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ABSTRACT

Interest Rates in Kenya

This paper is one of a series of brief analyses, "snapshots," of the financial sectors of the countries in East and Southern Africa where the RHUDO is active. The emphasis in these papers is on the interest rate structure. The need for these papers arises from several factors. The financial sectors are being called upon to shoulder a large share of the job of marshalling development resources; there is concern about whether deposit and lending rates are positive in real terms, particularly for shelter finance; and finally, we know relatively little about what is happening to these sectors and how they work.

Studies have been done on Botswana, Kenya, Malawi, and Zimbabwe.

November 14, 1990

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INTEREST RATES IN KENYA

Introduction

This paper is one of a series of brief analyses, "snapshots," of the financial sectors of the countries in East and Southern Africa where the RHUDO is active. The emphasis in these papers is on the interest rate structure. The need for these papers arises from several factors. The financial sectors are being called upon to shoulder a larger share of the job of marshalling development resources, there is concern about whether deposit and lending rates are positive in real terms, particularly for shelter finance, and, finally, we know relatively little about what is happening to these sectors and how they work.

Kenya has a large and diverse financial sector, including the Central Bank of Kenya, 24 commercial banks, 53 non-bank financial institutions (NBFIs), over 30 insurance companies, and 26 building societies. Private institutions play a major role in the financial system. Twenty-two of the 25 commercial banks (accounting for 72 percent of commercial bank assets) are privately owned. Private institutions account for 82 percent of NBFI assets. All but two of the insurance companies, and all of the building societies are private.

Interest Rate Determination in Kenya

Interest rates for regulated institutions are established by the Central Bank, which sets maximum levels by institutional category. Some institutions, particularly where there is an element of competition, as in the case of building societies, will lend below the maximum. As elsewhere, the interest rate typically does not reflect the full cost of credit. Varying amounts of charges and points can be added. One of the objectives of interest rate policy in Kenya is to maintain the relative attractiveness of central government borrowing instruments. This has been quite successful to the point that savings in other "paper" has been discouraged.

Interest rates are not the only means of rationing credit. In 1988, under an agreement with the IMF and World Bank, the Central Bank established monthly quotas on the shilling amount of new lending by credit institutions. These restrictions are still in force.

In addition to the regulated credit system, there is the quasi-regulated system of "hire-purchase", or consumer credit companies that do not come under the Banking Act. For short and intermediate term loans they can and do charge in the range of 18 to 20 percent. There is also a substantial informal credit system available to Kenya's dominant commercial minority. Loans can be substantial -- for cars, or inventory, or capital, for instance --usually for three to six months, occasionally for a year, and interest rates range from 25 to 100 percent. In the two cases mentioned above, risk plays a larger role in determining the cost of money than does supply and demand.

On the subject of supply and demand for credit in the context of Kenya's regulated market, it should be kept in mind that the system was regarded until 1989 to be quite liquid, though not awash. Informal contact with members of the financial community indicated that because of this liquidity, Kenya's interest rate caps were not keeping the lid on potentially explosive rates. Further, if the maximum limits were lifted, there would be some increases in certain sectors, but not in others, and interest rates would not run away. This suggests that the administered rates were not unreasonable. In 1989 increased government borrowing began to crowd out borrowing by the private sector. In addition to the government's limit on credit expansion mentioned above, financial institutions were tacitly allowed to charge fees and points in addition to regular interest rates. In some cases these fees and points amount to five to eight percent. Thus, the system is no longer viewed as liquid, and interest rates are expected to rise when they are freed in 1991.

The National Development Plan 1989-93 has as one objective - the gradual freeing of interest rates on Government bonds to make them more responsive to market forces. This will be done in the context of the over-all liberalization of interest rates beginning in July, 1991.

Even in Kenya's regulated market, risk is addressed, though perhaps not perfectly. As one would expect, riskier ventures, such as crop loans, and longer term commitments command higher interest rates.

Finally, it should be kept in mind that virtually every government exerts some control over the credit system, and Kenya is no different. The Federal Reserve System in the U.S. regularly attempts to influence interest rates and the supply of credit. It simply uses more indirect, and perhaps less onerous methods. At least some of the objectives are the same however. Further, there are specific limits on what each type of credit institution can and cannot do, in terms of kinds of activities, and sometimes in terms of interest rate ceilings.

Trends in Real Interest Rates

In addition to maintaining the relative attractiveness of Treasury borrowing instruments, a second objective of the Kenya Government is to assure to the extent possible a positive real return on savings and investments. This has been a largely successful policy, in contrast to much of the rest of East and Southern Africa.

Nominal and real interest rates over the past six years are shown in Tables 1 and 2. The latter figures depend directly on the reliability of inflation rate estimates, also shown in the Table. The market basket and weightings used to calculate Kenya's official CPI changes have not been updated since 1974. It is clear from the table that variations in real interest rates are the result of sharp fluctuations in the inflation rate from year to year.

USAID Policy on Financial Markets and Interest Rates

USAID/Kenya supports the GOK's emphasis on positive interest rates. The Rural Enterprise Loan Program, for example, has been implemented through the commercial banking system at commercial rates. Similarly, the Private Sector Housing Guaranty Program will be implemented in accordance with housing finance institution interest rates, which have been positive in real terms for the past five years (Table 2). In support of the GOK's strategy to modernize the financial markets, the Mission provided substantial assistance for the formation of the Capital Markets Development Authority. The Mission has also been supportive of the RHUDO's efforts to encourage the establishment of a Municipal Finance Corporation, or other arrangements which would bring public sector infrastructure financing into the mainstream of the credit markets. Finally, given the prevalence of positive real interest rates in the housing finance sector at this time, this is one area of policy dialogue the RHUDO does not have to concentrate on.

Table 1a
Principal Interest Rates

Institutional Category	1986	1987
CENTRAL BANK OF KENYA		
Discount Rate for Treasury Bills	11.15	13.00
Advances against Treasury Bills	12.00	12.00
Bills & Notes under Crop Finance Scheme:		
Discounts	11.25	11.25
Advances	11.50	11.50
Other Bills and Notes:		
Discounts	12.00	12.00
Advances	12.50	12.50
KENYA COMMERCIAL BANKS		
Time Deposits:		
12 months (Ksh.250,000-1,000,000)	11.75-12.00	9.50-10.00
Savings Deposits	11.00	11.00
Loans and Advances (Maximum 3 years)	14.00	14.00
OTHER FINANCIAL INSTITUTIONS		
Kenya Post Office Savings Bank deposits	11.00	11.00
Agricultural Finance Corporation, Loans		
Land Purchase	12.00	12.00
Seasonal Crop Loan	14.00	14.00
Other	13.00	13.00
Hire-Purchase Companies:		
Deposits (time)	13.00-14.50	10.00-13.50
Loans	19.00	18.00
Housing Finance Institutions:		
Deposits	13.00-14.25	10.75-12.50
Loans	16.00	16.50

Source: Economic Survey 1990, Central Bureau of Statistics, Ministry of Planning and National Development, Government of Kenya; p.63.

Note: US$1.00 equals 16.45 Kenya Shillings in 1986, and 20.85 Kenya Shillings in 1989. Economist Intelligence Unit, Kenya Country Report, No.1, 1990.

Table 1b
Principal Interest Rates

Institutional Category	1988	1989
CENTRAL BANK OF KENYA		
Discount Rate for Treasury Bills	15.00	14.00
Advances against Treasury Bills	15.00	15.50
Bills & Notes under Crop Finance Scheme:		
Discounts	16.00	16.50
Advances	16.00	16.50
Other Bills and Notes:		
Discounts	16.00	16.50
Advances	16.00	16.50
KENYA COMMERCIAL BANKS		
Time Deposits:		
12 months (Ksh.250,000-1,000,000)	12.50-13.00	12.50-13.00
Savings Deposits	10.00	12.50-13.00
Loans and Advances (Maximum 3 years)	15.00	15.50
OTHER FINANCIAL INSTITUTIONS		
Kenya Post Office Savings Bank deposits	11.00	15.50
Agricultural Finance Corporation, Loans		
Land Purchase	12.00	12.00
Seasonal Crop Loan	14.00	14.00
Other	13.00	13.00
Hire-Purchase Companies:		
Deposits (time)	10.00-15.00	12.00-15.00
Loans	18.00	18.00
Housing Finance Institutions:		
Deposits	11.00-12.50	11.75-14.00
Loans	16.50	16.50-18.00

Source: Economic Survey 1990, Central Bureau of Statistics, Ministry of Planning and National Development, Government of Kenya; p.63.

Note: US$1.00 equals 16.45 Kenya Shillings in 1986, and 20.85 Kenya Shillings in 1989. Economist Intelligence Unit, Kenya Country Report, No.1, 1990.

Table 2
Trends in Selected Real Interest Rates

Institutional Category	Year	Nominal Interest	Inflation Rate	Real Interest
1. Commercial bank savings deposits (min)	1984	11.0	9.1	+1.9
	1985	11.0	10.7	+0.3
	1986	11.0	5.7	+5.3
	1987	11.0	7.1	+3.9
	1988	10.0	10.7	-0.7
	1989	12.5	10.5	+2.0
2. Commercial bank loans and advances (max)	1984	14.0	9.1	+4.9
	1985	14.0	10.7	+3.3
	1986	14.0	5.7	+8.3
	1987	14.0	7.1	+6.9
	1988	15.0	10.7	+4.3
	1989	15.5	10.5	+5.0
3. Post Office savings deposits	1984	11.0	9.1	+1.9
	1985	11.0	10.7	+0.3
	1986	11.0	5.7	+5.3
	1987	11.0	7.1	+3.9
	1988	11.0	10.7	+0.3
	1989	11.0	10.5	+0.5
4. Housing Finance Inst. loans	1984	16.0	9.1	+6.9
	1985	16.0	10.7	+5.3
	1986	16.0	5.7	+10.3
	1987	16.5	7.1	+9.4
	1988	16.5	10.7	+5.8
	1989	18.0	10.5	+7.5

Source: Annual Report, Central Bank of Kenya, 1987 and 1989; and, Economic Survey for 1988 and 1989.

Sources

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Interviews

1. Maurice Kanga, Director of Research, Central Bank of Kenya.

2. Manlio Blasetti, Managing Director, First American Bank of Kenya Limited.

3. Kurt Savosnick, Consultant, Price Waterhouse Kenya Limited.

4. Gary Moser, Mission Economist, USAID/Nairobi.

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