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Trade Liberalization and Growth in Kenya

Abstract

Trade liberalization and openness are advocated as a key prescription to attain high economic growth. The opening up of trade in the developed world has been ongoing since the 1950s under the GATT/WTO arrangements. By contrast, in developing countries, particularly most African countries, this process of opening up economies came later, starting in the 1980s under the structural adjustment programs, but with effective implementation of policies often only in the 1990s. This paper looks at the case of Kenya to check whether changes in trade policy and exchange rate regime have made any significant impacts on its growth performance.

Since independence, Kenya has been through a process of protecting and controlling its markets that went through a build up that peaked in the early 1980s. In parallel, Kenya lost its major regional markets through the 1970s. This left Kenya as a closed economy through the 1980s, but Kenya began opening up its economy again through trade liberalization and price decontrols starting in 1987, with liberalization reaching a peak in 1993-94. These changes in policy regime had major and very obvious changes in the patterns of international trade. Were these changes in policy regime and trade sufficient to lead to similarly significant changes in economic growth?

This paper lays out in some detail the changes in market policy regime since independence, and explores which of the policy levers were critical to changing the Kenyan international trade experience. It attempts to identify any significant relationship between these changes in trade patterns and economic growth through exploring a broad range of factors that affect growth and investment. Based on this analysis, conclusions can be reached about the relative importance of trade and exchange rate policies relative to other elements of the overall policy environment on Kenyan growth performance and prospects.



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This study of Kenya trade and growth experience has generated many significant findings:

Trade and exchange rate policy has had major impacts on the trade performance and experience of Kenya. The two major impacts on trade have been:

The loss and regaining of the East African markets for exports. Tanzania closed its border in 1977 and Ugandan import demand declined from the late 1970s through the 1980s with internal civil instability. These markets began to recover through the late 1980s and early 1990s. Access to the East African and regional markets have been extremely important for exports of manufactured and processed goods. Hence, regional trade policy has significant consequences for manufacturing investment prospects.

The imposition of foreign exchange allocations by the Central Bank for all imports in 1983 and its removal in 1993. This had the most dramatic effect on aggregate trade performance. These comprehensive import controls effectively constrained import demand to significantly lower levels than existed either prior to their imposition or after their lifting. Imports of goods dropped by some 6% of GDP during the period from 1981 to 1992 compared to both earlier and later performance. Aside from the imposition of other market controls, the comprehensive foreign exchange allocation mechanism for imports made the 1981-92 period the most distinctive policy regime period in terms of its major and clear impact on restricting trade.

The imposition of comprehensive foreign exchange controls not only adversely affected imports, but also adversely affected export performance, particularly in manufactured and processed goods. When imports dropped by some 6% of GDP, exports dropped over the same period by a similar share of GDP. It is also evident that the East African market was lost before 1983 and was opened again before 1993. The significant shifts in exports came, however, with the changes in foreign exchange allocation restrictions to imports, particularly in 1993 and thereafter with a dramatic increase in exports of manufactured and processed goods to Uganda, Tanzania and other COMESA countries. Particularly in manufactures, low cost and flexible access to imported raw materials and industrial intermediate goods is critical to export success - increased imports are essential to achieve increased exports of manufactures or merely expanded re-export trade.

Up to 1993, Kenya had used a large range of policies to restrict imports (including tariffs, deposit requirements, licensing, no objection certificates, etc.) and protect domestic industry. Post 1993, effective trade protection has largely come from relatively modest tariff rates. While these import protection devices clearly caused market distortions and resource misallocation, these policies were generally partial and often ineffective such that trade could continue at reasonably high levels. It is notable that in the early period of the East African Economic Community, trade

was open within this community, but not with the rest of the world.

No direct link could be established between the growth performance of Kenya and the changes in trade policy regime or trade performance. This does not imply that trade and exchange rate policy are not important for three reasons:

Kenya has only experienced a truly open trade and exchange rate policy since the major liberalization of 1993-94. Hence, the time period for the effects of an open trade policy to evidence themselves has been limited. The dramatic increases in manufactured exports since liberalization points to growth potential in the manufacturing and processing sectors over the longer term.

Kenya has had a poor performance in creating all the other complementary supportive factors that would allow the economy to fully exploit the benefits of more open trade and international competition. Kenya has under performed in the provision of economic infrastructure and a competitive macroeconomic environment. High growth generally is the result of a number of favorable factors combining in an explosive manner to achieve significant surplus generation. Openness in trade is not sufficient to overcome other adverse factors.

Indirect relationships between trade and growth are found. Access to regional trade markets does appear to promote private investment significantly by over 13% which is estimated to have added 1.2 percentage points to growth.

The period of low openness to trade (1981-92) contains a period from 1985 to 1990 of significant economic growth at an average rate of 5%. This was generally driven by inward looking investments, except for a major expansion in the tourism sector. Imports increased significantly during this period while exports of goods were at their lowest levels since independence. The foreign exchange requirements of this growth spell were financed by higher service sector earnings from tourism and a significant increase in net Official Development Assistance starting in 1987 with the various economic adjustment programs for the development of export and other markets.

Private investment is the strongest and most significant contributor to growth. Private sector investment has been the only major engine of growth.

1. Public investment by central and local government and parastatals shows up as weak contributors to growth, but positively related to private investment. Out of public investment, parastatal investment has a weak direct impact on growth, but a stronger indirect impact through supporting private sector investment. This is consistent with the economic support role of the major utilities, which, until recently, were all parastatals. Government investment has a stronger, but still weak, direct effect on growth. This effect can act through investments in roads, for example.

2. Private sector investment can be increased through improved market incentives, particularly lower real interest rates which can be achieved

primarily through reducing the domestic debt burden of the government. Enhancing the efficiency of public sector investments and expanding the volume of government investments will also have significant direct and indirect effects on growth.

3. Measures of operating and maintenance expenditures per employee by the central government show a significant, if not large, impact on investment and growth on a lagged basis. The large drop in real government wage rates, particularly in the managerial and

professional cadres, has no doubt also undermined the efficiency of the use of operating and maintenance funds in effective public sector service delivery.

4. Formal sector employment (private and public) has a weak and inconsistent relationship to growth.

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