(i) The building of a strong, self-reliant and indigenous base for industry.

(ii) Promotion and assistance to the establishment of industries based largely on locally available resources whose products have export potential and are also required by the masses within the country.

(iii) Creation of increased opportunities for providing productive and gainful employment particularly self-employment all over the country especially in the semi-urban and rural areas; and

(iv) Ensuring that as far as possible, the benefits of industrial development become available in all regions and parts of the country.
DFIs as government agencies can be expected to play a crucial role in achieving these goals, which I have restated as:

(i) Building of a diversified industrial base comprising consumer industries as well as intermediate and capital industries.

(ii) Building up of industries utilising locally available resources instead of imported inputs; and

(iii) Employment creation and widespread entrepreneurship development by encouraging rural industrialisation, assisting small and medium scale enterprises, and encouraging the use of factor appropriate technology.

Preliminary observation however seems to indicate that DFIs have fallen short in achieving these objectives and in order to determine the truth or falsity of this view, I have formulated the following hypotheses:

(i) DFIs lending practices have failed to support a broad range of consumer, intermediate, and capital industries.

(ii) DFIs have encouraged industries that are heavily reliant on imported inputs rather than locally available resources.

(iii) DFIs lending practices have encouraged the centralisation of projects in urban areas.

(iv) DFIs have a tendency to support large industries rather than small and medium scale enterprises.
(v) DFIs do not encourage their clients to make use of factor appropriate methods of production.

METHODOLOGY

The research design will comprise case studies of the development finance institutions. These will be based on the annual reports of the institutions which are expected to show sources of funding, profitability of the institutions, and the sectoral and spatial distribution of investments and commitments. In addition, I shall visit the offices of these institutions where I intend to interview officials using a detailed interview schedule. With this interview schedule, I hope to determine,

(i) Whether the lack of imported inputs is a major complaint among client firms. If it is, this would be an indication of reliance on foreign rather than local resources.

(ii) The levels of investment by DFIs in consumer goods industries, intermediate goods industries, and capital goods industries. However, it needs to be noted that the divisions between intermediate goods and consumer goods, and between intermediate goods and capital goods are sometimes unclear. Nonetheless, intermediate goods industries are often understood to be industries that provide inputs to both consumer goods industries and capital goods industries and we may therefore consider intermediate goods as goods requiring further processing or assembly. Based on this criteria, we can list the intermediate goods industries as being textile, metal, vehicle components,
leather, and wood products industries. Consumer goods industries would be agricultural processing, food, and beverage industries, while capital goods industries would be the traditional heavy engineering, chemical, and pharmaceutical industries.

(iii) The firm sizes enjoying the most DFI assistance, i.e., whether they are small scale, medium scale, or large scale firms. However, there is no universally accepted way of measuring the size of an industrial establishment. Diverse measures have been used to rank firms according to the amount or type of capital or assets of the enterprise. the number of employees, the volume or value of output, floor area of workshops and offices, amount of energy used, functional characteristics like form of management, or any combination of these criteria. DFIs use the amount of capital invested as the yardstick for size. According to the statements of policy appearing in the annual reports of the DFIs, projects with a total capital investment of less than one million shillings are deemed as small scale industries while those with capital investment between one million and five million shillings are considered medium scale. Those with capital investments exceeding five million shillings are considered large scale projects.

(iv) Whether efforts are being made by DFIs to encourage the use of factor appropriate techniques among their clients.

Data Analysis

The hypotheses numbered (iii), (iv) and (v) relating to the dispersal of industry, support to small and medium scale projects,
and the use of factor appropriate technology respectively, seem amenable to evaluation using econometric methods since the related data are readily quantifiable. The number of projects based in the rural areas can be used to determine DFI lending practices in regard to delocalisation of industry, while the number of small and medium scale projects assisted can be used to determine DFI lending practices towards small and medium scale enterprises. The number of employees engaged in client firms can be linked to the type of technology used since in a labour abundant economy labour intensive technology would be considered factor appropriate.

I have introduced a model which I shall use to display the effect of government policy on DFI loan/equity (loans and equity participation) assistance to projects. In an ideal world, loan/equity approvals should be a function of government policies supporting delocalisation of industry, building up of small and medium enterprises, and alleviation of the unemployment problem by use of factor appropriate technology. However, according to some of my hypotheses:

\[ LE = a + b_{1} LOCAT + b_{2} SME + b_{3} EMPLOY \]

Whether the above expression is true or false shall be determined using the following multiple regression equation:

For the purposes of this study, Rural will be defined in terms of distance from the major cities, Nairobi and Mombasa which have relatively high industrial concentrations. Regions outside the two
cities and their peripheries will therefore be termed as rural.

In the model, the parameter 'LOCAT' represents the number of rural-based enterprises, 'SME' represents the number of small and medium scale enterprises, and 'EMPLOY' represents the number of employees. For the purpose of this model I intend to use cross section and time series data for a period spanning the last 15 years or so, which seems a sufficient duration for a trend to manifest itself. If the information is available, parameters such as 'collateral cover', 'LOCAT', and 'foreign exchange impact' (import substitution/export promotion), 'FOREX', will be added to the model. Needless to say, the more parameters there are in the model, the less the likelihood of bias in the final estimate.

From various Economic Surveys, it is apparent that expenditures on loan/equity by DFIs are greatly influenced by the value of the Kenyan shilling in relation to the major currencies these institutions being quite reliant on foreign banks and donor agencies.

Increasingly high exchange rates have made it difficult for DFIs to repay loans to foreign lenders and the government often has to make payments on loan instalments on behalf of the institutions. Loan and equity assistance to industrial projects has also been curtailed while due to the unfavourable exchange rates, the nominal costs of initiating and expanding projects have been increasing even though it is probable that real costs have not changed or have actually fallen due to the possible rationalization of production.
In order to obtain the real values of loan/equity assistance offered from one year to the next, it is necessary to deflate those figures using either the CPI (Consumer Price Index) or a Foreign Exchange Index based on the five major currencies that command general confidence, i.e. the American dollar, English pound, Japanese yen, German mark and French franc. I consider a foreign exchange deflator to be more appropriate to the investigation at hand because:

1. DFIs rely considerably on foreign currency loans and when the shilling depreciates, or is devalued, foreign currencies become dearer in comparison. This makes it difficult to repay foreign denominated loans and therefore puts a damper on borrowing by the DFIs. This consequently diminishes their ability to lend to clients locally.

Conversely, when foreign exchange rates are favourable, foreign borrowing is likely to be encouraged and the capacity to lend strengthened as a result. These fluctuations need to be eliminated.

2. In relation to the above, various Economic Surveys indicate that the Kenyan economy has been experiencing frequent depreciations and devaluations: there were three devaluations in 1981 and 1982, and in 1993 the shilling was devalued three times all in the first half of the year.

A foreign exchange deflator is therefore necessary if we are...
to arrive at reasonably accurate values of financial assistance offered by the institutions.

CONCLUSION

Industrialization has a crucial role in long-term development. It can reduce dependence on external forces, provide employment, foreign exchange and domestic savings. For industrialization to take off access to capital must be assured.

Unfortunately in Kenya, such access is limited. Commercial banks prefer to give short-term loans rather than the medium and long-term loans industry needs. Also, in recent years the commercial banking sector has been the victim of crises which have reduced public/client confidence.

The stock market, now forty years old, has all along been an Over-The-Counter (OTC) market with restricted access for the public resulting in a low trading volume and low capitalisation. With the formation of a Capital Markets Authority reforms have been introduced, but it is rather early for them to have a significant impact.

Non-Bank financial institutions such as insurance companies, due to an overbearing government presence in their activities, have been severely limited in their ability to work as activators of resources, e.g. the Insurance Act which limits access of insurance companies to the stock market.

As for informal finance institutions, e.g. Rotating Savings and
Credit Associations, the resources available to these mostly rural
organizations are too limited for them to be of any appreciable
help to industry as large.

That therefore leaves development finance institutions. The
purpose of this study is to discuss and analyze their activities
with regard to the manufacturing sector. I hope that by closely
observing these institutions, fresh insights into their viability
and efficiency can be attained and recommendations made on how to
improve their effectiveness in regard to the allocation of
resources, financial or otherwise, to industries in Kenya.
NOTES

3. Ibid.
4. Ibid. p.25.
5. Ibid. p.27.
10. Ibid. p.84
12. Ibid. p.27.
27. Ibid, p.125.
32. Ibid.
41. Ibid, p.5.
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APPENDIX I

\[
(1 + R)E_j (1 - p_j) X_j : E_j (1 + i a) X_j
\]

Where, \( P \) is financial loss per unit of principal loaned,

\( (1 + R) \) is principal plus interest due per unit of principal,

\( P_j \) is financial loss per unit of principal on a loan \( j \),

\( X_j \) is the actual size of a loan \( j \).

\( i \) is the cost of interest to the financial institution of raising resources, per unit of principal.

\( a \) is the cost of administering and supervising loans per unit of principal.

The financial costs and the administrative costs of a loan \( X_j \) can be shown in the following manner:

\[
(1 - c) - (1 - p_j) X_j / E_j \quad \text{financial costs},
\]

\[
a = \sum \ x_j / E_j \quad \text{administrative costs}.
\]

Substituting this back into the above expression, we then have:

\[
(1 - p) (1 + r) > (1 + i) + a
\]

or

\[
r > (1 + i + a + p) / (1 - p)
\]

The term on the right hand side gives the total costs of lending, including expected losses due to default, expressed as an interest rate. \( P \) appears in both the numerator and the denominators since the interest payments on the good accounts must cover the lost principal in addition to the lost interest on those in default.

Government policy

Are there any other criteria not included here?

Who determines the amount of funds available for an lending?

- Self-determined (Board of Directors, etc.)
- Shareholders
- Foreign lenders
- The government
- Others

How long does an appraisal take?

Who conducts the project appraisal?

Who comes up with project ideas?

Do you provide any entrepreneurial training?

Do you sponsor entrepreneurial education courses?

If yes, at what level?

Do you use any non-financial criteria in loan assessment?

If yes, describe the criteria.

Could you give examples of such projects?

Do you assist enterprises in the following aspects of business?

- Feasibility studies
- Project preparation
- Market of products
- Choice of technology and equipment
- Managerial training/administration
- Dealing with government regulations

Could you comment briefly?

Do you provide working capital?
Do you provide different maturities for loans of different usage?

Small scale enterprises are unable to negotiate effectively for inputs. Do you assist them in procuring necessary raw materials, machinery, spare parts, etc.? Do you finance the development of adaptations of imported technology to local conditions (appropriate technology)? If yes, how do you spread knowledge of this appropriate technology techniques (i.e. marketing, utilization and servicing)? Could you mention a few examples of these new techniques and where have they been implemented?

Do you have a method of keeping in touch with other development finance institutions (DFIs) in the world? If yes, please explain. What is the extent of inter-institutional co-operation between this and other DFIs?

Commercial Banks?

Non-Bank Financial Institutions?

Informal Credit Mechanism e.g. rotating savings and credit associations?

Do you have figures showing regional distribution of projects? Regional distribution of loans?

What percentage of your loans have you managed to recoup, on average, over the last ten years?

Do you accept debt to equity conversions?

Do you offer other financial services besides lending?

What financial instruments do you use?
APPENDIX II

AGENCY INFORMATION SHEET

NAME OF INSTITUTION

PERSON BEING INTERVIEWED

POSITION

Could you give a brief background of this institution?

Does the institution have a mandate statement?

Copy Available

No Statement

Do you use the statement in evaluating and supporting project?

What is your source of funds?

What documentation do you require before considering a loan application from?

Local investor

Foreign investor

To investors you provide:

Only seed capital

Venture capital, encompassing managerial, marketing and technical assistance

Seed capital and equity - participation

Venture capital and equity - participation

What do you ask for as collateral?

Title deeds

Machinery/Fixed assets

Personal guarantees

Others

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Do you ever lend without collateral?

The government in Sessional Paper No. 1 of 1985 discusses reducing collateral requirements established by commercial and public banks. Have you been asked to reduce collateral requirements?

If so, by how much and by whom?

What is your current lending rate on security value?

Do you have figures on collateral cover on your loans?

What proportion of total capital do you provide to clients?

How do you determine the following?

- Duration of loan
- Grace period
- Interest rate
- Limits (amount) of loan facility.

Describe your loan structure

- Short-term (%): 
- Long-term (%):

How do you ensure finance is utilised for the objective?

Which Act governs your institution?

Does the government require a particular debt: Equity ratio?

How would you term the following in order of importance in determining the organization's loan policy towards projects?

- Employment creation potential
- Export potential
- Import-substitution potential
- Linkages
- Ownership: African
- Asian
One of the reasons for the perpetuation of parasitism of war in Africanized business is still considered militarization as one of your primary goals?

What proportion of your clients fall under the following categories?

- African
- Foreign

Do you assist the informal sector in any way?

Could you sub-divide your clients into the following groups for the last 20 years?

1. Small scale
2. Medium scale
3. Large scale

It is argued that compared to SMCs, large enterprises contribute more to employment by encouraging indirect employment through backward and forward linkages. Does your experience support or dismiss this argument?

Are figures available to back your answer?

Studies seem to indicate that small scale enterprises (SMCs) capital needs for investment and working capital are met largely from internal cash generation, personal savings and informal intermediaries (moneylenders and middlemen). Institutional credit is the last resort. How do you respond to this view?

Compare the costs for project promotion, appraisal, and supervision of small enterprises and larger enterprises.

Are new devices for screening small projects being prepared?
Often we find that institutional credit for large enterprises is at an artificially lower interest rate than for SSEs. Comment on this.

Does the government offer credit guarantees for loans given to SSEs?

If yes, what are the conditions for compensation given by the government?

Does the government subsidize any of your loans?

Commercial Banks are wary of lending to small enterprise due to costs and risks involved. Has this organization considered acting as a guarantor of such loans?

If so, what percentage of risk do you guarantee?

What factors do you take into consideration when you accept to act as guarantor to a loan?

Do you have any foreign operations?

Do you undertake any of the following functions?

a) Re-financing of loans
b) Underwriting of capital issues
c) Leasing
d) Pilot projects

Do you undertake business training, problem-solving seminars or business extension services for entrepreneurs?

What effect did government-controlled interest rates have on borrowing by SSEs and larger enterprises?

Discouraged
Encouraged
Hard to say.
What effect, if any, did they have on the repayment of loans?

Now that interest rates have been reduced, what effect is this likely to have on borrowing by SMEs and other enterprises?

What are your current lending rates?

How do you compare the supervision and collection of debts from small-scale and larger enterprises?

Do you encourage large industry to collaborate with small enterprise through sub-contracting arrangements?

If yes, please give examples.

Do you encourage SSEs in their transition from small to larger enterprises?

Please give examples.

Please describe an Industrial Estate?

What were the objectives of setting up Industrial Estates?

Where are these Industrial Estates located?

What are R.I.D.Cs?

Where are they located?

What problems have affected Industrial Estates?

How about R.I.D.Cs?

Comment on the IPA and proposed S.R.D.C

How does a revolving fund work?

Are R.I.D.Cs and Industrial estate staff allowed to approve loan applications and collect loan payments?

If yes, what size of loan can they approve?

What effect have Industrial Estates had on surrounding areas?

How does a person join an Industrial Estate?
How about an R.I.P.C?

Which sub-sector of manufacturing have you been involved with the most?

What would you attribute this to?

Please explain 'risk exchange' in regard to funds received from abroad.

Please explain how it is transferred to borrowers of the organization.

Numerous projects have benefitted from loans given by your organization, creating employment opportunities; Do you have figures on the number of employment opportunities created?

Do you keep estimates of value-added for your projects?

Has the organization been approached to assist in the country's export-promotion drive by assisting M.U.B and Export Processing Zones?

If yes, which projects has the organization assisted?

Do you have figures on the foreign-exchange impact of projects?

Are there any areas you consider priority areas?

Do you maintain information on your clients regarding:

- Number of employees?
- Product and size of market?
- Profitability?
- Export potential?
- Production technique?

Can such information be made available to me?

Do you share information on clients with other DFIs?
Have you had any failed projects?
Do you have figures?
What have been the main reasons for failure?
Please comment on the chances of a project appraisal foreseeing any of these problems.
What policy and financial assistance measures do you think the Government of Kenya (GoK) or donor community should extend to DFIs so that they meet their objectives?
Are there plans to increase local sourcing of funds?
If so, comment.
A World Bank report claims that the bad financial reputation of small-scale enterprises results in part from the 'slipshod' practices of lending institutions when it comes to loan supervision and collection. It goes on to say that institutions should enforce repayment obligations strictly thus instilling financial discipline in SSEs. Do you agree with this observation?
Finally, would you be able to share a copy of a project evaluation summary with me?
If not, would it look like this?
EVALUATION SUMMARY

Title of Project:
Output in value terms:
Output in physical terms:
Investment:
No. of people employed:
Project to start:
To be completed:

CRITERIA

1. Commercial profitability:
   1. Simple rate of return
   2. Net present value
   3. Financial aspects
   4. 

EVALUATION RESULTS

General comments about Commercial profitability

111. 1. Net national value added criterion
   1.1 Absolute efficiency test
   1.2 Relative efficiency test

   2. Additional indices.
   2.1 Employment effect
   2.2 Distribution effect
   2.3 Foreign exchange effect
   2.4 

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3. Supplementary considerations

3.1 Infrastructure implications

3.2 Environmental implications

3.3

General conclusions about national profitability

III: Uncertainty Analysis

1. Break-even analysis

2. Sensitivity analysis

3. Risk analysis

Recommended policy, managerial and other measures to secure successful implementation of the project.