THE EFFECTS OF EXCHANGE RATE LIBERALISATION ON THE BALANCE OF PAYMENT OF A DEVELOPING COUNTRY: A CASE OF KENYA.

A RESEARCH PROJECT.

BY

SIMIYU MUNGAMI EDDIE
SCHOOL OF HUMANITIES AND SOCIAL SCIENCES
INSTITUTE OF BUSINESS
DEPARTMENT OF FINANCE.

A PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE OF MASTERS OF BUSINESS ADMINISTRATION (MBA), KENYATTA UNIVERSITY.

JULY 2003
DECLARATION

This research project is my original work and has not been presented anywhere for consideration for a degree in any other University.

Signature ______________________ Date 29.07.03

SIMIYU MUNGAMI EDDIE
DEPARTMENT OF FINANCE
KENYATTA UNIVERSITY

This research project has been submitted with my approval as university supervisor.

Signature ______________________ Date 29.07.2003

MR. DAVID KIPROP SIRIKWA YEGO
LECTURER
DEPARTMENT OF FINANCE
KENYATTA UNIVERSITY
DEDICATION

To almighty God, your grace is sufficient.

To Rose and Eric, my parents, what could I do without you?

To my brothers and sisters, it is up to you.
ACKNOWLEDGEMENT

I owe much gratitude to my supervisor, Mr. David Yego for his guidance, suggestions, comments and the many hours that he devoted to the improvement of the research paper. His relentless effort to ensure that I come up with a refined document will always linger in my memory. Many thanks also to my classmates for their company, I will always cherish your friendship. I am equally indebted to my lecturers, for their dedication to ensuring that I get quality education.

I am equally grateful to my brother Alex for being close in the most trying moments in my life, he has been more than a brother. I cannot forget my friends Kisaka, Ekuam, Okusacha, Sitati, Moses, Jacob oduor and many others that I could not remember your love and friendship touched me deeply. For special mention is Charles Odhiambo for his selfless efforts to ensure that my document is typed in time.

Once again I thank the unbwogable crew of Eric and Rose, their love, dedication and commitment to ensure that nothing stops in my way to access quality education will always be dear to me. Thanks also to Dr Maurice Otube for his assistance. To the rest of the Baangami stop wondering what happen and make it happen.

Lastly like the lizard that fell from the iroko tree, there being no one to appreciate my efforts I take this rare opportunity to look back where I have come from, really it has
been a long journey that requires patience but the end has not yet come I have to stay focused and make my contribution to humanity.

I take responsibility for any error of omission or commission in the paper.
# TABLE OF CONTENTS

DECLARATION ........................................................................................................... II

DEDICATION ............................................................................................................... III

ACKNOWLEDGEMENT .............................................................................................. IV

TABLE OF CONTENTS ............................................................................................... VI

LIST OF TABLES .......................................................................................................... VIII

DEFINITION OF TERMS .............................................................................................. IX

ABSTRACT .................................................................................................................. X

CHAPTER ONE: INTRODUCTION .......................................................................... 1

1.1 BACKGROUND TO THE STUDY ................................................................. 1

1.2 LIBERALIZATION OF THE EXCHANGE MARKET ....................................... 3

1.3 KENYA'S EXPERIENCE .................................................................................. 4

1.4 STATEMENT OF THE PROBLEM ................................................................... 8

1.2 OBJECTIVES OF THE STUDY ........................................................................ 11

1.3 HYPOTHESIS ................................................................................................... 11

1.4 SCOPE OF THE STUDY .................................................................................. 12

1.5 RESEARCH QUESTIONS .................................................................................. 12

1.6 SIGNIFICANCE OF THE STUDY ................................................................... 12

CHAPTER TWO: LITERATURE REVIEW ......................................................... 14

2.1 KENYA'S BALANCE OF PAYMENT ............................................................... 14

2.2 IMPORTANCE OF THE BALANCE OF PAYMENT TO KENYA ...................... 16

2.3 EMPIRICAL FINDINGS ON BALANCE OF PAYMENT ................................. 16

CHAPTER THREE: METHODOLOGY ............................................................... 25

RESEARCH DESIGN ............................................................................................... 25

3.1 POPULATION OF THE STUDY ...................................................................... 25

3.2 SAMPLE AND SAMPLING DESIGN .............................................................. 25

3.4 DATA ANALYSIS TECHNIQUES .................................................................... 26

CHAPTER FOUR: RESULTS OF DATA ANALYSIS ......................................... 28

4.1 OVERVIEW OF THE DATA COLLECTED AND ANALYZED ....................... 28

4.2 ANALYSIS OF PRIMARY DATA .................................................................... 28

4.3 ANALYSIS OF SECONDARY DATA .............................................................. 41

4.4 DISCUSSION OF THE FINDINGS ................................................................... 44

CHAPTER FIVE: CONCLUSIONS, POLICY RECOMMENDATIONS AND AREAS FOR FURTHER RESEARCH ................................................................. 49

5.1 SUMMARY AND CONCLUSION .................................................................... 49

5.2 POLICY RECOMMENDATIONS ..................................................................... 51

5.4 SUGGESTED AREAS FOR FURTHER RESEARCH ........................................ 54
List of Tables

<table>
<thead>
<tr>
<th>Table</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Table 1</td>
<td>International Business</td>
<td>29</td>
</tr>
<tr>
<td>Table 2</td>
<td>Goods Exported</td>
<td>29</td>
</tr>
<tr>
<td>Table 3</td>
<td>Kenya Currency Stability</td>
<td>30</td>
</tr>
<tr>
<td>Table 4</td>
<td>Exchange Rate Mechanism Usage</td>
<td>32</td>
</tr>
<tr>
<td>Table 5.1</td>
<td>Exchange Rate Effect on Export* Exchange Rate Mechanism</td>
<td>33</td>
</tr>
<tr>
<td>Table 5.2</td>
<td>Exchange Rate</td>
<td>33</td>
</tr>
<tr>
<td>Table 6</td>
<td>Exchange Rate effect on Exports</td>
<td>34</td>
</tr>
<tr>
<td>Table 7</td>
<td>Percentage Decline as a Result of Exchange Rate</td>
<td>35</td>
</tr>
<tr>
<td>Table 8</td>
<td>Cross-tabulation Percentage Decline* Goods Exported</td>
<td>36</td>
</tr>
<tr>
<td>Table 9.1</td>
<td>Cross-tabulation of Exchange Rate* Goods Exported</td>
<td>37</td>
</tr>
<tr>
<td>Table 9.2</td>
<td>Chi-square Test</td>
<td>38</td>
</tr>
<tr>
<td>Table 10</td>
<td>Exchange Rate Effect on Imports</td>
<td>38</td>
</tr>
<tr>
<td>Table 11</td>
<td>Goods Imported</td>
<td>39</td>
</tr>
<tr>
<td>Table 12.1</td>
<td>Cross-tabulation Exchange Rate Effects* Goods Imported</td>
<td>40</td>
</tr>
<tr>
<td>Table 12.2</td>
<td>Chi-square Test</td>
<td>40</td>
</tr>
<tr>
<td>Table 13</td>
<td>Balance of Payment</td>
<td>41</td>
</tr>
<tr>
<td>Table 14</td>
<td>Current Account</td>
<td>42</td>
</tr>
<tr>
<td>Table 15</td>
<td>Balance of Trade</td>
<td>43</td>
</tr>
<tr>
<td>Table 16</td>
<td>Exchange Rates</td>
<td>43</td>
</tr>
<tr>
<td>Figure 1</td>
<td>Graph of Exchange rate movement from 1973 to 2001</td>
<td>8</td>
</tr>
<tr>
<td>Figure 2</td>
<td>Pie Chart of Exchange rate opinion</td>
<td>31</td>
</tr>
<tr>
<td>Figure 3</td>
<td>Pie Chart of Companies use of Exchange Rate Hedging Mechanism</td>
<td>32</td>
</tr>
</tbody>
</table>
Definition of Terms

1. Exchange rate: The price of one currency in terms of another.

2. Futures contract: Agreement to buy or sale a fixed quantity of currency/security for delivery at a fixed date in the future at a fixed price.

3. Hedging: Economic operation undertaken to protect investors in an open market economy against currency fluctuation.

4. Hot money: Funds of speculative nature that are used to buy or sell foreign currency to take advantage of interest differentials.

5. Investment: The use of money to create more wealth either in form of interest, dividends or profits.

6. Investment appraisal: The perusal of an investment portfolio with the purpose to ascertain the strengths and weaknesses.

7. Option: Right to buy or sell a fixed quantity of a currency at a particular date at a particular time.

8. Dirty float: It is a kind of flexible exchange rate which the Government intervenes in the foreign exchange market to stabilize the Exchange rates.
ABSTRACT

Exchange rate is one of the macro economic fundamentals that play a key role in ensuring that the economy of a country remains competitive in the international market. It plays an important role of efficiently allocating and use of economic resources hence ensuring a country remains competitive externally. The exchange rates are important in improvement of the balance of payment.

The study was concerned with the effects of exchange rate on the balance of payment. Primary data was used in the study to determine the effect of exchange rate liberalization on the balance of payment components from selected companies. Secondary data was used to analyse the effect of exchange rate on the overall balance of payment performance. Descriptive statistics was used to analyse data. Graphical representation of the balance of payment was also drawn. The results show that the exchange rate liberalization has improved the overall balance of payment but it has not improved the current account or reduced the balance of trade deficit as envisioned by Bretton woods institution.

The study found out that the exchange rate liberalisation had a negative effect on the companies export sales due to wide fluctuations that make planning hard and losses that are incurred as a result of the fluctuation. Most companies do not employ any hedging mechanism hence bear the brunt of the upswing and downswing of the shilling. The firms factored in their prices the adverse effect of the exchange rate fluctuation.
The study recommends that the Central Bank of Kenya use target zones to reduce wide fluctuation of the shilling against other currencies. The government of Kenya should link with neighbouring countries to hasten regional integration by harmonizing the fiscal and monetary policies and possibly creation of a single currency that will completely eliminate exchange rate fluctuation. The study also recommends development of forward, futures and options markets. These markets will enable the companies to certainly forecast the expected exchange rates in the future hence facilitate planning.
CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

Among the instruments that are crucial in economic management and stability is foreign exchange rate. This is because it determines the ability of an economy to effectively respond and adjust to exogenous shocks. Further, as a relative price exchange rate is important in making spending and investment decisions/ Ogiogio (1996) restated the importance of exchange rates for a developing country like Nigeria by stating that the price of foreign exchange plays a highly significant role in the ability of the economy to attain optimal productive capacity. The exchange rate is the price of a domestic currency in terms of a foreign currency. This price can be rigidly fixed, or alternatively, allowed to be market determined. Bogunjiko (1992) stated:

"The exchange rate is conceptualized as a link between the price structures of nations and as a result, is important to patterns of international commodity flows and the international mobility of capital resources. The local and foreign currencies trade for each other at an exchange rate in the framework of different foreign arrangements".

Developing countries have been facing balance of payment crisis. This situation has resulted to these countries embracing reforms aimed at reducing the ever-increasing balance of payment deficits. The policy package, Structural Adjustment Programme (SAPs), as advised by the International Monetary Fund (IMF) and the World Bank, included among others, foreign exchange deregulation. The desirability of a competitive exchange rate rests on the theoretical prediction that it would lead to a more efficient
allocation and use of economic resources within economies and as a result improve external competitiveness, Durdunoo et al (1997).

Were (2000) noted that as a major element in the adjustment programme strategy, of deregulating the economy and enhancing the role of market forces in the co-ordination of economic activities, the efficacy of exchange rate can be judged on the basis of it is effect on the balance of payment. He went further to add that, this was necessary because exchange rate was expected to work through appropriate changes in the structure of relative price to achieve its primary objective of altering and realigning aggregate domestic expenditure and productive patterns. The strategy is aimed at minimizing dependence on imports, enhance the non-import export base and bring the economy back to the path of steady and balanced growth. Silumbu (1995) noted that the significance of relative prices which is a trade balance phenomenon. In a commodity -based economy such as Malawi’s, relative prices may be a reflection of the dominance of trade (current account) balance changes in the overall balance of payment.

Kenya adopted the IMF structural adjustment programme (SAP) in 1992. It gradually liberated the foreign exchange market; the aim was among other economic policy targets, to improve the balance of payment. A chronic balance of payment deficit for a country suggests to the rest of the world that it is unable to increase the country's international trade and investment hence resulting to decline in a country's economic development.
1.2 Liberalization of the Exchange Market

Exchange rate reform is one of the key policy recommendations by the Bretton woods institutions under structural adjustment program. Economic analysts agree that getting the exchange right is essential for economic and growth stability in developing countries. Over the past two decades, many developing countries moved from fixed exchange rate (that is those that peg the domestic currency to one or more foreign currency) to more flexible exchange rates (those that determine external value more or less by the market supply and demand of it). Jebuni et al (1994) stated that many developing countries have been experienced a series of external shocks in the 1980s. These shocks included a steep rise in international interest rates, a slowdown of growth in industrial world and debt crisis. Often adjustment to these disturbances required not only discrete depreciation but also adaptation of more flexible exchange rate arrangement.

The shift from a fixed to a flexible exchange rate regime has been gradual in many developing countries, including those in Africa. Although such shift in Africa dates back to early 1970s, when the Bretton Woods system collapsed, most developing countries continued pegging their exchange rates. Caramazza and Aziz (1998) noted that back in 1975, for example, 87 percent of the developing countries had some type of pegged exchange rates. By 1996, this proportion had fallen to well below 50 percent. The shift is even more pronounced when the relative size of economies is taken into consideration.

Were (2001) noted that by 1996, countries that pegged exchange rates accounted for only about 20% of the developing world's total trade from 70 percent in 1975, these countries
were either pegged their exchange rate to a single key currency (especially the US dollar or the French franc) or to a basket of currencies such as the IMF's special drawing rights. It was not until the early 1980s that developing countries started moving explicitly towards more flexible exchange rate arrangements. Specific considerations notwithstanding, increased flexibility in the exchange rate has been greatly associated with a general shift towards increased openness, outward-looking policies on trade, and increased emphasis on the market determined exchange and interest rates.

The rationale of adopting floating exchange rate, according to Ndung'u (2000), is based on the following benefits that accrue to a country:

- It allows a continuous adjustment of the exchange rate in line with the demand and supply condition of foreign exchange in the economy.
- It equilibrates the demand and supply of foreign exchange by changing the exchange rate rather than the level of reserves.
- External shocks and imbalances are reflected in exchange rate movements rather than in reserve movements or the central bank intervention to control the adjustment process.

1.3 Kenya's Experience

In Kenya, exchange rate regimes have gradually changed along the general macroeconomic policies adopted since independence. The period between 1963 and 1982 was characterized by fixed exchange rates and therefore there were controls on domestic prices, foreign exchange transactions, interest rates and import licensing among others.
(Were 2001) also noted that the trade and current defects were quite low between these periods except in 1971.

Were et al (2001) noted that by 1982, it was clear that macro-economic policies pursued by Kenya had glaring loopholes and were unsustainable thereby forcing the government to change its course. Consequently, the government started to liberalize the economy following typical structural adjustment. As an intermediate step, the exchange rate was changed to a crawling one. Even with these experiences the control regime was still in place, preventing adjustment through price. The adjustment process was slow and marked by reluctance to undertake reform, thus it worsened the country's balance of payment crisis.

They also noted that Kenya experienced severe trade deterioration in 1971, which led to the past balance of payment crisis. The trade and current account that had remained low in the 1960s and 1970s reached unprecedented high levels in 1978 and 1981.

Ndung'u (2001) noted that subsequently in the 1990's liberation was intensified in both financial and goods market. Foreign exchange controls were gradually relaxed. In 1992, the exchange rate regime operated under a dual system in 1992 since here was an official exchange rate and a market rate. By March 1993, speculation in the foreign exchange market was prevalent and hence Kenya was in danger of capital flight. The market was characterized by uncertainty, especially in regard to future exchange rate transactions such as importation on trade credit.
In an attempt to avert the ensuing crisis the official exchange rate was devalued in the first half year 1993. Silumbu (1995) while emphasizing the importance of the policy decision, he stated that Depreciation and devaluation were accepted as realistic measures of enhancing the balance of payment based on a number of considerations. Firstly as a price of foreign exchange, it is expected that a realistic exchange rate is a necessary tool for appropriately conditioning supply of and demand for foreign exchange. Secondly, exchange rate actions are supposed to alter relative prices thereby inducing expenditure switching effects. Thirdly, the exchange rate has been used to compliment structural adjustment measures. For example, devaluation has been used to effect diversification of the production base, especially in the promotion of non-traditional exports.

By November 1993 the Government had abolished the official exchange rate and allowed the public to hold foreign exchange. The then Central Bank of Kenya governor, Cheserem (1995) emphasized the policy action taken, by stating, “the government will only intervene to put in place the necessary fiscal and monetary policies but not to control the money market”. Further the Central Bank of Kenya (CBK) (1995) noted that a floated shilling provides a mechanism, which automatically regulates the volume of imports into the country thereby obviating the need to use quantitative controls and discriminatory currency tendencies. The CBK added a floated exchange rate minimizes the risk of an overvalued currency, which implicitly taxes exports while subsidizing imports.

1. CBK.(1995) CBK rules out fixing exchange rates, page 3
The foreign exchange market in Kenya, like any other developing country prior to exchange rate reforms, were characterized by three main features: excessively overvalued exchange rate, a thriving black market and allocation of official foreign exchange based on import licensing arrangement mandated by the government. In order to rationalize the official exchange rate, absorb the parallel sub-markets into the legal market, and allow the forces of demand and supply to determine the rate and allocation of foreign exchange and achieve convergence of official and parallel markets the government adopted a series of exchange rate reforms. Karingi (2002). Ndung’u (1999). emphasized the importance of the policy option taken by Kenya by stating that the overriding objective of the shift in the foreign exchange regime were to correct fundamental distortions in the economy, achieve international competitiveness and ensure viable balance of payment.

Greater flexibility need not imply free floating. It may for example involve adoption of wider bands around formal or informal parities and active intervention within the band.

Deregulation of Kenyan economy was the fastest Africa had ever seen according to London daily (1994). These sentiments were supported by were et al (2001) who noted that liberalization of the foreign exchange market was done hastily although the reforms were necessary.

Between 1963 and 1972 the Kenya shilling was stable under fixed exchange rate regime. it was exchanged at a rate of Ksh 7.143 per US Dollar. Between 1992 and 1993 the Kenyan shilling had depreciated from 36.216 to 65.142 per US dollar. Currently it is trading at around Ksh. 78 per US Dollar. Against the sterling, it was trading at around
Ksh 19.54 per sterling pound in 1970’s and 1980’s however after liberalization the Kenyan shilling depreciated in 1992 from 51.368 per Sterling to 98.498 per Sterling pound currently it is trading at around Ksh 125 per Sterling pound.

![Figure 1: Trend in nominal exchange rate (1973-99)](image)

1.4 Statement of the Problem

Kenya adopted the IMF policy of structural adjustment programme, which recommended among other policies, liberalization of the financial sector. In the 1990s, the country eliminated controls on interest rate and exchange rates among others. It then embraced flexible exchange rates, which was aimed at leaving the determination of exchange rate to market forces of demand and supply, but at the same time the government intervenes to influence international transactions and subsequently steer the balance of payment towards improvement.

---

It may be useful to distinguish between the real and nominal exchange rates. The real exchange rates express the value of domestic currency in terms of real purchasing power.

The ratio of the domestic prices of two economies measures the real exchange rate. The nominal exchange rate expresses the quantity of one currency in terms of another. The real exchange rate is perceived to send signals to domestic and external absorption and production. It is important that these signals be correct, otherwise would be distorted leading to adverse internal and external balances (Lewich 1985). Given this premise the key issue is the deviation of the nominal exchange rate which is directly determined (in any exchange rate regime). Ojo (1990) noted that if the deviation is non-zero the implication is that the mechanism of determining exchange rate is distortionary he further observed that:

“Inappropriate exchange rates tend to create instability in the foreign exchange market and perpetuate widespread distortions in international economic transactions”.

Exchange rate fluctuations are not bad because they enable the economy to adjust to external shocks but the wild movement whether positive or negative, is not desired as it increases risks and uncertainty in international transactions. There are arguments that exchange rate variability also tends to induce macro-economic phenomena that are undesirable such as inflation. Kaisero (1995) noted that the volatility of the exchange rate has been a source of concern to the business community with exporters complaining that the strengthening of the shilling reduced their profits.
Adobi (1999) pointed out that if the firms hedge against exchange risk one cannot expect to find a strong negative effect on trade, hedging against risk can be done via future or forward markets. Where forward markets cushion against risk the nature of uncertainty faced by traders is transformed. Forward market represents in effect a guaranteed forecast of the exchange rate that will prevail at the end of the contract period which a trader can take advantage of by payment of small margins around the forward rates. Unfortunately, the futures market in Kenya is still at a nascent stage and the possibility of hedging via this route is remote. It, therefore, follows that hedging, not withstanding exchange rate volatility – which tend to increase the risk and uncertainty in international transactions, may adversely affect the major components of balance of payment; trade and investment flow.

Exchange rate risk measures the volatility and erratic patterns of exchange rate movements, the more volatile the higher the risk. Kenya like any other emerging market (developing countries) where currency devaluation is expected to be an incentive to export growth and capital inflows hence improve the balance of payment.

Despite reforms undertaken to make the exchange rate competitive such that Kenyan exports become competitive, increased investment and hence improve the Balance of payment, No study has been conducted on the effects of liberalization of the exchange rate on Kenya's economy, hence a study of the effect of exchange rates on the balance of payment was necessary. Ad hoc policy responses to balance of payment problems and associated costly mistakes can only be reduced if solutions emerge through a formal and
vigorous study. The balance of payment account constitutes, in analytical terms, perhaps the single most revealing reflection of the health of an open economy.

The primary concern was the nature and magnitude of Kenya’s exchange rate market liberalization on the balance of payment. Has it produced desired results especially, reducing the county's balance of payment deficits? Has the liberalized exchange rate spurred export growth and capital inflows?

1.2 Objectives of the Study

The overall objective of the study was to study the effect of exchange rate liberalisation (fluctuations) on the balance of payment. Specifically the study sets to:

- Evaluate the effect of Kenya’s exchange rate liberalisation on Kenya’s balance of payment.
- Establish the impact of liberalised exchange rates on Kenya’s export growth.
- Establish whether the liberalised exchange rate is favourable to trade and investment.
- Offer policy recommendations that will promote effective exchange rate management in Kenya.

1.3 Hypothesis

- The liberalised exchange rate has led to a deterioration of the balance of payment in Kenya.
- The liberalised exchange rates have hampered Kenya’s export and import growth.
- The liberalised exchange rate is not favourable for trade and investment in Kenya.
Kenyan companies do not use exchange rate hedging mechanism to cushion against adverse effect of exchange rate fluctuation

1.4 Scope of the Study

The research reported focused on Kenyan’s exchange rate liberalisation and its impact on the balance of payment. Kenya had been selected due to the following reasons: it is an emerging market, which embraced the Bretton woods policies of structural adjustment programme. Liberalisation of exchange of exchange rates was at the centrepiece of the reforms. The exchange rate remains one of the key macro economic variables that the country’s policy makers have to persistently keep monitoring. Data of Kenya’s balance of payment was easily accessible and because of resource limitation it was not possible to venture beyond the borders. The research was based on the major components of the balance of payment: export, import and investments.

1.5 Research Questions

The study sought to answer the following questions: -

i) Has deregulation of Kenya’s exchange rate (deregulation) improved the country's balance of payment?

ii) How does devaluation of the exchange rates improve international trade and investment inflow of a country?

iii) Does flexible exchange rate improve export?

1.6 Significance of the Study

This research is very significant in that it will benefit the CBK's foreign exchange
Department as it provides the basis on which future exchange rate reforms should be hinged. It provides information on the likely effect of the policy decision made on the exchange rate on the balance of payment and by extension the whole economy.

It also provides firms that aim to exploit foreign markets effectively, off-shore savers and investors the likely cost of exchange rate on their business endeavours and hence their bottomline.

To the exchange rate analyst and students, the paper is a thought-provoking discussion that elicits an academic reaction and hence generates more ideas about the way forward for exchange rate management in Kenya.
CHAPTER TWO
LITERATURE REVIEW

Since the adoption of floating exchange rates in the developing countries under structural adjustment programme, the question of whether the exchange rate uncertainty have independent adverse effects on trade and exports hence on the balance of payment has attracted a lot of attention. Kenya being a developing country has not been spared from the heated debate about the impact of liberalized exchange rate on the balance of payment.

2.1 Kenya's Balance of Payment

The balance of payment of any country records the revenue and payments from all economic and non-economic transactions between the government, firms (including foreign subsidiaries) and residents and government, firms and residents of those countries with which it trades. Bo Sodersten et al (1994) noted that a balance of payment account records flows between countries over a specified period of time (usually a year for full account). Kreinin (1983) summarized the balance of payment as a statement that reflects what a nation puts into the global economic pie and what it takes out. Basically the balance of payment is divided into two parts; the current account and capital account. The current account represents net of exports and imports while the capital account represents net of capital flows.

A simple model representative of the balance of payment is shown below:

$$B = X(y,e) - M(y,e) + F(e)$$
Where: X represents exports (goods and services from government, businesses and individuals).

M- represents imports (goods and services from government, businesses and individuals).

F- represents net capital flows (difference capital inflows and capital outflows).

Y- represents income

E-represents exchange rate

Kenya's balance of payment is composed of the following; in term of exports Karingi (2002) observed that Kenya exports mostly agricultural products namely Tea, Coffee, Horticultural and Tourism. He further noted that in order to shift competition and give Kenya an edge especially over African countries such as Uganda, South Africa and Tanzania, the country the export prices have to be lowered by at least 5 percent. The point was emphasized by Swedish ambassador, Mr. engfeldt (1994)\(^2\) when he lamented about the continued appreciation of the Kenyan shilling as a dark cloud hanging over tourism industry.

Karingi (2002) noted that imports are considered leakage from the domestic economy therefore an increase of imports leads to decline in real GDP of \(-3.7\%\), \(-2.2\%\), \(-1.7\%\) and \(-0.3\%\) respectively from the base of 2002, 2002, 2003 and 2004. The extra import of goods and services cause deterioration in the balance of payment. Kenya’s imports are

Capital account balance, with free movement of international capital flows, the country experienced a sudden capital inflow. For example a 5% increase in the capital account balance in 2001- the equivalent of Ksh 892 million would result in extra foreign exchange thereby improving balance of payment. In 1992 the overall balance of payment moved from a surplus of Ksh 304 million to a deficit of Ksh 102 million in 1993 mainly due to deterioration of the capital account. Daily nation (1994).

2.2 Importance of the balance of payment to Kenya.

According to Karingi (2003), the balance of payment has the following roles in an economy;

- It enhances macro-economic stability if positive. It is a good indicator of whether macro-economic fundamentals are sound.
- It facilitates trade of a country and also its ability to meet external obligations
- If positive, it is good for the economy, up to a point (appreciation question) and if negative, not necessarily bad for the country (the depreciation question). The balance of payment is critical to the stability of the foreign exchange market.
- Indirectly, it is important for the fiscal health and conduct of monetary policy.

2.3 Empirical Findings on Balance of Payment

In Nigeria, Ajayi et al (1988) while taking the structuralist approach in their study of the external trade flow in Nigeria, opposed the adoption of more flexible exchange rate policy in Nigeria. Their arguments was based on structuralist view that exchange rate
devaluation would be stagflationary and has no significant effect on external trade balance in the less developed countries. This is because of the low elasticity generally associated with excess import and demand functions.

Adubi et al (1999) noted that exchange rate increases the risk and uncertainty in international transactions and has discouraged trade. If traders are risk averse, they will be willing to incur an added cost to avoid the risk associated with the exchange rate volatility thus a firm export supply (import demand) curve will shift to the left (right) in the presence of exchange rate volatility. This means that for any quantity of exports or import, the corresponding price will be higher under exchange rate volatility (risk) than without it.

Kroner and lastrapes (1991) indicated that under perfect competition convexity in the profit functions, symmetrical cost of capital adjustments and risk neutrality increases to exchange rate volatility would increase exports. According to them, unfavorable exchange rate movements lead to a reduction in production by firms; a situation that will increase and they have more capital than is optimal. But with favourable exchange rates firms’ production increases and will then have less capital. Assuming a convex profit function the potential profit due to insufficient capital is higher than the losses due to capital. So profit-maximizing firms will tend to over invest and thus export more in the face of uncertainty.
Adubi et al. (1999) argued that due to the political economy of exchange rate volatility, the increase in volatility was responsible for the slow down in trade in 1975s. The flexible exchange rate led to misalignments of major currencies, which led in turn to adjustment problem in the tradable good sectors and political pressure toward protectionism.

McCallum (1996) argued that floating rates, firms engaging in foreign trade or investment must be concerned not only with the possibility that exchange rate involvement will wipe out or (perhaps enlarge) the net rewards measured in their own country's currency. Such uncertainty is often presumed to have an inability effect on international trade.

Hussein (1996) noted that policies suggested by the IMF are inappropriate to mitigate structural disequilibrium in the balance of payment. For example, the government devaluation of the domestic currency may accelerate the rate of the inflation instead of improving the balance payment. The structuralists see the IMF stabilization measures as a recession-inducing growth-wrecking agent.

Abel (1983) showed that if one assumes perfect competition, convex and symmetric cost of adjusting and risk neutrality, investment is a direct function of price (exchange rate) uncertainty. Marinan (1989), argued that exchange rate movements have not been consistent with the prediction of economic models. Instead exchange rates have been found to be more volatile under floating regime than had been anticipated with frequently
month-to-month variability. One of the key explanations is linked to market expectations about the future rate.

De Grauwe (1990) noted that although it cannot be denied that financial markets provide insurance services like futures and options against exchange risk, it is important to note that these services are not costless. Traders who want to hedge have to pay a price and therefore the increased risk in international trade. This price can also be considered to have the same effect as an increase in tariffs. That is it slows down the international trade.

Exchange rate ranges that wonder away from purchasing power parities for a long period of time lead to “real effects” in the economy. These misalignment lead to a boom in the traded good sectors of countries whose currency have become undervalued. In the countries whose currencies have become over valued as a result of the swing in the real exchange rate, the traded good sectors are squeezed, leading to a loss of output and employment that is not easily absorbed in the short run by other sectors of the economy.

Dhliwayo (1996) doubted the efficacy of devaluation in developing countries. He argued that the elasticity’s of export and imports are sufficiently low, therefore devaluation cannot be expected to lead to an improvement of the balance of payment. A similar source of pessimism surrounds the lags in response of the current account to relative price changes. The argument is that trade volumes responds sluggishly to price changes because of the inertia of imports switching expenditure away from imports and the existence of contract. Thus in the short- run, it is unlikely that domestic export following
devaluation will increase enough to off-set the initial increase in the value of expenditure on imports. This is the "J" curve effect on the current account whose following a devaluation the balance of trade appears before it improves.

Kidane (1997) noted that the effect of devaluation on the balance of payment in developing countries assumes that producers of primary products will be beneficiaries in reforming or eliminating marketing boards or reducing taxes on the agricultural sectors in general and hence tradable goods will cause improvement in the balance of payment. Improvement in the balance of payment occurs as a result of devaluation depends crucially on the foreign elasticity for export and home elasticity of demand for imports denoted Ex and Em respectively. If the elasticity condition that is \( Ex + Em > 1 \) is held devaluation would improve the balance of payment. Ceteris paribus this is the Marshall-lerner condition.

A study conducted by Alzehran (1998) suggested that aggregate investment is higher under a fixed exchange rate regime than under a flexible exchange rate rate for both productivity and monetary shocks. Flexible exchange rates stabilize employment and expected income in the presence of real shocks but at the cost of reducing the expected GNP and investment.

Rugonon & Hodgetts (1992) noted that floating rates automatically brings about trade balance adjustments. For example, if a nation were importing more than it was expanding and had trouble breaking out of this cycle, the devaluation of its currency in the
international market would make its exports cheaper and its imports more expensive. As a result the exchange rate depreciation would correct the trade deficit.

Ndungu (1992) noted that since exchange rate variability can be expected to be at least somewhat greater in amplitude, frequency and unpredictability under floating exchange rates than under fixed rates, the cost of exchange rate will also be greater. He further noted that Kenya had experienced short-run capital flows responding to interest differential. These capital flows are essentially portfolio flows for speculation. The policy dilemma relates to targeting both a competitive exchange rate and low inflation. To pursue these goals, the CBK have to intervene occasionally in the foreign exchange market to stabilize (and sometimes to defend) the nominal exchange rate in the face of volatile capital flows in the money market, thereby raising domestic interest rates. The result has been that the exchange rates are stabilized on the short-run but at the cost of high interest rates, which jeopardize the goal of increased domestic investment and economic recovery.

A Nation Business analyst (1995) noted that a floated shilling is not a bed of roses. A free foreign exchange market tends to be over sensitive to short-run factors, which have no relationship with economic aspects of the country such as unfavorable news or rumors. This can injure prospects for trade and investment as they make business difficult to plan. For example, the shilling appreciated marginally from Ksh 78 per dollar to Ksh 75 per dollar after National Alliance Rainbow Coalition (NARC) won the election of 2002.
Rognon and Hodgetts (1992) noted that it is fair to generalize that when the currency of an industrialized country (including the United States) depreciates, the domestic prices of its exports will (at least) in the short run remain unchanged while those of its imports will rise. This deteriorates in its balance of trade will cause the current account balance to worsen until exports and imports volume have responded sufficiently to offset the unfavorable change in relative prices. The current balance will thus tend to follow “J curve” path and may not show improvement from its initial position until a year or more has passed. This means that the role of equilibrator of the foreign exchange market must pass to the capital account otherwise the market will be unstable.

Bonori (1992) noted that when a nation’s currency floats, it is subjected to violent fluctuations due to speculative bubbles, what he aptly described as a game of snap or musical chairs. This was clear in 1994 when the shilling, which had been on an appreciation note plunged against other world currencies at a pace, which indicated there had been some speculative dealings in the currency market. The then governor of CBK requested the exporters and those in the tourism industry and the foreign exchange dealers not to rush to exchange their currencies in anticipation of further depreciation as it will disrupt the money market, Kenya times (1994).

Friedman (1983) argued that adjustment in real exchange rates is often necessary in response to various shocks. Adjustment of prices is usually slow, disruptive and painful process. In addition he emphasized that when recession is high, popular governments will often attempt to avoid them by adopting quantitative controls and barriers to trade, these
two courses of action that are extremely harmful to the longer term efficiency of the economy. Again there are possibilities of avoiding both types of restrictions by leaving the exchange rates free to adjusting in response to be initial stocks.

Durdunoo et al (1997) in a comparative study of foreign policy management in Ghana, Uganda and Nigeria, doubted the efficacy of the flexible exchange rate. They concluded that there was need to accompany unified market based exchange based exchange but appreciated exchange rates with development policy measures and going beyond static efficiency. A Unified, market based, exchange rate raises the fundamental questions of the extent to which government should refrain from intervening in the foreign market. Appreciation of exchange rates taxes exports and subsidizes imports. This makes the attainment of equilibrium unfeasible. Had Uganda not been lucky enough to experience the coffee boom, the current account would have remained persistently negative.

Kidane (1997) noted that the Ethiopia balance of payments and the current account deficit showed a slight improvement in the balance of payment position after October 1992 devaluation, suggesting a positive impact on exchange rate realignment. He noted that in a free market or open economy both monetary and fiscal policies have to be consistent with the prevailing exchange rate. If this condition is met, then the economy is said to be a stable and sustainable equilibrium, thereby generating a positive growth rate. On the other hand, if monetary and fiscal policies are not internally consistent with the prevailing exchange rate, a country is certainly to face a disequilibria and exchange rate
misalignment leading to fiscal deficits as well as exchange rate and balance of payment crisis.

Adubi (1999) The balance of payment adjustment mechanism under flexible exchange rate requires currency depreciation in the case of an incipient deficit or relatively higher domestic inflation. The depreciation will alter the relative prices of imports relative to the price of imports and exports by increasing the prices of exports relative to the price of exports and non-tradable in some cases the depreciation could be excessive and overshoot the equilibrium mark in relation to relative domestic cost and prices, consequently the depreciation would cause intensified inflation. This situation was experienced in Kenya when the shilling depreciated from Ksh 64 to Ksh 68. With many still doubting the banking sector ability to maintain price stability, the resultant effect was the possibility of inflation rising from a single digit to a double-digit range as oil companies had factored in higher crude oil prices and a weaker shilling in their pricing.

Previous studies have concentrated on the fundamentals of exchange rate in Kenya. Ndung’u (2001) in his study linked the exchange rate and interest rates in Kenya, while Were et al (2001) examined the trend behavior of Kenya’s exchange rate movement in a liberalized environment. This study tried to give the link between the exchange rate and economy by bringing out the effects of liberalized exchange rates on the balance of payment.
CHAPTER THREE

METHODOLOGY

Research Design

This chapter discusses the population of the study, the sample size and selection method, a description of the data collection method(s) and instrument and data analysis techniques.

3.1 Population of the Study

Both secondary and primary data was used. The population of the study comprised of companies dealing with exports and imports. According to the Export Promotion Council Directory (1998), there were 90 best performing companies in Kenya and therefore comprise the population of the study. Yearly statistics for the period between 1980 and 2002 was also used. This gave the twenty-three (23) data points. The data was obtained from the Central Bureau of Statistics (CBS). Three Government bodies and 8 research institutions, obtained from the yellow pages directory 2002-03, were also used.

3.2 Sample and Sampling Design

Rosco (1975) proposed the rule of thumb for determining a sample size and says a size of 30 to 500 is appropriate. 40 companies were selected from the population; the companies were selected using systematic random sampling technique to ensure that companies that are easily accessible are selected. A census of the research institution was also taken.

3.3 Data Description and Collection

The study used both secondary and primary data. Primary data was collected using questionnaire containing both unstructured and structured questions. The questionnaires
were pre-tested to identify errors of omission or commission that may not have been foreseen by the researcher. The necessary modifications were made to enable the questionnaire meet the objectives of the study.

The questionnaire was administered to Economic analysts in government bodies and economic research institutions and company executives dealing with the international business of the companies as indicated in appendix (3). Probes was used where necessary to capture desired information.

Drop and pick later method was used to collect data but the interviewer was available to clarify unclear questions. Secondary data was obtained from the CBS. Secondary data was collected through document review. This entailed the collection of documents, work sheets, reports and literature. The secondary data was yearly review of the CBK’s balance of payment performance from 1980 to 2002. The following documents were used.

- Central Bank of Kenya's Quarterly and annual economic reviews.
- Central Bureau of Statistics annual statistical abstracts.
- World Bank reports.

The secondary data gave the actual performance of the balance of payment and exchange rates for the period of the study.

3.4 Data Analysis Techniques.

Data collected was first edited for accuracy, consistency, uniformity, completeness and arranged to simplify coding and tabulation (See Copper and Schindler 1998).
Descriptive statistics was used to analyse data collected. Descriptive statistics included the use of graphs, tables, and mean scores. This descriptive analytical technique has been exclusively applied in similar studies in the past like Steel and Webster (1992). The impact of exchange rates on the balance of payment was largely comparative. Data on exports, imports, investments and exchange rates was graphed to indicate the position for post-liberalization and pre-liberalization periods.
CHAPTER FOUR
RESULTS OF DATA ANALYSIS

INTRODUCTION
This chapter presents the findings of the study. It is divided into four parts namely overview of the data collected and analysed, analysis of primary data, analysis of secondary data and discussion of the findings.

4.1 Overview of the Data Collected and Analyzed
51 questionnaires were distributed (40 to companies and 11 to research organizations and government bodies). 31 were received back from companies and 4 from research organizations, representing 77% and 36% response rates respectively as in table 4.1.

Table 4.1: Questionnaires Distributed and Returned

<table>
<thead>
<tr>
<th>Type of Response</th>
<th>Questionnaire Distributed</th>
<th>Questionnaires Returned</th>
<th>Response Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Companies</td>
<td>40</td>
<td>31</td>
<td>77%</td>
</tr>
<tr>
<td>Research bodies and government bodies</td>
<td>11</td>
<td>4</td>
<td>36%</td>
</tr>
<tr>
<td>Total</td>
<td>51</td>
<td>35</td>
<td>68%</td>
</tr>
</tbody>
</table>

Source: Survey Data May 2003

This means that 68% of the respondents filled and returned their questionnaire while 32% of the respondents did not fill the questionnaires citing stringent company rules and policies.

4.2 Analysis of Primary Data.
Primary Data was collected on all the effects of exchange rate on the major balance of payment components namely exports, imports and capital inflows. Since Kenya is an
agricultural based country, these variables remains key to her balance of payment improvement. Exchange rate effect on these two variables cannot be overemphasized hence the premise on which the study has been conducted

Firms Engaging in International Business

4.2.1: International Business

Table 1: International Business

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Export</td>
<td>5</td>
<td>16.1</td>
</tr>
<tr>
<td>Import</td>
<td>3</td>
<td>9.7</td>
</tr>
<tr>
<td>Export and import</td>
<td>22</td>
<td>71.0</td>
</tr>
<tr>
<td>Any other</td>
<td>1</td>
<td>3.2</td>
</tr>
<tr>
<td>Total</td>
<td>31</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Survey Data May 2003

The respondent companies gave the kind of international business they engage in as represented in Table 1 above. The Companies that responded were 31 of which 16% dealt with exports only, 10% dealt with imports alone, 71% dealt with both import and export and 3% dealt with a variety of trades.

4.2.2: Export Goods

Table 2: Goods Exported

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agricultural</td>
<td>10</td>
<td>35.7</td>
</tr>
<tr>
<td>Horticultural</td>
<td>3</td>
<td>10.7</td>
</tr>
<tr>
<td>Consultancy</td>
<td>1</td>
<td>3.6</td>
</tr>
</tbody>
</table>
Respondent companies exported various kinds of goods to international market. The percentages in terms of goods exported are as indicated in the Table 2 above. Companies that exported agricultural products were 37%, 11% exported horticultural products, 4% dealt with consultancy and 46% dealt with Manufactured products, 4% dealt with a variety of products.

4.2.3 Exchange Rate Stability

Table 1: Kenyan Currency Stability

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>9</td>
</tr>
<tr>
<td>No</td>
<td>21</td>
</tr>
<tr>
<td>Total</td>
<td>30</td>
</tr>
</tbody>
</table>

Source: Survey Data (May 2003)

Stability of Currency is very important hence the view of companies was sought. The response of companies of what they felt about the currency is as represented in table 3 above.
70% of the companies felt that the exchange rate variability against other currencies, especially the dollar, had a negative impact on the companies' performance in the international trade. Only 30% of the companies felt the Kenyan shilling was favorable in terms of stability, to their international business. Most companies (70%), had an opinion that free floating exchange rates had caused a lot of uncertainty in the international business such unexpected wide swings in the shilling causes large losses to businesses. Also most companies indicated that the shilling does not respond to economic fundamentals but market sentiments hence making it hard for the companies to forecast the likely direction, which the shilling might move towards hence making it hard to factor in the likely effects of its erratic movement resulting in a lot of uncertainty in the international trade.
4.2.4: Exchange Rate Mechanism Usage

Table 2: Exchange Rate Hedging mechanism that companies use

<table>
<thead>
<tr>
<th>Usage of hedging mechanism</th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>11</td>
<td>35.5</td>
</tr>
<tr>
<td>No</td>
<td>20</td>
<td>64.5</td>
</tr>
<tr>
<td>Total</td>
<td>31</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Survey Data (May 2003)

Figure 3

Exchange rate mechanism

Propotion of companies that use exchange mechanism

Source: Survey Data (May 2003)

Use of hedging mechanism by companies was also investigated. The response of companies is as indicated in the table 4 above and proportion of the companies that use hedging mechanism was represented in figure 3.
Companies which use exchange rate mechanisms to hedge against adverse effect of exchange rate fluctuation were only 36% percent as compared to 64% percent that were at mercy of the Central bank pertaining the exchange rate policy, that is, leave it to market forces of demand and supply.

4.2.5 Effects of Exchange Rate on Exports

Table 5.1: Cross-Tabulation Exchange Rate Effects on Export* Exchange rate mechanism

<table>
<thead>
<tr>
<th>Chi-Square</th>
<th>Valu</th>
<th>df</th>
<th>Asymp. (2-)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pearson Chi-</td>
<td>9.27*</td>
<td>2</td>
<td>.01</td>
</tr>
<tr>
<td>Likelihood</td>
<td>9.03</td>
<td>2</td>
<td>.01</td>
</tr>
<tr>
<td>Linear-by-Associati</td>
<td>5.05</td>
<td>1</td>
<td>.02</td>
</tr>
<tr>
<td>N of Valid</td>
<td>28</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. 4 cells (66.7%) have expected count minimum expected unt

Table 5.2

exchange rate effect on exports * exchange mechanism that companies use

Crosstabulation

<table>
<thead>
<tr>
<th>exchange mechanism that companies use</th>
<th>yes</th>
<th>no</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>increased export sales</td>
<td>5</td>
<td>1</td>
<td>6</td>
</tr>
<tr>
<td>% of Total</td>
<td>17.9%</td>
<td>3.6%</td>
<td>21.4%</td>
</tr>
<tr>
<td>reduced export sales</td>
<td>3</td>
<td>15</td>
<td>18</td>
</tr>
<tr>
<td>% of Total</td>
<td>10.7%</td>
<td>53.6%</td>
<td>64.3%</td>
</tr>
<tr>
<td>mixture of reduction and increase</td>
<td>1</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>% of Total</td>
<td>3.6%</td>
<td>10.7%</td>
<td>14.3%</td>
</tr>
<tr>
<td>Total</td>
<td>9</td>
<td>19</td>
<td>28</td>
</tr>
<tr>
<td>% of Total</td>
<td>32.1%</td>
<td>67.9%</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

Source: Survey Data May 2003
A cross-tabulation of the effect of exchange rate and the companies that use exchange rate hedging mechanism was performed to determine whether there was a difference in performance of companies that hedged and those that did not. As seen from the cross-tabulation Table 5.2, the proportion of companies that used exchange rate mechanism that suffered reduced export sales compared to those that did not use any was lower. Companies that used exchange rate mechanism to reduce adverse effects of exchange rate and suffered reduced export sales were 10% of the sample obtained while those that did not use any were 54%. Respondent companies that had used exchange rate mechanism, which had increased export sales, were 18% as compared to which did not use any which were 4%. Companies that had fluctuating performance, which used exchange rate mechanism, were 3.6% as compared to the ones that did not use which were 11%.

The chi-square had a value 9.279 (P=0.010, d.f 2). The chi-square was significant at 0.05, indicating that exchange rate fluctuation affected very much those companies that did not use any exchange rate mechanism as compared to those that did not use any.

Exchange rate effect on exports

<table>
<thead>
<tr>
<th>Effects</th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increased export sales</td>
<td>6</td>
<td>21.4</td>
</tr>
<tr>
<td>Reduced export sales</td>
<td>18</td>
<td>64.3</td>
</tr>
<tr>
<td>Mixture of reduction and increase</td>
<td>4</td>
<td>14.3</td>
</tr>
<tr>
<td>Total</td>
<td>28</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Survey Data  May 2003
Table 6. indicates the effect of exchange rate fluctuation on the export sales of the respondent companies. 64% of the companies attributed their decline to performance to exchange rate variability while 21% of the companies international trade volumes increased because of exchange rate liberalization. 14% could not certainly tell whether it has had negative or negative impact on their sale volume.

Table 7: Percentage Decline as a Result of Exchange Rate

<table>
<thead>
<tr>
<th>Percentage decline</th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%-20%</td>
<td>4</td>
<td>19.0</td>
</tr>
<tr>
<td>21%-40%</td>
<td>7</td>
<td>33.3</td>
</tr>
<tr>
<td>41%-60%</td>
<td>10</td>
<td>47.6</td>
</tr>
<tr>
<td>Total</td>
<td>21</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Survey Data May 2003

Respondent companies estimated the percentage loss in export sales. The range in percentage decline is as in Table 7 above. 33% of the companies registered a decline of between 21% to 40%, 47.6% declined in export sales in the percentage range of between 41% and 60% and 19% declined in export sales by percentage of between 0% and 20%. This indicates that companies were hit hard by sudden policy shift toward liberalization of the exchange rate with 48% of the companies losing business of between 21% to 60%.

The mean decline rate was 35.7%
Table 8: Cross Tabulation Percentage Decline *Goods Exported

percentage decline as a result of exchange rate * goods exported Crosstabulation

<table>
<thead>
<tr>
<th>percentage decline as a result of exchange rate</th>
<th>goods exported</th>
<th>agricultural</th>
<th>horticultural</th>
<th>manufactured</th>
<th>any other</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%-20%</td>
<td>Count</td>
<td>1</td>
<td>3</td>
<td></td>
<td></td>
<td>4</td>
</tr>
<tr>
<td>% within goods exported</td>
<td></td>
<td>33.3%</td>
<td>37.5%</td>
<td></td>
<td></td>
<td>19.0%</td>
</tr>
<tr>
<td>% of Total</td>
<td></td>
<td>4.8%</td>
<td>14.3%</td>
<td></td>
<td></td>
<td>19.0%</td>
</tr>
<tr>
<td>21%-40%</td>
<td>Count</td>
<td>3</td>
<td>3</td>
<td>1</td>
<td></td>
<td>7</td>
</tr>
<tr>
<td>% within goods exported</td>
<td></td>
<td>33.3%</td>
<td>37.5%</td>
<td>100.0%</td>
<td></td>
<td>33.3%</td>
</tr>
<tr>
<td>% of Total</td>
<td></td>
<td>14.3%</td>
<td>14.3%</td>
<td>4.8%</td>
<td></td>
<td>33.3%</td>
</tr>
<tr>
<td>41%-60%</td>
<td>Count</td>
<td>6</td>
<td>2</td>
<td>2</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>% within goods exported</td>
<td></td>
<td>66.7%</td>
<td>66.7%</td>
<td>25.0%</td>
<td></td>
<td>47.6%</td>
</tr>
<tr>
<td>% of Total</td>
<td></td>
<td>28.6%</td>
<td>9.5%</td>
<td>9.5%</td>
<td></td>
<td>47.6%</td>
</tr>
<tr>
<td>Total</td>
<td>Count</td>
<td>9</td>
<td>3</td>
<td>8</td>
<td>1</td>
<td>21</td>
</tr>
<tr>
<td>% within goods exported</td>
<td></td>
<td>100.0%</td>
<td>100.0%</td>
<td>100.0%</td>
<td>100.0%</td>
<td>100.0%</td>
</tr>
<tr>
<td>% of Total</td>
<td></td>
<td>42.9%</td>
<td>14.3%</td>
<td>38.1%</td>
<td>4.8%</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

Source: Survey Data May (2003)

A cross-tabulation to determine whether some of the sub sectors were affected more than the others produced the results as indicated in Table 8 above. Companies in the agricultural and horticultural sub sectors were worst hit by exchange rate fluctuation, with both of them registering 66% of companies that had a decline of between 41% and 60%. In the manufacturing sector the companies that recorded a decline of between 41% and 60% were 25%.
A cross-tabulation to determine on sectoral basis the effect of exchange rate fluctuation on the kind of goods the companies exported is as indicated in Table 9.1. Most companies experienced reduction in export sales with 18 companies out of the 28 engaged in exporting recording a reduction in sales, which represent 64% of the companies. 21% of the respondent companies registered an increase in trade volume while 14% registered a mixture of reduction and increase. On sectoral basis, agricultural and horticultural based companies registered a higher percentage of companies that had reduced export sales, with agricultural companies 80% of them declining, horticultural products registering 66% of companies that experienced reduction in export sales unlike those in the manufacturing sector which had 25% experienced reduction in the export sales. Respondent Companies dealing with agricultural and horticultural products felt that they were more prone to exchange rate fluctuations because of the nature of the products where a slight change in the exchange rate say one shilling appreciation could
cause a loss of up to Ksh 40 million in terms of export sales due to their price sensitivity to exchange rate fluctuations.

Table 9.2

Chi-Square Tests

<table>
<thead>
<tr>
<th></th>
<th>Value</th>
<th>df</th>
<th>Asymp. Sig. (2-sided)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pearson Chi-Square</td>
<td>7.513a</td>
<td>8</td>
<td>.482</td>
</tr>
<tr>
<td>Likelihood Ratio</td>
<td>7.776</td>
<td>8</td>
<td>.456</td>
</tr>
<tr>
<td>Linear-by-Linear</td>
<td>.511</td>
<td>1</td>
<td>.475</td>
</tr>
<tr>
<td>Association</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>N of Valid Cases</td>
<td>28</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. 13 cells (86.7%) have expected count less than 5. The minimum expected count is .14.

From table 3.6 the exchange rate effects on exports were not significantly related to the kind of goods that were exported ($X^2=7.513, df=8, P=0.482$). It indicates that the effect of exchange rate cut across the sector regardless of the sector the company is in. No sector was significantly affected by exchange rate fluctuation than the other sectors. Exchange rate fluctuation affected all the sectors adversely.

IMPORT INFORMATION

4.2.7 Effects of Exchange Rate on Imports

Table 10: Exchange rate Effect on Import Volumes

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increased</td>
<td>5</td>
<td>18.5</td>
</tr>
<tr>
<td>No change</td>
<td>10</td>
<td>37.0</td>
</tr>
<tr>
<td>Fluctuating</td>
<td>5</td>
<td>18.5</td>
</tr>
<tr>
<td>Decreased</td>
<td>7</td>
<td>25.9</td>
</tr>
<tr>
<td>Total</td>
<td>27</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Survey Data May 2003
The effect of exchange rate fluctuation on imports by the respondent companies is as indicated in table 10 above. 37% Companies responded that exchange rate had no effect on their import volume, 18% had a view that it has had a positive effect on their import volume, 26% had a view that it had a negative effect on their trade volumes and 18% were unsure of the effect hence had a view that it was fluctuating.

Table 11: Goods Imported

<table>
<thead>
<tr>
<th></th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agricultural</td>
<td>3</td>
<td>11.1</td>
</tr>
<tr>
<td>Manufactured</td>
<td>4</td>
<td>14.8</td>
</tr>
<tr>
<td>Company inputs</td>
<td>14</td>
<td>51.9</td>
</tr>
<tr>
<td>Any other</td>
<td>3</td>
<td>11.1</td>
</tr>
<tr>
<td>Company inputs and</td>
<td>1</td>
<td>3.7</td>
</tr>
<tr>
<td>agricultural</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Manufactured goods and</td>
<td>2</td>
<td>7.4</td>
</tr>
<tr>
<td>company inputs</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>27</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

Source: Survey Data May 2003

The frequency of the kind of goods the respondent companies imported into the country is as in the Table 11 above. Most of the goods imported into the Country are mostly company inputs. 52% of the companies imported inputs to be used in production and processing of final products, 15% imported finished products to be sold in the local market. 11. % were companies that imported a variety of products that are also sold in the local market.
Table 12.1: Cross Tabulation Exchange Rate effects\* Goods Imported

<table>
<thead>
<tr>
<th>Exchange rate effect on import volumes</th>
<th>Goods imported</th>
<th>Company inputs</th>
<th>any other</th>
<th>Company inputs and manufactured goods and company inputs</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>agricultural</td>
<td>manufactured</td>
<td>company</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increased</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>% of Total</td>
<td>7.4%</td>
<td>3.7%</td>
<td>3.7%</td>
<td>3.7%</td>
<td>18.5%</td>
</tr>
<tr>
<td>No change</td>
<td>8</td>
<td></td>
<td></td>
<td>1</td>
<td>10</td>
</tr>
<tr>
<td>% of Total</td>
<td>29.6%</td>
<td></td>
<td></td>
<td>3.7%</td>
<td>37.0%</td>
</tr>
<tr>
<td>Fluctuating</td>
<td>3</td>
<td>2</td>
<td></td>
<td>3.7%</td>
<td>5</td>
</tr>
<tr>
<td>% of Total</td>
<td>11.1%</td>
<td>7.4%</td>
<td></td>
<td>3.7%</td>
<td>18.5%</td>
</tr>
<tr>
<td>Decreased</td>
<td>3</td>
<td>2</td>
<td>2</td>
<td></td>
<td>7</td>
</tr>
<tr>
<td>% of Total</td>
<td>11.1%</td>
<td>7.4%</td>
<td>7.4%</td>
<td></td>
<td>25.9%</td>
</tr>
<tr>
<td>Total</td>
<td>3</td>
<td>4</td>
<td>14</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>% of Total</td>
<td>11.1%</td>
<td>14.8%</td>
<td>51.9%</td>
<td>11.1%</td>
<td>3.7%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>7.4%</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

Source: Survey Data  May 2003

Table 12.2: Chi-square test

<table>
<thead>
<tr>
<th>Chi-Square Tests</th>
<th>Value</th>
<th>df</th>
<th>Asymp. Sig. (2-sided)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pearson Chi-Square</td>
<td>26.881a</td>
<td>15</td>
<td>.030</td>
</tr>
<tr>
<td>Likelihood Ratio</td>
<td>29.097</td>
<td>15</td>
<td>.016</td>
</tr>
<tr>
<td>Linear-by-Linear Association</td>
<td>5.327</td>
<td>1</td>
<td>.021</td>
</tr>
<tr>
<td>N of Valid Cases</td>
<td>27</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. 23 cells (95.8%) have expected count less than 5. The minimum expected count is .19.

Source: Survey Data  May 2003

A cross-tabulation of exchange rates effect on imports and the kind of imported into the country produced the results in Table 12.1 above. Companies that import company inputs, in terms of trade volumes, were less affected by the fluctuations in exchange rate as the decision to import depended on the company policy and the projected production as budgeted for during the financial year. 18% represents the companies that increased their imports during this period, 26% reduced their imports, 18% had fluctuating kind of
import situation and 10 out of 27 companies respondents said that exchange rate had no
effect on their import volume, which represents 26%. As indicated in the figure above, of
which 8 of the companies imported company inputs and 2 imported company inputs with
other products. Only one company responded that it imported agricultural products and it
reported decreasing trade volume, which represents 5% of the total company respondents.
Very few companies import agricultural products because the country is majorly an
agricultural one.

Conducting a chi-square had a value of 26.881 (P=0.030, d.f 15) the chi-square was
significant it indicated that the types of exchange rates fluctuation affected the kind of
goods imported. It had no effect on the volume of company inputs but caused significant
variations in the imported volume of the other king of goods imported.

4.3 Analysis of Secondary Data.

Table 13: Balance of Payment

<table>
<thead>
<tr>
<th>Balance of Payment for the years Between 1983-2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>k#millions</td>
</tr>
<tr>
<td>10000000000</td>
</tr>
<tr>
<td>5000000000</td>
</tr>
<tr>
<td>0</td>
</tr>
<tr>
<td>-500000000</td>
</tr>
<tr>
<td>-1000000000</td>
</tr>
<tr>
<td>-1500000000</td>
</tr>
</tbody>
</table>

Table 13. Represents Kenya's balance of payment performance for the period from 1983 to 2002. The balance of payment for the period between 1983 and 1992 indicated marginal increase or reduction. The balance of payment surplus was at peak in the years 93 and 96. Most of the years under liberalization registered surplus in balance of payment.

Table 14: Current Account

<table>
<thead>
<tr>
<th>Current Accounts for the year Between 1983 and 2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Years</td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td>83</td>
</tr>
<tr>
<td>84</td>
</tr>
<tr>
<td>85</td>
</tr>
<tr>
<td>86</td>
</tr>
<tr>
<td>87</td>
</tr>
<tr>
<td>88</td>
</tr>
<tr>
<td>89</td>
</tr>
<tr>
<td>90</td>
</tr>
<tr>
<td>91</td>
</tr>
<tr>
<td>92</td>
</tr>
<tr>
<td>93</td>
</tr>
<tr>
<td>94</td>
</tr>
<tr>
<td>95</td>
</tr>
<tr>
<td>96</td>
</tr>
<tr>
<td>97</td>
</tr>
<tr>
<td>98</td>
</tr>
<tr>
<td>99</td>
</tr>
<tr>
<td>0</td>
</tr>
<tr>
<td>1</td>
</tr>
<tr>
<td>2</td>
</tr>
</tbody>
</table>


Table 14 represents the performance of the current account from 1983 to 2002. The current account recorded surplus in the years 1994 and 1999. The rest of the years from the graph recorded deficit. The deficits became large during the liberalized period with 1997 and 1998 recording deficits of over K£1,000 Million. The liberalization of exchange rate that encouraged flexibility achieved extreme results with the balance of payment recording surplus and highest level of deficits within the same period.
Table 15: Balance of Trade

The balance of trade deficits was low for the pre-liberalization period as compared to after liberalization period. The deficits increased with the years between 1996 and 2001 showing increasing deficits. Balance of trade deficits were minimal before liberalization in 1992 but recorded increased deficits after liberalization.

Table 16: Exchange Rates

Table 16 represents the yearly exchange variability from 1983 to 2002. The Period before liberalization, 1983 to 1992, when the exchange rate was stable as it under crawling peg but it rose steadily after liberalization in 1993 when it depreciated fast
against the dollar. In 1994, but since 1995 it appreciated fast but after that it has been depreciating and appreciating steadily.

4.4 Discussion of the Findings

The exchange rate liberalization in Kenya was supposed to improve the balance of payment by encouraging export growth and attract capital inflows in Kenya. As seen in Table 13 Kenya balance of payment improved with 1993 and 1996 registering the highest level of surplus indicating that Exchange rate liberalization had a positive impact on the overall balance of payment position. The Surplus, however, have been diminishing and heading towards deficits by the year 2002. The current account was in surplus in the year 1994 and 1999 but the rest of the years from 1983 to 2002 witnessed deficits. The balance of trade deficits have been increasing and increased rapidly during the period after liberalization of the exchange rate in 1992. In 1993 when the Kenyan shilling depreciated fast, it is in the same year that the country registered the highest surplus in the balance of payment.

When the shilling appreciated in 1994 as seen from Table 16, the balance of payment as seen from Table 13 recorded a deficit. When the shilling fluctuated steadily between 1983 and 1992 there was minimal variation in the balance of payment in the coinciding period. Liberalisation has a positive impact on the balance of payment overall performance but has not improved the current account and balance of trade. This means that there has been a lot of capital inflows, which in most cases has been short term speculative funds, as seen in 1993 when the shilling depreciated sharply against the
dollar, the current account remained in deficits and the balance of payment recorded a high surplus and in 1994 when the shilling appreciated the balance of payment was in deficit due to "flight to safety".

In order to improve the current account and balance of trade the CBK has to look into the issue of the stability of the Kenyan shilling. Most of the respondent companies were not comfortable with the continued wide fluctuation in the Kenyan shilling, as it had affected negatively their international business as indicated in Table 3. 70% of the respondent companies felt that the exchange rate was not favorable for trade and investment. The average decline was 36% among the companies that responded. The exchange rate is supposed to respond to Macro economic fundamental variables such as inflation differential, interest rate differential, current account balance, net foreign inflows and expectations (read economic) but Kenyan exchange rate has also, for the better part, been influenced by increased speculation beside being oversensitive to short run factors that have no direct economic bearing such as rumours and bad news which has resulted to steeper than expected appreciation and depreciation.

Most Companies in Kenya do not use hedging mechanism to cushion themselves against the adverse effect of wide fluctuations in the exchange rates as indicated in Table 5.1. A chi-square conducted yielded a value of 9.279 (P=0.010, d.f=2) which was significant at 0.05 confidence level indicating that using hedging mechanism to cushion against adverse effects of exchange rate fluctuation significantly reduced the reduction in export sales in the Companies. Due to undeveloped nature of futures and option market most of
the Companies do not hedge their foreign exchange trade. The firms that hedge had dollar
denominated- account through which they paid foreign liabilities. The other option is
usually to have a forward contract with the Central Bank but the costs involved in this
option are prohibitive hence most firms avoid it.

A cross tabulation of exchange rate and goods exported as shown in Table 9.2, revealed
a chi square value of 7.513 (P=0.482, d.f 8) indicating that it was not significant at 0.05.
This mean that on sectoral basis, no sector was adversely affected as compared to the
others. This shows that exchange rate variation affects all sectors. However most of the
companies in agriculture recorded reduced export sales. It means overally, the findings
show that sectors were affected by the increased intensity in the shilling rapid movement.

A cross tabulation of goods imported and exchange rate produced a chi-square value of
26.881 (P=0.030, d.f 15) at 0.05 confidence level, in Table 12.2, was significant
indicating that import volume of companies was affected by the kind of goods. Most of
the companies that imported company inputs did not vary their import because of
exchange rate fluctuation as the decision to import depended on the company decision as
outlined in the projected expenditure during the financial period. On the other hand,
companies, which imported goods to be sold in the local market, were affected by the
exchange rate fluctuation.

The net effect of exchange rate fluctuation depended on where the companies obtained
their raw material. Companies which got most of their there raw materials from the
domestic market tended to feel more impact of the exchange rate fluctuation if its exports most of its products because the domestic raw material are not affected by exchange rate fluctuation apart from oil and tend to pass over the resultant increase, in case of an appreciation, to the consumer while the companies that imported their raw materials had a reduced net effect as an appreciation of exchange rate will make the raw materials cheaper hence may reduce the cost of production and may pass over the benefits to the consumer in terms of reduced prices.

Most of the firms were of the view that the government should intervene in the foreign exchange market but felt that it had to be careful as continuous intervention through open market operation results in higher interest rates. In order to maintain a competitive exchange rate, low inflation government through the CBK, intervenes in the Foreign exchange market, which instead pushes up interest rates to a higher level hence hampering investment.

The study indicated that due to exchange rate liberalization the balance of payment improved especially the periods after liberalization in 1992 and 1993 due to inflow of capital but the surplus has been reducing over time, the improvement during these period most likely due to speculation that was occasioned by the liberalization. The Balance of payment improvement was not as a result of real sector as indicated by the continuous deterioration of the current account. The results concurred with the hypothesis that exchange rate had affected exports negatively but imports were not affected adversely. The respondent companies indicated that exchange rate indeed affected their business in a negative way and they were not comfortable with the volatility of exchange rate hence
affecting their confidence in investing more. The economic analysts linked the exchange rate fluctuation to high interest rates that further discourages investment. These concurred with the hypothesis.

The study revealed that many companies did not use hedging mechanism as hypothesized in the study.
CHAPTER FIVE

CONCLUSIONS, POLICY RECOMMENDATIONS AND AREAS FOR FURTHER RESEARCH.

This chapter summarizes and describes the findings of the study, provides policy recommendation to address the concerns of the study, highlights the shortcomings of the study and suggests areas for further research.

5.1 SUMMARY AND CONCLUSION

The desirability of a competitive exchange rests on the theoretical prediction that it will lead to a more efficient allocation of economic resources and as result improve a country's external competitiveness. An exchange rate is competitive if it improves a country's goods on the international market and is relative stable to increase certainty and predictability in the international market. Exchange rates that always on a "random walk" with large amplitude movements, due to appreciation and depreciation, cause uncertainty and unpredictability in the foreign exchange market which may have a negative impact on trade and investment.

The objective of the study was to identify the effect of liberalized exchange rate on the Balance of payment. In order to achieve this objectives the main components in the Balance of payment, that are important to Kenya were identified and then investigated with a view of determining the extent of exchange rate liberalization impact on the components and subsequently on the Balance of payment. This was done through collecting views from companies operating in Kenya, seeking expert opinion from various economic research institutions and government bodies and perusing through data.
recorded in the government documents, especially the Economic reviews for the period selected for the study. The findings of the study revealed that free-floating exchange rate has had a positive effect on the overall balance of payment as envisaged by the Bretton Woods institution but the current account and balance of trade continued to deteriorate. The study corroborates with the arguments by Rognon and Hodgetts (1992)

The study revealed that companies were unhappy about the stability because it oscillates with wide margins causing incidental losses to companies hence resulting to reduced trade and investment. Most of the companies estimated their losses between 21% and 60% in export sales as a result of frequent fluctuation of the shilling. One company in horticultural sub sector estimated that if the shilling strengthens by one shilling it causes a loss of Ksh 40 million in terms of export sales. Another firm with a subsidiary in Uganda had estimated in its financial modeling a depreciation of 4% but the gradient was steeper than anticipated pushing the currency by 10%. Between January and march. The firm does its factor costing and budgeting in dollars and it is estimated the firm lost between U.S$ 400,000 and U.S $ 500,000. Exchange rate fluctuation has had a negative effect on the investment as the efforts of the CBK to attain competitive exchange rate ends up fuelling higher interest rates hence inhibiting investment.

The study observed that most of the companies trading in Kenya do not use hedging mechanism to cushion against adverse effects of exchange rate fluctuation. During the study the researcher found out that out of the 31 companies, only 7 companies used any hedging mechanism. Most of the companies were of the view that the Futures and
Forward markets were not well developed hence could not serve the companies effectively. Hedging by the Central Bank holding dollars for the companies is not effective because of the cost involved due to charges. This is because the hedging markets are not well developed and hence they are exorbitant resulting to the same effects as tariffs. This makes them not viable as an option of reducing adverse effects of exchange rate fluctuation.

It is clear from the study that those firms, which hedged their foreign transactions, were less adversely affected by wild exchange rate fluctuation. 10.7% of the firms that hedged their international trade suffered reduced export sales as compared to 53.6% that did not hedge. The findings corroborate with Adobi (1999) who argued that forward markets act as a guaranteed forecast of future exchange rates.

5.2 POLICY RECOMMENDATIONS

The finding that exchange rate “random walk” has a negative on trade and investment hence on the balance of payment calls for urgent action by the Central Bank. Exchange rate is one of the major macroeconomic variables that determine Kenya’s competitiveness hence it needs continuous monitoring and policy action that will enable Kenya remain competitive and reap economic benefits in the globalised environment.

One of the recommendations to the Kenya Government is that the CBK should establish target zones within which the Kenyan shilling will be allowed to freely float. The target zone should be set after putting into consideration all Economic fundamentals and aimed at promoting the competitiveness of Kenya’s products. It is suggested that the target zone
of between Ksh 80 and Ksh 85, which corroborates with most companies desire and suggestions put forward by an Economic analyst. If the shilling goes beyond the target zone then the CBK should be obligated to intervene in the foreign exchange market to bring it back within the target zone range.

The second recommendation is that the Government should liaise with regional governments to move fast towards full integrations especially the East African regional bloc to form an Economic union within which fiscal and monetary policies will be unified, probably with the creation of a single currency. Use of a common currency will eliminate the adverse effect of a fluctuating currency. The vision of the future is having an economic union with a single currency in Africa.

The CBK, in collaboration with the Capital Market Authority, should work towards development of a derivative market in which forward, futures and options can be bought and sold freely. These should include making the cost of hedging cheaper to encourage companies to use forward contract as a way of cushioning against adverse effects of exchange rates. The development of derivative market where the exchange securities can be easily traded will enable companies to effectively reduce heavy losses occasioned by upswing and downswing of the Kenyan shilling.

There is a need for the Central Bank to collaborate with other stakeholders in the economy especially players in the industrial sector in order to come up with public policies that are acceptable and viable this involves regular consultation and collaborative
research. Policy issues that are addressed by a single line statement in the budget may not auger well for the country’s determination to promote export growth.

5.3 SHORTCOMINGS OF THE STUDY

The researcher expected to get a wide range of views from companies however the returns from companies was not 100% as some refused to complete the questionnaires.

Some of the managers dealing with international business of some of the companies were not willing to provide full information due to company policy that do not allow divulging of some information they consider proprietary with the fear that it will filter out to their competitors.

The study should have been comparative that means carrying out the study in other countries to find out the impact of exchange rates so as to come up with a more comprehensive. Due to limited resources the study was confined to Kenya. It is not, therefore, comprehensive and hence the results may not be generalized.

Some of the would be respondents did not were not fully aware of the exchange operation hence were not able to give valuable information that will enable the study to capture the real effects of exchange rate on Kenya’s balance of payment.

Lastly there is a need to create an industrial-institution link in order to facilitate collaboration in areas such as research and attachment to reduce the suspicion that exists over the motive of the studies conducted that involve gathering information. This will
encourage information sharing hence steer the country towards perfect and strong efficiency.

5.4 SUGGESTED AREAS FOR FURTHER RESEARCH

This study covered only one aspect of exchange rate, a study on the effect of exchange rate on the balance of payment. The shilling has always had an erratic pattern in its movement, the reasons that cause this frequent movement are yet to be subjected to vigorous study to identify and offer viable policy recommendations hence can be an area of research concern.

There is a clamor for the formation of a monetary union in Africa modeled on the European union, hence the intense discussion for the charting of the road map towards single currency. There is need, therefore, to research on the factors to be considered in order to harmonize the fiscal and monetary operations of the countries in the continent and hence effectively reduce impediments that may hinder full integration of the economies.

There is also a need to study the relationship between exchange rate and short term capital flows. Movement in exchange rate cause flight of capital or inflow of short term capital flows depending on the perception of the investors. There is a need to study and provide the link between the two as the exchange rate movement and the capital flow impact on the economy heavily.
REFERENCE


LETTER OF INTRODUCTION

Dear Sir/Madam

REF: REQUEST FOR RESEARCH ASSISTANCE.

I’m a postgraduate student at Kenyatta University undertaking a research project as part of the requirement of the degree of masters of Business Administration. The topic of my research is “The effect of exchange rate on the balance of payment of a developing country: of case of Kenya.

Your Institution has been selected to form part of the study. I kindly request you to fill the attached questionnaire. My information provided will be treated in strict confidence and used solely for Academic purposes.

A copy of the research will be made to you upon request. Your co-operation will be greatly appreciated.

Yours faithfully,

SIMIYU MUNGAMI EDDIE
Student

DAVID YEGO
Supervisor
APPENDIX TWO

QUESTIONNAIRE

Please tick in the brackets as necessary

Name of the institution

For how long has your company been in existence

What kind of international business do you engage in?

Export ( )
Import ( )
Both import and export. ( )
Any other

NB. If your line of international business is importation, please fill section B below and if it is exportation, then fill section C. If you deal with both import and export business please fill both B and C. For research and government institution, the respondent is requested to fill in part D.

SECTION A : IMPORT INFORMATION

1. What kind of goods do you import into the country?

Agricultural ( )
Manufactured goods ( )
Company inputs ( )
Any other (please specify)

2(a) What effect has the exchange rate liberalization had on your company volume of trade over time?

Increased ( )
Decreased ( )
Fluctuating ( )
2(b) Incase the effect has been fluctuating, which one has been more dominant?

- Decrease (  )
- Increase (  )
- Indifferent (  )
- Not applicable (  )

3. If the exchange rate has caused a decline in volume of your operations, what is the estimated percentage range of decline over normal volume?

- Between 0 %-20% (  )
- 21%-40% (  )
- 41%-60% (  )
- 61%-80% (  )
- Over 80% (  )

3(a) If the volume increased, what is the range of percentage increase?

- Between 0-20% (  )
- 21%-40% (  )
- 41%-60% (  )
- 61%-80% (  )
- Over 80% (  )

4(a) In your opinion, is the Kenyan currency (shilling) favorable for your business growth?
Yes ( )
No ( )

(b) Please give at least two reasons for your answer in 4 (a) above

5. Do you have a mechanism, like forward exchange rate, in place for reducing negative effects of exchange rates in your business?
   Yes ( )
   No ( )

6. In your opinion rate the company performance in for the periods before and after liberalisation

Key:
Increased – I, Decreased - D, No change -N

<table>
<thead>
<tr>
<th>Year</th>
<th>I</th>
<th>D</th>
<th>N</th>
<th>Year</th>
<th>I</th>
<th>D</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td></td>
<td></td>
<td></td>
<td>1996</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1987</td>
<td></td>
<td></td>
<td></td>
<td>1997</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1988</td>
<td></td>
<td></td>
<td></td>
<td>1998</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1989</td>
<td></td>
<td></td>
<td></td>
<td>1999</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td></td>
<td></td>
<td></td>
<td>2000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

7. In your opinion what should the Central Bank of Kenya (CBK) do to achieve stability of the Kenyan shilling hence encourage growth of your business
SECTION B : EXPORT INFORMATION

1. Which kind of product or service do you put in the international market?

- Agricultural ( )
- Tourism ( )
- Horticultural ( )
- Consultancy ( )
- Manufactured ( )
- Any other (please specify) ____________________________

2.(a) What effect does the exchange rate liberalization had on your export business

- Increased export sales ( )
- Reduced export Sales ( )
- Mixture of reduction and increase ( )
- No change ( )
- Any other (please specify) ____________________________

(b) IF the exchange rate has caused decline in the volume of your trade, what is the range of percentage decline:

- Between 0%-20% ( )
- 21%-40% ( )
- 41%-60% ( )
- 61%-80% ( )
- Over 80% ____________________________
3. (a) Does the current Kenyan shilling against other currencies averagely encourage growth of your company's export?

Yes ( )
No ( )

(b) Please give the possible reasons for your answer in 3(a) above


4. (a) Do your company have a mechanism, such as forward contracts, of reducing the adverse effect of exchange rate on your export business?

Yes ( )
No ( )

(b) Give reasons for your answer in 4(a) above


5. Compare your performance for the period before and after liberalisation.

Key: I- Improved, D-Declined, N- No change.

<table>
<thead>
<tr>
<th>Before liberalisation</th>
<th>After liberalisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986 ( ) ( ) ( ) ( )</td>
<td>1996 ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>1987 ( ) ( ) ( ) ( )</td>
<td>1997 ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>1988 ( ) ( ) ( ) ( )</td>
<td>1998 ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>1989 ( ) ( ) ( ) ( )</td>
<td>1999 ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>1990 ( ) ( ) ( ) ( )</td>
<td>2000 ( ) ( ) ( ) ( )</td>
</tr>
</tbody>
</table>

6. Does the exchange rate have any role in pricing of your company products?

Yes ( )
No ( )
7. What is the effect of strengthening of the Kenyan shilling, have on the prices of your products?

- Increased prices to the consumer (  )
- Reduced prices to the consumer (  )
- No change in consumer prices (  )

Any other (please specify) 

SECTION D: Information from research institution and Government organization

1. Name of the institution (optional) 

2. In your opinion, what is the importance of the balance of payment to Kenya 

3. In your opinion what has been the performance of Kenya's balance of payment after liberalizations of the exchange rate market?

- Improved (  )
- Declined (  )
- No change (  )

4. What do you think has majorly contributed to the current Kenya's balance of payment situation? Please, list a few possible factors 

5. (a) Is the Kenyan shilling stable enough to encourage growth of international trade 

- Yes (  )
- No (  )

Please give reasons for your answer 5(a) above
6. Compare Kenya’s performance for the period before and after liberalisation. In terms of trade

Key: I- Improved, D- Declined, N- No change.

<table>
<thead>
<tr>
<th>Year</th>
<th>Before liberalisation</th>
<th>After liberalisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td>( ) ( ) ( ) ( )</td>
<td>1996 ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>1987</td>
<td>( ) ( ) ( ) ( )</td>
<td>1997 ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>1988</td>
<td>( ) ( ) ( ) ( )</td>
<td>1998 ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>1989</td>
<td>( ) ( ) ( ) ( )</td>
<td>1999 ( ) ( ) ( ) ( )</td>
</tr>
<tr>
<td>1990</td>
<td>( ) ( ) ( ) ( )</td>
<td>2000 ( ) ( ) ( ) ( )</td>
</tr>
</tbody>
</table>

7. The following are some of the factors that affect a country’s exports. Using ticks as indicated, rate the factors that affect Kenya’s export growth.

<table>
<thead>
<tr>
<th>Factors</th>
<th>Important</th>
<th>Very important</th>
<th>Least important</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low elasticity of export and import</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prices of the products on the world market</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Infrastructure</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Competition from other countries</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Behavior of local currency against world major currencies</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
8. What has been the effect of foreign exchange market liberalization on international trade in Kenya.

__________________________________________________________________________
__________________________________________________________________________
__________________________________________________________________________

9. In your opinion what is the likely effect of Kenya’s shilling fluctuation against other major Currencies on export oriented and import-oriented business in Kenya and the country’s commodity export payment.

__________________________________________________________________________
__________________________________________________________________________
__________________________________________________________________________
__________________________________________________________________________

10. What should the companies engaged in international trade do to cushion themselves against adverse effects of exchange rate fluctuation.

__________________________________________________________________________
__________________________________________________________________________
__________________________________________________________________________
__________________________________________________________________________
APPENDIX THREE

The list of government bodies and research institution to be used

1. Kenya Institute for Public Policy and Analysis.
2. Institute of Policy and Analysis.
3. Institute of Economic Affairs.
5. International Centre for Economic Growth.
10. Treasury.
11. Kenya External Trade Authority

Name of best performing Companies according to export promotion council report (1998) selected.

1. Associated battery manufacturers
2. Twiga chemicals
3. Kenya wines agencies
5. Kenya tea development authority
6. Coffee board of Kenya
7. General motors.
8. Ryce Motors
9. Total Kenya
10. Homegrown (k)
11. Sasini Tea and Coffee limited
12. B.A.T kenya
13. Reckitt and Colman
14. Athi river mining
15. Hoechist E.A limited
17. Green-Gulf enterprises
18. Unilever
19. Unga group
20. Shell development Kenya
21. Chloride Exide
22. Bayer East Africa limited
23. Holman Brothers
24. Nation Media Group
25. Coates brothers
26. Plainland exporters and importers
27. Dorman coffee
28. Crown Paints
29. Gide link freight forwaders
30. Global Allied Industries
31. Mabati rolling mills
32. El nasr export and import
33. Mitchell cotts freights
34. Nestle foods Kenya ltd
35. Crown berger (k) ltd
36. George Williamson Kenya
37. Wiggleworth exporters
38. Mumias Sugar company
39. Kenya Breweries limited
40. Oserian flowers company